

FOREWORD

I wish to thank my promoter, Prof Jopie Pretorius, for the inspiration to undertake this thesis. To my wife, Irene, I wish to express my gratitude for her patience and understanding. I also wish to thank my joint promoter, Prof Lotz, who came out of retirement to assist with the thesis!

**ASPECTS OF BANKER LIABILITY: DISCLOSURE AND OTHER DUTIES OF BANKERS
TOWARDS CUSTOMERS AND SURETIES**

BY

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SUBMITTED IN ACCORDANCE WITH THE REQUIREMENTS FOR THE DEGREE OF

DOCTOR OF LAWS

AT THE

UNIVERSITY OF SOUTH AFRICA

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NOVEMBER 2001

SUMMARY

Suretyships given in favour of banks are being challenged in the courts on the basis of equitable doctrines of unconscionable conduct, undue influence, or statutory provisions dealing with unfair conduct or unfair contract terms.

This thesis is an enquiry into a bank's duties of disclosure or advice to an intending surety. Such an investigation also necessitates a study of the relationship between banker and customer, as the surety is quite often a customer of the bank as well, and, as a surety's obligation to the bank is an accessory obligation, the obligation is dependent on a valid principal obligation between the bank and the principal debtor — the customer.

The face of modern banking has, however, changed dramatically and most major banks have become multi-functional. As a result, the banker-customer relationship may often be seen as a fiduciary relationship. A major problem brought about by multi-functioning banks is that of conflicts of interest between the bank and its customer. Furthermore, the banker-customer relationship is providing much more scope for lender liability than in the past.

Various factors are currently having an impact on the law of contract, and this is expected to affect the legal policy makers in their assessments of whether a duty of disclosure of material facts exists or not.

A surety has long been a favoured debtor in the eyes of the law, and the courts have developed a plethora of technical principles on which a surety can be relieved of his obligation. The escape routes of the surety, especially if he is a consumer as well, on new grounds of public policy, unconscionability, good faith or unreasonableness, are growing. The result of these trends is the expected demise of suretyship as an acceptable, cheap form of debt security in the banking sector.

KEY WORDS

Banker-customer relationship; bank confidentiality; multi-functional banking; suretyship; lender liability; duty to disclose material facts; duty to advise; good faith; *boni mores*; consumer protection; unconscionability.

SELECTED ABBREVIATIONS

A	Atlantic Reporter (USA)
A 2d	Atlantic Reporter Second Series (USA)
ABGB	Allgemeines Bürgerliches Gesetzbuch (Austria)
ABLB	Australian Banking Law Bulletin
ABLR	Australian Business Law Review
ABR	Australian Bar Review
AC	Appeal Cases (Law reports, House of Lords and Privy Council)
AcP	Archiv für die civilistische Praxis
ADHGB	Allgemeines Deutsches Handelsgesetzbuch
AGBG	Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen
AktG	Aktiengesetz
Ala	Alabama; Alabama Supreme Court Reports (USA)
ALJ	Australian Law Journal
ALJR	Australian Law Journal Reports
All ER	All England Law Reports
ALR	American Law Reports Annotated
Am J Comp L	American Journal of Comparative Law
Am Jur 2d	American Jurisprudence Second Edition
Anglo Am LR	Anglo American Law Review
AO	Abgabenordnung
App Cas	Law Reports, Appeal Cases (1875-1890)
App Div	Appellate Division Reports (New York Supreme Court)
art	article
arts	articles
Atk	Atkyns
B & Ald	Barnwall & Alderson
B & C	Barnwall & Creswell
Bar Rev	Bar Review
BB	Der Betriebs-Berater
Bb	Bedrijfjuridische berichten
BCLC	Butterworths Company Law Cases
Beav	Beavan
BGB	Bürgerliches Gesetzbuch
BGH	Bundesgerichtshof
BGHZ	Bundesgerichtshof, Entscheidungen in Zivilsachen
Bing	Bingham
BJIBFL	Butterworths Journal of International Banking and Financial Law
BL	Business Lawyer

Bligh NS	Bligh New Series
BLR	Business Law Review
BML	Businessman's Law
Bos PNR	Bosanquet & Puller New Reports
Burr	Burrow
Bus LJ	Business Law Journal
BverfGE	Bundesverfassungsgericht
BW	Burgerlijk Wetboek
CA	Decisions of the English Court of Appeal
CA	United States Court of Appeals
Cal 2d	California Supreme Court Reports Second Series (USA)
Cal 3d	California Supreme Court Reports Third Series (USA)
Cal App 2d	California Appellate Reports Second Series (USA)
Cal App 3d	California Appellate Reports Third Series (USA)
Cal Rptr	California Reporter (USA)
Can Bar Rev	Canadian Bar Review
CB	Common Bench
CB(NS)	Common Bench New Series
<i>cf</i>	compare
ch	chapter
Ch	Law Reports, Chancery Division (from 1891)
Ch App	Law Reports, Chancery Division, Appeal Cases
Ch D	Law Reports, Chancery Division (1875-1890)
CJQ	Civil Justice Quarterly
Cl & Fin	Clark & Finnelly
CLC	Current Law Consolidation
CLQ	Commercial Law Quarterly
CLR	Commonwealth Law Reports
Coll	Collyer's Chancery Cases
Colo	Colorado Supreme Court Reports (USA)
Com Cas	Commercial Cases
Com LR	Common Law Reports
Conn	Connecticut Reports (USA)
CP	Common Pleas
Cth	Commonwealth
DC	United States District Courts
De GF & J	De Gex Fisher & Jones
De G & J	De Gex & Jones
De G & Sm	De Gex & Smale
De GJ & S	De Gex Jones & Smith

De GM & G	De Gex McNaghten & Gordon
DLR	Dominion Law Reports
EEC or EC	European Economic Community
E & E	Ellis & Ellis
EB & E	Ellis Blackburn & Ellis
<i>eg</i>	for example
EGBGB	Einführungsgesetz zum Bürgerlichen Gesetzbuch
EGCS	Estates Gazette Case Summaries
EL & BL	Ellis & Blackburn
<i>et seq</i>	and the following
EwiR	Entscheidungen zum Wirtschaftsrecht
Exch	Exchequer Reports
F	Federal Reporter (USA)
F2d	Federal Reporter, Second Series (USA)
F Supp	Federal Supplement (USA)
FCR	Family Court Reporter (UK)
F & F	Foster & Finlason
FTLR	Financial Times Law Reports
Ga App	Georgia Appeal Reports (USA)
Giff	Giffard
HGB	Handelsgesetzbuch
HLC	House of Lords Cases
H & C	Hurlstone & Coltman
Holt NP	Holt's English Nisi Prius Reports
HR	Hoge Raad der Nederlanden
<i>ibid</i>	in the same place
ICC	International Chamber of Commerce
ICLQ	International and Comparative Law Quarterly
ICLR	International and Comparative Law Review
<i>ie</i>	that is to say
Ill App	Illinois Appellate Court Reports (USA)
Ind	Indiana Supreme Court Reports (USA)

<i>infra</i>	within
Int Enc Comp	
L	International Encyclopedia of Comparative Law
J	Journal
JBFLP	Journal of Banking and Finance Law and Practice
JC & UL	Journal of College and University Law
JIBL	Journal of International Banking Law
JR	Juristische Rundschau
JW	Juristische Wochenschrift
JZ	Juristen Zeitung
KB	Law Reports, King's Bench Division
KO	Konkursordnung
KG	Kort Geding
La	Louisiana Reports (USA)
LAWSA	The Law of South Africa
LDAB	Legal Decisions Affecting Bankers
Lev	Levinz
LIJ	Law Institute Journal
LJ	Law Journal
LJ Ch	Law Journal Reports, Chancery (1831-1949)
LJ QB	Law Journal Queen's Bench
Lloyds Rep	Lloyds List Law Reports (UK)
LMCLQ	Lloyds Maritime and Commercial Law Quarterly
LQR	Law Quarterly Review
LR	Law Review
LR Ch App	Law Reports, Chancery Appeal Cases (1865-75)
LR Ex	Law Reports, Exchequer Cases (1865-75)
LRHL	Law Reports, English and Irish Appeals (1866-1875)
LT or LTR	Law Times Report
Mac & G	MacNaughten & Gordon
Macq	Macqueen's Scotch Appeal Cases
Madd	Maddock

MB	Moderne Besigheidsreg/Modern Business Law
Md	Maryland Reports (USA)
Mich	Michigan Reports (USA)
Mich App	Michigan Court of Appeals
MLR	The Modern Law Review
Mo	Missouri
Mont	Montana
M & S	Maule & Selwyn
M & W	Meeson & Welsby
My & Cr	Mylne & Craig
My & K	Mylne & Keen

NBW	Nieuw Burgerlijk Wetboek
NC	North Carolina Reports (USA)
NE	North Eastern Reporter (USA)
NE 2d	North Eastern Reporter, Second Series (USA)
NH	New Hampshire Reports (USA)
NJ	Nederlandse Jurisprudentie
NJB	Nederlandse Juristenblad
NJV	Nederlandse Juristen-Vereniging
NJW	Neue Juristische Wochenschrift
NLJ	New Law Journal
NPC	New Property Cases
NSWLR	New South Wales Law Reports
NVB	Nederlandse Vereniging van Banken
NW	North Western Reporter (USA)
NW 2d	North Western Reporter, Second Series (USA)
NY	New York Court of Appeal Reports (USA)
NYS	New York Supplement (USA)
NYULR	New York University Law Review
NZLJ	New Zealand Law Journal
NZLR	New Zealand Reports

OJLS	Oxford Journal of Legal Studies
Okla	Oklahoma Reports (USA)
OLG	Oberlandesgericht
OR	Ontario Reports
OR	Obligationsrecht (Switzerland)
Or	Oregon

P	Pacific Reporter (USA)
P 2d	Pacific Reporter, Second Series (USA)
par	paragraph
pars	paragraphs
Pol'y	Policy
P Wms	Peere Williams
QB	Law Reports, Queen's Bench Division (1891-1900;1952-)
QBD	Law Reports, Queen's Bench Division (1875-90)
QLJ	Queensland Law Journal
QLSJ	Queensland Law Society Journal
QUTLJ	Queensland University of Technology Law Journal.
RabelsZ	Zeitschrift für ausländisches und internationales Privatrecht
Rb	Arondissementsrechtbank
RG	Reichsgericht
RGZ	Reichsgericht, Entscheidungen in Zivilsachen
RTR	Road Traffic Reports
Russ & M	Russel & Mylne
RvdW	Rechtspraak van de Week
RW	Rechtskundig Weekblad
SA	South Africa(n)/Suid-Afrika(anse)
SALJ	The South African Law Journal
SA Merc LJ	SA Mercantile Law Journal
SASR	Southern Australia State Reports
SCR	Supreme Court Reports (Canada)
SE	South Eastern Reporter (USA)
SE 2d	South Eastern Reporter, Second Series (USA)
Sim	Simons
Sim & St	Simons & Stuart
SLT	Scots Law Times
Sm & G	Smale & Giffard
So 2d	Southern Reporter, Second Series (USA)
Sol J	Solicitor's Journal
s	section
ss	sections
StPO	Strafprozessordnung
S Ct	Supreme Court (USA)

supra above

Taunt Taunton
 Tex Civ App Texas Civil Appeal Reports (USA)
 THRHR Tydskrif vir Hedendaagse Romeins-Hollandse Reg
 TLR Times Law Reports
 TPR Tijdschrift voor Privaatrecht
 Tr LR Trading Law Reports
 TRW Tydskrif vir Regswetenskap
 TSAR Tydskrif vir die Suid-Afrikaanse Reg
 TvC Tijdschrift voor Consumentenrecht
 TVVS Tijdschrift voor Vennootschappen, Verenigingen en Stichtingen

U University, Universiteit, Université, Universität
 UCP
 UNCITRAL United Nations Commission of International Trade Law
 UNIDROIT L'Unification du Droit
 UNSWLJ University of New South Wales Law Journal
 US Reports of Cases in the Supreme Court of the United States of America
 USFLR University of San Francisco LR

VandJTransL Vanderbilt Journal of Transnational Law
 Ves Sen Vesey Senior
 Ves Jun Vesey Junior
 VLR Victorian Law Reports
 VR Victorian Reports

Wash App Court of Appeals Washington
 Wis Wisconsin Reports
 WLR Weekly Law Reports (UK)
 WM Wertpapier-Mitteilungen
 WphG Wertpapierhandelsgesetz
 WPNR Weekblad voor Privaatrecht, Notarisambt en Registratie
 Wyo Wyoming

Y & C Younge & Collyer

ZBB	Zeitschrift für Bankrecht und Bankwirtschaft
ZeuP	Zeitschrift für Europäisches Privatrecht
ZGB	Zivilgesetzbuch
ZHR	Zentralblatt für Handelsrecht; Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht.
ZIP	Zeitschrift für Wirtschaftsrecht (bis 1982); Zeitschrift für Wirtschaftsrecht und Insolvenzpraxis
ZPO	Zivilprozessordnung
ZvglRWiss	Zeitschrift für vergleichende Rechtswissenschaft

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CHAPTER 1: THE BANKER'S DUTIES OF DISCLOSURE AND ADVICE TO CUSTOMERS AND SURETIES

1.1 INTRODUCTION

1.1.1 Scope of thesis

Misrepresentation is one of the factors¹ which may result in a contract being rescinded.² Although it is conceivable that a banker may deliberately make a positive misrepresentation, a more common and more difficult problem arises in cases of the non-disclosure of material facts by a banker to a surety, for example.³

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- 1 The others being *dolus* (see *Derry v Peek* (1889) 14 App Cas 337; *Bagus v Estate Moosa* 1941 AD 62; *R v Myers* 1948 (1) SA 375 (A); *Vereeniging Consolidated Mills Ltd v Newman* 1958 (2) SA 20 (C)), *metus* (see *Broodryk v Smuts NO* 1942 TPD 47; *Arend and Another v Astra Furnishers (Pty) Ltd* 1974 (1) SA 298 (C)), as well as undue influence (see *Mauerberger v Mauerberger* 1948 (4) SA 902 (C); *Preller v Jordaan* 1956 (1) SA 483 (A); *Patel v Grobbelaar* 1974 (1) SA 532 (A)). Farlam & Hathaway *Contract* 321 states that the remedy of rescission is restricted to cases in which the agreement reached is vitiated by circumstances which are believed to distort the autonomous powers of the aggrieved party. In *Hare's Brickfields Ltd v Cape Town City Council* 1985 (1) SA 769 (C) 774 these grounds for avoidance were seen as being a *numerus clausus*. Cf Joubert *Contract* 89 *et seq*, 111 *et seq* but see, however, Van der Merwe *et al Contract* 73 who propose with reference to *Plaaslike Boeredienste (Edms) Bpk v Chemfos Bpk* 1986 (1) SA 819 (A) that the various grounds for rescission be subsumed under one single ground, namely improperly obtained consent.
 - 2 *Viljoen v Hillier* 1904 TS 312; *Woodstock, Claremont, Mowbray and Rondebosch Councils v Smith* (1909) 26 SC 681; *Brink v Robinson & Wife* 1916 OPD 88; *Karoo and Eastern Board of Executors & Trust Co v Farr* 1921 AD 413; *Van Niekerk and Van der Westhuizen v Weps and Morris* 1937 SWA 99; *Novick v Comair Holdings Ltd* 1979 (2) SA 116 (W); *Uni-Erections v Continental Engineering Co Ltd* 1981 (1) SA 240 (W).
 - 3 See *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 (Australia); *Sumitomo Bank of California v Iwasaki* 70 Cal 2d 81 73 Cal Rptr 564 447 P 2d 956 (1968) (USA); *Lloyds Bank v Bundy* [1975] 1 QB 326; *Barclays Bank plc v O'Brien and Another* [1993] 4 All ER 417; [1994] 1 AC 180 (England); BGH NJW 1994 1341 (Germany); *Eerste Nasionale Bank van Suidelike Afrika Bpk v Saayman NO* 1997 (4) SA 302 (A), (South Africa).

Contracts are entered into in order to create obligations.⁴ People enter into contracts mainly for economic reasons.⁵ They have to satisfy some need or other.

When contracting, a contracting party reasonably expects the results that he bargained for.⁶ Often, the contractant takes a risk. A surety, for instance, would reasonably expect, or take the risk that the principal debtor would perform, and only upon the principal debtor's default, would he, the surety, have to perform.⁷

In order to assess risk,⁸ one needs to have information.⁹ Often, on the face of it, mere information may not be enough. Information may need to be dissected, and analysed to assess the probability of risk, and often advice may have to be sought to make sense of bare information.¹⁰ Briefly, the problem which will be addressed in this thesis, concerns what duty a banker has to inform or advise a prospective surety, particularly in circumstances where the surety himself is also a customer of the bank, and what duty the surety has to investigate the obligations that he is undertaking. I have chosen to discuss suretyship as the focal contract form because it would seem that the impact of a series of far-reaching judgments in which the appellate division has reformed the modern Roman-Dutch law of contract is being felt most severely in the case of suretyship.¹¹ The duty of disclosure in regard to sale contracts with their peculiar legal principles, such as the aedilician remedies, will not form part of this investigation.

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- 4 Joubert (ed) 5 *LAWSA* par 124; *Conradie v Rossouw* 1919 AD 279 at 324; Van der Merwe *et al Kontraktereg* 7; De Wet & Van Wyk *Kontraktereg* 5; Joubert (ed) 2 *LAWSA* par 228.
- 5 Kronman & Posner *Economics* 1.
- 6 Fuller & Perdue 1936 *Yale LJ* 52 at 54.
- 7 See *Corrans & Another v Transvaal Government and Coull's Trustee* 1909 TS 605 at 612; *Trust Bank of Africa Ltd v Frysch* 1977 (3) SA 562 (A) at 584F; *Sapirstein & Others v Anglo African Shipping Co (SA) Ltd* 1978 (4) SA 1 (A) at 11H; *Nedbank Ltd v Van Zyl* 1990 (2) SA 469 (A) at 473I.
- 8 Risk can be described as "a hazard; peril; exposure to loss or injury". See Brigham & Gapenski *Financial Management* 102. The 1978 Oxford Dictionary describes risk as: "Chance of or of bad consequences, loss etc ... exposed to danger."
- 9 Kronman 1978 *J of Legal Studies* 1 at 4 describes information as the antidote to mistake.
- 10 Brigham & Gapenski *Financial Management* 101.
- 11 See, eg, *Bank of Lisbon and South Africa Ltd v De Ornelas & Another* 1988 (3) SA 580 (A) where the *exceptio doli generalis* was dispatched "to the outer darkness." For a critical discussion, see Lambiris 1988 *SALJ* 644; Van der Merwe *et al* 1989 *SALJ* 235; Forsyth & Pretorius 1993 *SA Merc LJ* 181.

Most Western countries are attempting to level the playing field between contracting parties.¹² An imbalance in bargaining power could be an important contributing factor in holding an agreement to be unconscionable.¹³ It is impossible to create absolute equality between the parties. Nothing, for example, can be done about the relative sizes, or capital backing of the parties. In the banker-surety relationship, for example, the bank will nearly always have a stronger capital base and bargaining power than the surety. However, if the parties are placed on a more equal footing as far as gaining information in regard to the transaction is concerned, the prospect of the agreements being struck down as unconscionable, should start to wane.¹⁴

The law of obligations has been described as the apportionment of risk according to rules, norms and, especially, principles.¹⁵ Principles have a strong social and ethical "flavour" and are therefore subject to change. For the law of obligations it would mean that changing social-ethical principles may influence the apportionment of risk directly. In Europe, especially, there is a renewed interest in the question of disclosure duties, advisory duties, and information duties, as well as duties of investigation in the law of obligations.¹⁶

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- 12 In the European Community Countries see, eg, EC Directive (Consumer Protection) 85/577/EEC; [1985] OJ L372/31; EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC; [1993] OJ L95/29. In Australia, see the Trade Practices Act of 1974 (Cth); Uniform Consumer Credit Code of 1996. In the USA, see s 1-203 of the Uniform Commercial Code. In England, see the Unfair Contract Terms Act of 1977, Unfair Terms in Consumer Contracts Regulations of 1994. South Africa also has various enactments in this regard. See, eg, the Harmful Business Practices Act 71 of 1988; Credit Agreements Act 75 of 1980; Consumer Affairs (Harmful Business Practices) Act of 1996 (Gauteng).
- 13 Kennedy 1982 *Maryland LR* 563 at 614-624. In England, see the remarks of Lord Denning MR in regard to inequality of bargaining power as a basis for relief in respect of unfair contracts, in *Lloyds Bank Ltd v Bundy* [1975] QB 326 at 339. See, also, *Arrale v Costain Civil Engineering Ltd* [1976] 1 Lloyds Rep 98; *A Schroeder Music Publishing Co Ltd v Macaulay (Formerly Instone)* [1974] 1 WLR 1308; [1974] 3 All ER 616; *Levison v Patent Steam Carpet Cleaning Co Ltd* [1978] QB 69; and the suggested definition of contractual unfairness by the SA Law Commission *Unreasonable Stipulations* 85.
- 14 See, in this vein, Holmes 1978 *University of Pittsburgh LR* 381 at 445-446; Kessler & Fine 1964 *Harvard LR* 401 at 445; Scheppele *Legal Secrets* 119; Kennedy 1982 *Maryland LR* 563 at 614-615.
- 15 *Vranken Plichten v.* More strictly, an obligation is a legal relationship which is recognized and regulated by law. See Joubert (ed) 19 *LAWSA* 235; De Wet & Van Wyk *Kontraktereg* 4.
- 16 *Vranken Plichten v* (The Netherlands); Vortmann *Aufklärungs-und Beratungspflichten* 1; Schmeltz *Verbrauchercredit* 153 (Germany); Legrande 1986 *OJLS* 322 (Canada); Nicholas in Harris & Tallon (eds) *Contract Law*; Waddams in Cane & Stapleton (eds) *Essays for Patrick Atiyah* 237 (England).

A standard of good faith will become an important factor to be reckoned with in future, if regard is had to European and American developments and the importance which the SA Law Commission attaches to the concept of good faith.¹⁷ The concept of good faith, therefore, will be referred to in the analysis of each of the selected legal systems.

The object of this thesis is to determine, against a background of changing mores, under what circumstances a duty of disclosure of facts or a duty to advise arises for the bank in the banker-surety relationship.

1.1.2 Duties of disclosure

1.1.2.1 Introduction

The legitimacy of contractual non-disclosure is a problem that has vexed ancient and modern scholars alike. Today, the law sometimes compels disclosure, but often it does not. The position appears to depend on a variety of variables, such as the nature of the contract, the kind of information that is withheld, the relationship between the contracting parties, and the dictates of good faith, or public opinion.¹⁸

This question is central to an understanding of many areas of commercial law including aspects

17 SA Law Commission *Unreasonable Stipulations* 85.

18 De Wet & Van Wyk *Kontraktereg* 45; *Meskin NO v Anglo American Corporation of SA Ltd and Another* 1968 (4) SA 793 (W); *Savage and Lovemore Mining (Pty) Ltd v International Shipping Co (Pty) Ltd* 1987 (2) SA 149 (W) (South Africa); Spencer Bower *Non-Disclosure* 3 to 17 (England); Kronman 1978 *J of Legal Studies* 1 *et seq*; Dennis & Masling 1991 *BL* 1323 *et seq* (USA).

of the law of sale,¹⁹ insurance law,²⁰ insider trading regulations,²¹ corporate director's duties,²² corporate prospectus requirements²³ and, of particular interest to this thesis, the principles relating to suretyships.

1.1.2.2 Ancient disclosure conceptions

The earliest and most famous discussion of the non-disclosure puzzle is to be found in Cicero's treatise on duties, *De Officiis*. This work²⁴ enjoyed the status of a "jurisprudential classic"²⁵ in Europe until around the end of the nineteenth century, when it fell out of scholarly favour. Its central passages, though no longer frequently quoted, continue to exert an influence on the law of many countries.

Cicero's concern was to explain for the benefit of his son ("a not over amiable young man of very mediocre abilities"²⁶) the difference between what is morally right and what is expedient. He gives the example of a grain-merchant who carries a cargo of corn from Alexandria to Rhodes

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- 19 See, eg, *Dibley v Furter* 1951 (4) SA 73 (C); *Cloete v Smithfield Hotel (Pty) Ltd* 1955 (2) SA 622 (O); *Van der Merwe v Culhane* 1952 (3) SA 42 (T). In England, see *Smith v Hughes* (1871) LR 6 QB 597. In Germany, BGH NJW 1965 341; BGH NJW 1982 1386.
- 20 See, eg, *Fine v The General Accident Fire and Life Assurance Corporation Ltd* 1915 AD 213; *Colonial Industries Ltd v Provincial Insurance Co Ltd* 1922 AD 33; *Iscor Pension Fund v Marine and Trade Insurance Co Ltd* 1961 (1) SA 178 (T); *Pereira v Marine and Trade Insurance Co Ltd* 1975 (4) SA 745 (A).
- 21 See, eg, Scheppele 1993 *Law and Contemporary Problems* 123; Olson *et al* 1991 *North Western University LR* 715; Loss 1970 *MLR* 34; US Federal Securities Exchange Act of 1935; S 234 of the South African Companies Act 61 of 1973 and the Insider Trading Act 135 of 1998. In the UK, see Company Securities (Insider Dealing) Act of 1985.
- 22 Scott 1949 *California LR* 539; Sealy 1962 *Cambridge LJ* 69. In South Africa, see s 234 Companies Act 61 of 1973; *Treasure Trove Diamonds Ltd v Hyman* 1928 AD 464; *Spieth & Another v Nagel* [1997] 3 All SA 316 (W). In Australia, see *Mills v Mills* (1938) 60 CLR 150; *Harlowe's Nominees (Pty) Ltd v Woodside (Lakes Entrance) Oil Co NL and Another* (1968) 121 CLR 483. In England, see *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 All ER 1126; *Hogg v Cramphorn Ltd* [1966] 3 All ER 420.
- 23 *R v Akoob* 1951 (4) SA 683 (T); *S v Rossouw* 1971 (3) SA 222 (T); *S v National Board of Executors Ltd* 1971 (3) SA 817 (D); *Devland Investment Co (Pty) Ltd v Administrator, Transvaal* 1979 (1) SA 321 (T). The current section applicable in the Companies Act 61 of 1973 is s 146.
- 24 Cicero *De Officiis*.
- 25 Lawson 1988 *Harvard Journal of Law and Public Policy* 727 at 737.
- 26 Rose *Literature* 161.

at a time of famine. In the course of the voyage, the merchant's ship overtakes a number of other vessels, all carrying grain and all bound for Rhodes. The question posed by Cicero is whether, upon arrival, the merchant should tell the Rhodians about the other ships, or whether he should say nothing and sell his cargo at the famine price. The merchant is assumed to be honest, and the issue is whether an honest man would regard it as wrong to keep the Rhodians in ignorance. Cicero presents both sides of the case through an imaginary dialogue between two Stoic philosophers, Diogenes of Babylon and his pupil, Antipater. Antipater says that the information should be revealed. He asserts that there is a duty to consider the interests of others, and to serve society. This derives from the bond of community that links all persons in the world with one another. Diogenes, on the other hand, supports the merchant's moral right to silence, provided he remains truthful. He says, in a much-quoted passage, that "concealing is one thing, but not revealing is another" (*aliud est celare, aliud tacere*).²⁷ To keep information secret is not necessarily to conceal it, and a seller is not obliged to disclose everything that it would be useful for a buyer to know. The bonds of community do not deny the existence of private property and, Diogenes says that if full disclosure were always required, then nothing should be sold at all, but freely given away instead.

The next example given by Cicero concerns the case of an honest man wanting to sell a house because of certain defects about which he alone knows: the building is supposed to be healthy, but it is actually insanitary; or it is infested with serpents; or it is badly built and falling down. Does the vendor behave dishonestly by not disclosing the defect? Antipater argues that non-disclosure in these circumstances is like failing to put right a traveler who has taken the wrong road (this was a crime in Athens). Diogenes counters by asserting the *caveat emptor* principle: "When the purchaser can exercise his own judgment, what fraud can there be on the part of the seller?"²⁸

Cicero sides with Antipater, arguing that the grain-merchant ought not to conceal the facts from the Rhodians, and that the vendor of the house ought not to withhold its defects from the purchaser. "Holding things back does not always amount to concealment; but concealment consists in trying for your own profit, to keep others in the dark about something which you know, when it is in their interest to know it."²⁹ The person who fails to disclose what he knows

27 Cicero *De Officiis* Book 3 ch 12.

28 Cicero *De Officiis* Book 3 ch 13.

29 "Neque enim id est celare, quicquid reticeas, sed cum, quod tu scias, id ignorare emolumentum tui causa velis eos, quorum intersit id scire." Cicero *De Officiis* Book 3 ch 12.

is "the reverse of open, straightforward, fair and honest: he is a shifty, deep, artful, treacherous, malevolent, underhand, sly, habitual rogue".³⁰

This is patently an ethical position, but Cicero goes on to assert that it is reflected in Roman law. He cites the case of a property owner who received a direction from the augurs to pull down parts of his building because they were an obstruction to the taking of auspices.³¹ The property owner immediately put the house on the market, and sold it without disclosing the existence of the augurs' directive. When the purchaser discovered the truth, he took the case before an arbitrator, Marcus Cato. The decision was that the vendor owed the purchaser a duty of disclosure, and was therefore required to make good the loss.³² On the authority of this case, argues Cicero, the hypothetical grain-merchant and the vendor of the insanitary house acted wrongly when they concealed the facts. He says, moreover, that these principles are not limited to cases involving real estate. For example, the law also requires disclosure when a person sells a slave whom that person knows to be unhealthy, a runaway, or a thief.³³

1.1.2.3 Modern disclosure conceptions

Cicero's illustrations have lost none of their currency down the centuries.³⁴ The Alexandrian grain-merchant has a modern counterpart in the company director who deals in a company's securities on the basis of inside information affecting their value, and the debate between Diogenes and Antipater on the case is echoed in present-day writing about the ethics of insider trading and its regulation.³⁵ The case of the defective house or property is one that still commonly

30 Cicero *De Officiis* Book 3 ch 13 .

31 In Rome in Cicero's day, many believed that the observation of, *inter alia*, the flight of birds could disclose the divine will. *Auspicia* literally means birdwatching. See Ogilvie *Gods* 56.

32 Cicero *De Officiis* Book 3 ch 16.

33 Cicero *De Officiis* Book 3 ch 17 .

34 Determining where what is unethical becomes unlawful, is a perennial problem. Cicero *De Officiis* Book 3 ch 17 states:

"Now the law disposes of sharp practices in one way, philosophers in another: the law deals with them as far as it can lay its strong arm upon them; philosophers, as far as they can be apprehended by reason and conscience."

35 See the discussions of Lawson 1988 *Harvard Journal of Law and Public Policy* 727; Scheppele 1993 *Law and Contemporary Problems* 123; Levmore 1982 *Virginia LR* 117; Anabtawi 1989 *Stanford LR* 377; Anisman *Insider Trading* (for a general overview); Brudney 1979 *Harvard LR* 322.

occurs.³⁶ While it is true that serpent infestation is not a modern preoccupation, termite infestation is — to the extent that, in the USA, it has been observed that the problem arises in case law with sufficient frequency to fill a book, while an entire annotation has been devoted to the topic of non-disclosure in relation to termites.³⁷ The case of the house that is condemned by the augurs has its modern equivalent in decisions concerning the sale, without disclosure, of property that is the subject of a compulsory acquisition order or a demolition notice.³⁸ The slave dealer who fails to disclose the undesirable characteristics of slaves that are offered for sale has a counterpart in the nineteenth century horse-trader³⁹ and the twentieth century used-car dealer.⁴⁰ This kind of problem is dealt with today by the law of warranties and, in some jurisdictions, legislation on the sale of goods.

For the most part, these examples are drawn from the law of sale. However, the non-disclosure problem occurs in many other contexts as well. For example, where contracts of suretyship are concerned, there is a question about the extent of the credit provider's duty to disclose to the surety, before transacting, information concerning the state of the debtor's account or other facts which are material to the risk the surety will be assuming.⁴¹ Various other examples spring to mind. In insurance law a duty of full disclosure is cast upon both insurer and insured.⁴² Non-

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- 36 In some jurisdictions the vendor of a newly constructed house has a duty of implied warranty of habitability. See *Miller v Cannon Hill Estates Ltd* [1931] 2 KB 113 (England); *Park v Sohn* 89 Ill 2d 453 433 NE 2d 651 760 Ill Dec 609 (1982) and *Redarowicz v Ohlendorf* 92 Ill 2d 171 441 NE 2d 324 65 Ill Dec (1982) (USA). Demko 1983 *Illinois Bar J* 724 n3 states that he found judicial support for such implied warranty in 39 of the states in the US.
- 37 Lawson 1988 *Harvard Journal of Law and Public Policy* 738 n 47.
- 38 Spencer Bower *Non-Disclosure* 125-129; *Re Leyland and Taylor's Contract* [1900] 2 Ch 625 (England); *Fletcher v Manton* (1940) 64 CLR 37; *Summers v Cocks* (1927) 40 CLR 321 (Australia).
- 39 For cases dealing with the sale of horses, see *Stevens v Beningfield and Son* (1884) 5 NLR 282; *Hulston and Smith v Sykes* (1889) 10 NLR 127; *Dodd v Spitaleri* (1910) 27 SC 196; *Von Mellenthin v Macdonald* 1969 (3) SA 471 (T).
- 40 See *Addison v Harris* 1945 NPD 444; *Schwarzer v John Roderick's Motors (Pty) Ltd* 1940 OPD 170 (South Africa); BHG NJW1982 1386 (Germany).
- 41 See, eg, *Sumitomo Bank of California v Iwasaki* 70 Cal 2d 81 73 Cal Rptr 564 447 P 2d 956 (1968) (USA); *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 (Australia); *Barclays Bank plc v O'Brien and Another* [1993] 4 All ER 417 (England); *Eerste Nasionale Bank van Suidelike Afrika Bpk v Saayman NO* 1997 (4) SA 302 (A) (South Africa).
- 42 In England, see Marine Insurance Act of 1906; *Carter v Boehm* (1766) 3 Burr 1905; *Locker and Woolf Ltd v Western Australian Insurance Co Ltd* [1963] 1 KB 408; *Lambert v Co-operative Insurance Society Ltd* [1975] 2 Lloyd's Rep 485 (England); *Bodemer v*

disclosure issues can also arise in the course of business dealings between partners⁴³ or joint venturers, or between principal and agent, by virtue of the rules governing fiduciary relationships. Certain statutory provisions, which prohibit misleading conduct⁴⁴ in trade and commerce, have confronted courts directly with the question posed by Cicero so long ago: When, as a matter of law, can it be said that silence is deception?

This issue has arisen repeatedly in case law in a variety of factual contexts, and particularly in the context of sale.⁴⁵ In addition, a wide range of statutory provisions explicitly requires the disclosure of information by one contracting party to another. Examples include:

- prospectus requirements in a corporation's statutes;⁴⁶
- consumer credit laws designed to ensure truth in lending, requiring disclosure of information concerning the cost of credit, including the annual percentage rate;⁴⁷
- trade descriptions law, imposing labeling and marking requirements in relation to products including textiles, furniture and footwear, and dealing with such matters as product composition and place of manufacture;⁴⁸
- food labeling requirements.⁴⁹

American Insurance Co 1960 (4) SA 428 (T); *Iscor Pension Fund v Marine and Trade Insurance Co Ltd* 1961 (1) SA 178 (T); *Pereira v Marine and Trade Insurance Co Ltd* 1975 (4) SA 745 (A) (South Africa).

- 43 *Fawcett v Whitehouse* [1829] 1 Russ & M 132; *Bentley v Craven* (1853) 18 Beav 75; *Dunne v English* (1874) LR 18 Eq 524 (England); *Hutton v Steimweiss* 1905 TS 293; *Doulet v Piaggio* 1905 TH 267; *Wegner v Surgeson* 1910 TPD 571 (South Africa).
- 44 A perfect example is the Australian Trade Practices Act of 1974 (Cth).
- 45 For South African cases, see *Dibley v Furter* 1951 (4) SA 73 (C); *Van der Merwe v Meades* 1991 (2) SA 1 (A). In Germany, see BGH NJW 1965 341; BGH NJW 1982 1386. In Australia, see *Collier and Others v Electrum Acceptance (Pty) Ltd* (1986) 66 ALR 613; *Collins Marickville (Pty) Ltd v Henjo Investments (Pty) Ltd* (1987) ATPR 46-020; *Trelor v Ivory* [1991] ASC 56-076; (1993) ATPR 41-203. In England, see *Becker v Partridge* [1966] 2 QB 155; [1966] 2 All ER 266; *English v Dedham Vale Properties Ltd* [1978] 1 WLR 93; [1978] 1 All ER 382; *Rignall Developments Ltd v Halil* [1988] 1 Ch 190.
- 46 S 162 of the Companies Act 61 of 1973 (South Africa); s 56 of the Companies Act of 1985; Financial Services Act of 1986 (UK).
- 47 Uniform Consumer Credit Code of 1996 (Australia); Credit Agreements Act 75 of 1980; Usury Act 73 of 1968 (South Africa).
- 48 Merchandise Marks Act 17 of 1941; Trade Marks Act 62 of 1963.
- 49 Fertilizers, Farm Feeds, Agricultural Remedies and Stock Remedies Act 54 of 1972.

These examples could be multiplied. One can therefore safely state that non-disclosure in business dealings is no less an issue for the law today than it was in Cicero's time. Indeed, non-disclosure is an intriguing modern topic because it lies in the grey area between what is clearly acceptable in the way of commercial behaviour, and what is clearly unacceptable.

As far as the banker-surety relationship is concerned, the disclosure dilemma is compounded by the following:

- The bank is nearly always in a stronger bargaining position.⁵⁰
- A standard contract form is nearly always used.⁵¹
- The bank often has superior information regarding material facts.
- The surety is often pressurized by a third party, into signing.⁵²
- The surety may be a customer of the bank, and the bank may have certain fiduciary duties towards the customer/surety.⁵³

50 This was clearly illustrated in *Lloyds Bank Ltd v Bundy* [1975] 1 QB 626.

51 A bank will nearly always insist that a surety sign its standard form of suretyship. The terms of the contract are not subject to debate and little could be expected in the way of modification of terms. The French speak of a *contrat d'adhésion* in this regard.

52 In our law, the situation is that if a fraud proceeds from an independent third person, it will have no effect upon the contract. See *Karabus Motors (1959) Ltd v Van Eck* 1962 (1) SA 451 (C). The situation is the same in Germany, see s 123 BGB; s 875 AGBG. In the UK, however, see *Barclays Bank plc v O'Brien and Another* [1994] 1 AC 180 where it was held that a bank will be fixed with constructive notice of the wife's right to set aside the transaction if it knows of certain facts that put it on inquiry as to the possible existence of the wife's right and fails to take steps to verify whether or not those rights exist. (At 195H-196A). This aspect of the law (nowadays popularly called "sexually transmitted debt" will be investigated in more detail in the comparison of English law in Chapter 2. Australian Courts are more reluctant to consider "a woman as a mere appendage of her husband." (See *Mercantile Mutual Life Insurance Co Ltd v Gosper* (1991) 25 NSWLR 32). See also *European Asian of Australia Ltd v Kurland and Another* (1985) 8 NSWLR 192; *Commonwealth Bank v Cohen* [1988] ASC 55-681.

53 Although the banker-customer relationship has traditionally been held to be one of debtor and creditor, and not fiduciary, (see, eg, *Nedperm Bank Ltd v Verbri Projects CC* 1993 (3) SA 214 (W)) the face of banking has changed enormously and in its multi-faceted format, a bank may well acquire a fiduciary duty or a "duty of good faith and fair dealing" to a customer or customer/surety. See *Commercial Cotton Co v United California Bank* 163 Cal App 3d 511 209 Cal Rptr 551 (1985); *Copesky v Superior Court of San Diego County* 229 Cal App 3d 678 280 Cal Rptr 338 (1991) (USA). Fiduciary duties are clearly imposed upon a bank as trustees and agents. In English law, furthermore, a duty of confidence or an assumption of responsibility to act in the customer's interests, have been suggested as the basis for a fiduciary relationship. See *White v Jones* [1993] 3 All ER 481; Finn in McKendrick (ed) *Fiduciary* 11-12 (England); Glover 1995 *Bond LR* 50 (Australia); Waters 1986 *Can Bar Rev* 37 (Canada); Curtis 1987 *Loyola LALR* 795

1.1.3 The relationships involved in a banker's suretyship

1.1.3.1 Banking law: modern trends

1.1.3.1.1 The so-called banker-customer relationship

Banking law is a broad subject.⁵⁴ It consists of statutory regulation⁵⁵ as well as the private law of banking transactions. One aspect of the latter is the law governing the banker-customer relationship. Rooted in contract, the relationship in Western democracies is overlaid with a range of rights and obligations having their origin in custom, delict, notions of equity and good faith, and statute law. Central to the banker-customer relationship in all Western jurisdictions is contract.⁵⁶ The banker-customer relationship is rarely reduced to one document, however, but instead comprises a variety of written forms supplemented by terms implied by law. Typically, a standard form contract governs specific aspects of the banker-customer relationship, whether it is the general account, electronic funds transfers or security (including suretyship). In countries such as Germany, the Netherlands and Switzerland there are general banking conditions, drawn

(USA).

54 As the Court observed in *Selangor United Rubber Estates Ltd v Cradock (3)* [1968] 2 All ER 1073 at 1118:

"Banking law is not a separate body of law, though, like innumerable other activities, it has statutory provisions dealing exclusively with it, and, being a distinctive and important activity, textbooks dealing separately with it".

55 In South Africa, see, eg, the Banks Act 94 of 1990, the Financial Institutions (Investment of Funds) Act 39 of 1984; the South African Reserve Bank Act 90 of 1989; In Australia, see Banking Act of 1959 (Cth); Financial Transaction Reports Act of 1988 (Cth); the Reserve Bank Act of 1959 (Cth); the Bank Integration Act of 1991 (Cth). In Germany, see the AGB-Gesetz of 1996; the Wertpapierhandelsgesetz of 1994; the Kreditwesengesetz of 1961. In the USA, see the Financial Institutions Reform Recovery and Enforcement Act of 1989 (103 Stat 183 (1989)); Competitive Equality Banking Act of 1987 (101 Stat 552 (1987)); Federal Deposit Insurance Corporation Improvement Act of 1991 (105 Stat 2236 (1991)); Bank Holding Company Act of 1956 (12 USC s 1841). In England, see the Banking Act of 1987; Financial Services Act of 1986.

56 *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110; *Bank of New South Wales v Laing* [1954] AC 135 (England); *GS George Consultants and Investments (Pty) Ltd v Datsys (Pty) Ltd* 1988 (3) SA 726 (W) (South Africa); The German General Conditions of Banking known as the AGB-Banken 1993 (contained *inter alia* in Grill *Recht* annexure C 15); Pikart 1957 WM 1238; Herold & Lippisch *Bank-und Börsenrecht* 33; Claussen *Bank-und Börsenrecht* 60; the Dutch Algemene Bankvoorwaarden of 1996 (contained *inter alia* in Tjittes & Blom *Aansprakelijkheid* 201 as an annexure). For a commentary on the relationship in the USA, see Symons 1983 *Banking* LJ 220; 1983 *Banking* LJ 325.

up by associations of banks.⁵⁷ British and Australian banks have adopted codes of practice⁵⁸ for banks dealing with personal customers. The British code is not of itself legally binding but the courts may well use it as a base for implying terms into the banker-customer relationship.⁵⁹ There is, however, further scope for the incorporation of the customer's viewpoint into the drafting of the standard form contracts, general banking conditions, and British code. One approach is that adopted in the Netherlands: there, representatives of customers negotiate directly with the banks.⁶⁰ Another approach — at the other end of the spectrum — is regulation: the State acts as a surrogate for the customer and compels banks to meet standards purportedly in the customer's interest. In contrast with Europe, the banker-customer relationship in the United States is more heavily affected by regulation.⁶¹ In various legal systems the regulation of unfair contract terms has a more general impact on the banker-customer relationship.⁶²

1.1.3.1.2 Common issues shared by bankers

Perhaps unsurprisingly, problems have arisen over the same sort of issues in the banker-customer relationship in the different Western countries, such as the question whether a bank statement is binding on customers if they do not object to its contents within a specific period. May a bank vary the terms of the relationship without agreement and/or without notice to customers? What services is a bank obliged to provide and generally what can it charge for its services? How enforceable is a suretyship or security given by a person for the business debts of a spouse or other close relation? The answers to these questions are not uniform across jurisdictions, and in

57 See AGB-Banken of 1993; Algemene Bankvoorwaarden of 1996.

58 English Code of Banking Practice (2) or (3); Australian Code of Banking Practice.

59 See, eg, in *Barclays Bank plc v O'Brien and Another* [1993] 4 All ER 417; [1994] 1 AC 180 at 197-198.

60 The present text of the General Conditions of Banking, which has been in force since 1 February 1996, is the result of consultations between the Association of Dutch Banks and representative consumer and business organisations. See Wessels 1966 WPNR 6222; Molenaar 1988 TVVS 99.

61 Gail, Norton & O'Neil 1992 *The International Lawyer* 993; There is a multitude of statutes regulating banking in the USA, eg, the Federal Deposit Insurance Corporation Improvement Act of 1991 (105 Stat 2236 (1991)); Bank Secrecy Act of 1970 (s 1951 of 12 USC); Competitive Equality Banking Act of 1987 (101 Stat 552 (1987)); Right to Financial Privacy Act of 1978 (s 3401 of 12 USC); Equal Credit Opportunity Act (s 1691 of 15 USC). On the regulation of banking in the USA generally, see Gail & Norton *Regulatory*.

62 See, eg, the German AGB-Gesetz of 1976; the English Unfair Contract Terms Act of 1977; the EC Council Directive 93/13/EEC:[1993] OJ L95/29 in regard to unfair terms in consumer contracts; and the Australian Trade Practices Act of 1974 (Cth).

any one jurisdiction subtle rephrasing of the issue may produce a different response.⁶³

Banks in many countries adhere to one or more interbank agreements, and this has implications for the banker-customer relationship. These may not be incorporated directly in the banker-customer contract; indeed, customers may not even be aware of their existence. Interbank agreements are often binding between the banks themselves as a matter of contract. But to what extent do they confer rights on or subtract from the rights of customers?

Other issues, for example, that bankers share are bank confidentiality, the multifaceted face of banking, liability for advice or liability for failing to give advice, consumer protection measures and debt security.

1.1.3.2 Bank confidentiality

European, South African and Australian jurisdictions recognize a form of bank confidentiality in which banks are legally compelled to keep the financial affairs of their customers secret.⁶⁴ Although as a matter of policy, bank confidentiality is based on the customer's right of privacy, as a concept it tends to have other origins.⁶⁵ This discrepancy can lead to privacy being breached with the law's sanction.⁶⁶ An example is the so-called status opinion or banker's reference, where a trader will obtain information about the financial standing of another trader through the banking

63 Cranston (ed) *European Banking Law* 2.

64 See *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461 (England); *Densam (Pty) Ltd v Cywilnat (Pty) Ltd* 1991 (1) SA 100 (A) (South Africa); the Dutch Privacy Act of 1989 (Wet persoonsregistraties); In Germany, see Rehbein 1985 ZHR 139; Sichtermann *et al* *Bankgeheimnis* 111; the AGB-Banken of 1993. In the USA, see *Peterson v Idaho First National Bank* 367 P 2d 284, 290 (1961); *Milohnich v First National Bank of Miami Springs* 224 So 2d 759 760 (Fla 1969) and the Algemene Bankvoorwaarden in the Netherlands.

65 Banking secrecy is said to be founded on legislation, contract and the protection of privacy. See Faul 1989 TSAR 145; Faul 1989 *De Jure* 312; Faul 1986 TSAR 180; Itzikowitz 1989 BML 255; Scott 1989 SA Merc LJ 248; Fourie 1990 *South African Banker* 20.

66 The concept of banking secrecy has come under severe pressure recently and disclosure of confidential information in appropriate circumstances in the public interest is increasingly required. In England, see *Bankers Trust Company v Shapira* [1980] 3 All ER 353; *Price-Waterhouse (A Firm) v BCCI Holdings (Luxembourg) SA* [1992] 1 All ER 778; [1992] BCLC 583 at 596; *A v B Bank (Bank of England Intervening)* [1992] 1 All ER 778 at 788; *Bank of England v Riley* [1992] 1 All ER 769. See also Drugs and Drug Trafficking Act 140 of 1992.

system,⁶⁷ leading to several issues. Examples of such issues would be whether the customer's consent is required,⁶⁸ and the liability of the bank giving the opinion.⁶⁹

Multi-functional banking is one reason why confidentiality is under attack at present: banks distribute information throughout the corporate group so that the whole range of bank services can be marketed to customers, despite the fact that this may be in breach of the principle.⁷⁰ The other, and more defensible reason why bank confidentiality is currently being undermined is because the banking system has been used for fraudulent and criminal activity. Money laundering is at the top of regulators' agenda,⁷¹ but other concerns include tax evasion,⁷² securities violations and insolvency offences.

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- 67 *Faul Bankgeheim* 508; *Malan & Pretorius Bills of Exchange* 375; *Neate Bank Confidentiality* 204-205; *The Royal Bank Trust Co (Trinidad) Ltd v Pampellone* [1987] 1 Lloyds Rep 218.
- 68 Bankers usually try to rely on an implied consent or the fact that the giving of the information is a trade usage. See *Commercial Banking Co of Sydney Ltd v RH Brown & Co* (1972) 126 CLR 337 (Australia); *Midland Bank Ltd v Seymour* [1955] 2 Lloyds Rep 1477; *Parsons v Barclay & Co Ltd and Goddard* (1910) 103 LT 196 (England). Lord Chorley *Banking* 24 pointed out that banker's opinions are often given out without the knowledge or consent of the customer, and if so would amount to a breach of the bank's duty of secrecy.
- 69 See, eg, *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465; [1963] 2 All ER 575; *Cornish v Midland Bank plc (Humes third party)* [1985] 3 All ER 513; *Bank of Tokyo Ltd v Karoon* [1987] AC 45; *Morgan Crucible Co plc v Hill Samuel Bank Ltd* [1991] All ER 148; *White v Jones* [1993] 3 All ER 481 (England); *Standard Chartered Bank of Canada v Nedperm Bank Ltd* 1994 (4) SA 747 (A) (South Africa).
- 70 *Bank of Tokyo Ltd v Karoon* [1987] AC 45; *Cranston Banking Law* 192-193; *Faul Bankgeheim* 180.
- 71 See South African Drugs and Drug Trafficking Act 140 of 1992; English Drug Trafficking Act of 1994; Australian Financial Transaction Reports Act of 1988 (Cth); Bank Secrecy Act of 1970 (US); the Dutch Disclosure of Unusual Transactions Act of 1993 and Identification Financial Services Act of 1993.
- 72 See South African Income Tax Act 58 of 1962. In Australia, see the Australian Income Tax Assessment Act of 1936; *Smorgon v Australia and New Zealand Banking Group Ltd*; *Smorgon v Commissioner of Taxation of the Commonwealth of Australia* (1976) 134 CLR 475; *Commissioner of Taxation of the Commonwealth of Australia and Others v The Australia and New Zealand Banking Group Ltd* (1979) 143 CLR 499. In the Netherlands, see the Dutch Algemene Wet inzake Rijksbelastingen of 1959. In Germany, the bank has an unlimited duty to to inform the authorities in regard to tax fraud (s 385 Abgabenordnung (Federal Taxation Act)).

1.1.3.3 Multi-functional banks

Multi-functional banking engenders various conflicts of interest. For example, a bank recommends to a customer the purchase of securities, or it effects purchase of such securities, the issue of which is being underwritten by the bank. Similarly, the transaction may relate to a company's issue of securities and the bank may be a substantial creditor of the company, or a financial adviser to the company, or may be advising someone who is contemplating a substantial acquisition of securities in the company.⁷³ The assumption seems to have been that competition will act as the regulator, driving customers from banks that abuse their position. Reliance may also have been placed on agency law: an agent must not use his or her position to acquire benefits for himself or herself at the expense of his or her principal (conflict of interest and duty). Therefore, a bank instructed to buy a certain number of securities cannot buy on its own account. If it does, it must account for the profits.⁷⁴ But agency law is not easily applied to the multi-functional bank. One theoretical problem is knowledge. Can the knowledge of its different parts be attributed to the business as a whole, even if one part does not know in fact what another part knows,⁷⁵ and especially as there are barriers such as Chinese Walls which have prevented the free flow of information?⁷⁶ There are also problems at the level of practice; for example, it is not always very easy to distinguish the case where a bank acts as agent for its customer from the case where the bank buys securities in its own name and subsequently resells them to the customer.

The ordinary law has sometimes treated disclosure as a solution to the problem of conflicts of interest. Make full disclosure of the conflict to the customer, and the bank is absolved of any

73 See Poser 1988 *Michigan Yearbook of International Legal Studies* 91 at 96-97; Cranston *Banking Law* 23.

74 See Cranston *Banking Law* 24-25.

75 There is authority that since a corporation is one entity in law, however many departments it can be divided into, if one department acts in terms of a mandate for a customer, and another unbeknown to the first, acts contrary to the interests of the customer, the company as a whole will be in breach of a fiduciary duty. See *Harrods Ltd v Lemon* [1931] 2 KB 157; *Lloyds Bank Ltd v EB Savory & Co* [1933] AC 201; [1933] All ER 106; *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500.

76 "Chinese Walls" has been broadly defined as procedures for restricting the flow of information within an organisation to ensure that information that is confidential to one department is not improperly communicated (whether deliberately or inadvertently) to other departments in the organisation. See the English Law Commission *Fiduciary Duties* par 2.16. See also the concept of Chinese Walls in the Dutch Gedragscode van de Nederlandse Vereniging van Banken (NVB). The primary role of these walls is to prevent the spread of *koersgevoelige informatie*, in regard to trading in securities. See Van Dijk 1997 *TVVS* 235 at 236.

wrongdoing.⁷⁷ Yet disclosure of a conflict of interest may be in breach of a duty to another customer.⁷⁸ The bank advising customer A to invest in the securities of customer B, whose financial health is dubious, should disclose that fact to A — but to do that would be in breach of the duty of confidentiality to B. If, as in this case, disclosure is a breach of duty to another, it may be that the bank must desist completely from acting. In the situation referred to, therefore, the bank would have to inform the client or customer that it was unable to advise or assist.⁷⁹ The difficulty⁸⁰ arises, of course, where one department of a multi-functional bank does not know that there is a conflict of interest as a result of what another department is doing. A Chinese Wall may be in operation, designed to keep particular parts of the bank ignorant of what the other parts are doing. The strict application of the rule "disclose or desist", however, means that the existence of a Chinese Wall is not sufficient.⁸¹ The bank must take positive steps to ensure that there is disclosure where this is permissible, or desist from acting. Such positive steps would include the American restricted-list procedure, where the bank would make no recommendations about, and would not deal in the securities of a company, either on its own account, or on a discretionary basis, as soon as it entered into a close business relationship with that company.⁸²

Only recently has regulatory law in Europe grappled with conflict-of-interest problems.⁸³ The criminalisation of insider dealing⁸⁴ is an example, although it misses a great deal of the

77 *Cranston Banking Law* 25; *Warne Litigation* 47; *Prince Jefri Bolkiah v KPMG (A Firm)* [1999] 1 All ER 517.

78 See, eg, *Winterton Constructions Pty Ltd v Hambros Australia Ltd* [1993] ATPR 41-205.

79 See, eg, *Standard Investments Ltd v Canadian Imperial Bank of Commerce* (1986) 22 DLR (4th) 410 at 436 (Canada) but cf *Washington Steel Corporation v TW Corporation* 602 F 2d 594 (3d Circuit 1979) (USA). In this controversial case it was decided that a bank may use confidential information obtained from prior contacts with a corporate customer, the target company, and was not precluded from financing the hostile takeover of that customer. For critical discussions, see Holland 1980 *Cornell LR* 292; Millhiser 1980 *Wash & Lee LR* 953 and Chao 1980 *California LR* 153.

80 See Law Commission *Fiduciary Duties* pars 2.12 to 2.15 for a discussion of practical problems.

81 See *Re A Firm of Solicitors* [1992] 1 QB 959 at 971; [1992] All ER 353.

82 See Lipton & Mazur 1975 *NYULR* 459 at 466-8; Brudney 1979 *Harvard LR* 322 (USA); *Warne Litigation* 38 (England).

83 See, generally, Hopt in Hopt & Wymeersch (eds) *Insider Dealing* 221-231; EC Directive (Insider Dealing Directive) 89/592/EEC, [1989] OJ L334/30; s 52 of the English Criminal Justice Act of 1993.

84 See, eg, the Criminal Justice Act of 1993; Financial Services Act of 1986 (England); the Dutch Securities Act of 1995; the use of Chinese Walls (see Van Dijk 1997 *TVVS* 235-

informational and positional advantage which can give rise to conflicts of interests. Obligations in company legislation on insiders to disclose shareholdings, and criminal prohibitions on concealing information and creating a false market, are also relevant. Most Western countries are now developing an elaborate system of investor protection, inspired in broad outline by the US systems of securities regulation.⁸⁵ Detailed rules may prescribe acceptable behaviour for a bank engaged in securities activity; breach can be a disciplinary offence and can ultimately lead to a bank's having its authorization to engage in such activity withdrawn.⁸⁶

1.1.3.4 Liability for advice

Advice can be given to customers or to third parties. Delictual liability enables third parties to sue banks for negligent advice,⁸⁷ as well as for fraudulent advice.⁸⁸ A customer may in certain instances also be able to sue its banker for negligent advice.⁸⁹ The question whether a duty to advise exists, will be investigated in each of the chosen jurisdictions.

Earlier in the twentieth century, it was said that a bank could not be liable for negligent advice given by its officers, since it was not a banking function to give advice.⁹⁰ But even before banks began to promote themselves as financial advisers it would have been unrealistic to divorce advice from banking; advice has always been intimately linked with the taking and lending of

234); the German Wertpapierhandelsgesetz of 1994; s 128 Aktiengesetz.

85 Securities Act of 1933 (s 77 of 15 USC); Securities Exchange Act of 1934 (s 78 of 15 USC).

86 On the American regulatory environment, see, eg, Norton 1986 *Oklahoma City University LR* 547; Hackley 1969 *Virginia LR* 1421; Scott 1977 *Stanford LR* 1; Norton & Gail 1990 *BL* 1103.

87 *Hedley Byrne Co Ltd v Heller & Partners Ltd* [1964] AC 465; [1963] 2 All ER 575 (England); s 826 BGB (Germany); *Standard Chartered Bank of Canada v Nedperm Bank Ltd* 1994 (4) SA 747 (A) (South Africa).

88 *Derry v Peek* (1889) 14 App Cas 337 (England); *Commercial Banking Co of Sydney Ltd v RH Brown & Co* (1972) 126 CLR 336 (Australia).

89 See, eg, *Verity v Lloyds Bank plc* [1995] CLC 1557; *Morgan v Lloyds Bank plc* [1998] Lloyds Rep 73 (England); *State Bank of Iowa Falls v Brown* 119 NW 81 (Iowa 1909); *Brasher v First National Bank of Birmingham* 168 So 42 (Ala 1936); *Mills County State Bank v Fisher* 282 NW 2d 712 (Iowa 1979) (USA); *Durr v ABSA Bank Ltd and Another* 1997 (3) SA 448 (A) (South Africa).

90 *Banbury v Bank of Montreal* [1918] AC 626.

money.⁹¹ A more serious legal obstacle has been the reluctance in some jurisdictions to impose non-contractual liability for economic loss dissociated from physical injury. The potential enormity of recoverable damages is perceived as the major obstacle. Whatever the general problem with "pure" economic loss,⁹² however, the extent of the liability consequent on negligent advice is limited — the money itself and the profit which may have been generated through its employment elsewhere.⁹³ It is not surprising, therefore, that in English law negligent advice has been carved out as an exception to the rule that there is no liability for pure economic loss.⁹⁴

Banks would normally be able to avoid the consequences of giving negligent advice by suitable notice to those receiving it.⁹⁵ Whether this is regarded, conceptually, as avoiding liability or as exempting from liability already incurred is quite valid, but the central issue in practice should be whether the disclaimer of, or exemption from, liability has been made clear to those being advised so they are in no doubt that the bank is washing its hands of the consequences of the advice proving inappropriate or wrong. Thus, a small-print clause in a document given to those being advised is unlikely to satisfy this test.⁹⁶

1.3.5 Consumer protection

Specific consumer protection for bank customers is a rarity. However, countries such as Britain,

91 Today there is no doubt that the giving of advice is within the scope of a bank's business. See *Compafina Bank v Australia and New Zealand Banking Group and Bennet* (1984) Aust Torts Rep 80-546 (Australia); *Morgan v Lloyds Bank plc* [1998] Lloyds Rep 73; *Verity v Lloyds Bank plc* [1995] CLC 1557; *Warne Litigation* 34; *Cranston Banking Law* 225-6 (England); *Durr v ABSA Bank Ltd and Another* 1997 (3) SA 448 (A) (South Africa).

92 See, eg, the conflicting decisions on pure economic loss in *Anns v London Borough of Merton* [1978] AC 728; [1977] All ER 492 and *Murphy v Brentwood District Council* [1991] 1 AC 398 (England). See further, *Winnipeg Condominium Corp v Bird Construction Co* [1995] 1 SCR 85 (Canada); Von Bar 1992 *RabelsZ* 410; *Hutchison & Zimmermann* 1995 *ZvglRWiss* 42 (Germany).

93 *Cranston Banking Law* 225.

94 *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465; *Verity v Lloyds Bank plc* [1995] CLC 1557.

95 See *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 (England); HR 1967-05-19 NJ 1967 261 (*Saladin v Hollandse Bank Unie*) (The Netherlands).

96 In *Hedley Byrne Co Ltd v Heller & Partners Ltd* [1964] AC 465, the bank avoided liability because of a disclaimer in the reference. In English law, problems of small print and unfair disclaimers will fall within the scope of unfair contract terms legislation such as the Unfair Contract Terms Act of 1977.

Australia, New Zealand, Ireland and Germany have banking ombudsmen for the resolution of banker-customer disputes. Several EC initiatives on funds transfers have led to consumer protection measures in the member States.⁹⁷ Proper prudential regulation should ensure a sound banking system and thus protection for customers.⁹⁸ In particular, deposit guarantee and protection schemes give some comfort to customers in the event that banks fail.⁹⁹ Usury laws, which limit interest charged on loans have gone by the board in Europe, although disclosure of interest and charges feature prominently in the consumer credit laws¹⁰⁰ of the different countries (which in some respect have been brought into line in the EC as a result of Directives). In the USA, consumer credit controls tend to be more extensive than elsewhere.¹⁰¹

General banking conditions,¹⁰² drawn up by associations of banks, have long been a feature of some Western jurisdictions. The introduction of electronic funds transfers has led banks across Europe to prepare standard terms for their customers.¹⁰³ Judicial and legislative control of standard-form contracts apply in theory to banks. Judicial control has operated by construing ambiguities in the banks' contracts against them and by invoking doctrines which in broad terms attack inequality of bargaining power.¹⁰⁴ Legislative control has largely replaced judicial control, although the courts are the instruments by which the legislative goal is achieved. In some European countries the solution to standard clauses is in part administrative.¹⁰⁵

97 EC Directive (Code of Conduct in the Area of Electronic Funds Transfer) 87/598/EEC:[1987] OJ L365/72. In the USA these issues are regulated by the Electronic Funds Transfer Act (15 USC s 1693).

98 General consumer protection laws, such as the EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC:[1993] OJ L95/29 can, of course, also be resorted to. See Cranston *Banking Law* 78.

99 EC Directive (Deposit Guarantee Schemes) 94/19/EEC: [1994] OJ L135/5.

100 See the Usury Act 73 of 1968; the English Banking Act of 1987.

101 See, eg, the detailed provisions prohibiting discrimination in the provision of credit, namely the Equal Credit Opportunity Act (15 USC s 1691) and the Community Reinvestment Act (12 USC s 2901).

102 See, eg, the English Code of Banking Practice (2); the Australian Code of Banking Practice; the German AGB-Banken; the Dutch Algemene Bankvoorwaarden.

103 EC Directive (Code of Conduct in the Area of Electronic Funds Transfer) 87/598/EEC:[1987] OJ L365/72. In the USA these issues are regulated by the Electronic Funds Transfer Act (15 USC s 1693).

104 EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC:[1993] OJ L95/29.

105 Reich & Micklitz *Legislation* 161-184; Beale 1989 *Current Legal Problems* 197; Bernitz 1973 *Scandinavian Studies in Law* 11 at 13-14.

Control of standard-term banking contracts has been given impetus by the EC Directive on Unfair Terms in Consumer Contracts.¹⁰⁶ Potentially this strikes at a number of standard clauses in banking contracts which could be said to violate the reasonable expectations of customers.

1.1.3.6 Conclusion

This thesis will, in part, endeavour to show that the law relating to the banker-customer relationship in Western countries, particularly in Europe, does converge to a degree.¹⁰⁷ However, the extent of this convergence falls far short of what has been achieved in bank regulation as a result of the work of the Basle Committee on banking regulations and the directives of the European Community. It is more of a convergence in outcomes rather than in the means to the outcomes; the different statutes and judicial methods remain as divergent as ever.¹⁰⁸

The pressures on the law relating to the banker-customer relationship to converge will continue.¹⁰⁹ In all countries banks face similar demands for more accountability and better service. Legal transplanting is expected to continue in all major trading partners.

International regulatory efforts will become even more of a catalyst for change in our domestic law — the drive against money-laundering and its impact on opening accounts and bank confidentiality are illustrative.¹¹⁰

In view of our being part of the worldwide banking matrix, it would be dangerous to ignore trends emanating from other parts of the world, as far as disclosure principles are concerned.

106 EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC: [1993] OJ L95/29.

107 Cranston *Banking Law* 68-69; Schneider 1991 *Law & Pol'y Int'l Bus* 261; Zavvos 1988 *Common Market LR* 263 at 276; Hadjiemmanuil in Norton & Andenas (eds) *Organisations* 183-185; EC Directive (Second Banking Directive) 89/646/EEC; [1989] OJ L386/1.

108 In particular between Britain and the USA, see Cranston *Banking Law* 69 (England); Gruson & Nikowitz 1989 *Fordham Int'l LJ* 205 (USA).

109 The process of harmonization of laws is taking place on various levels, by intergovernmental organizations, as well as private business or interest groups. See, eg, the activities of UNCITRAL, the ICC, UNIDROIT, and the International Law Association. One must remember that what is happening within the EC banking matrix is but part of a broader international convergence process. See Norton & Andenas *Organisations* 183-185.

110 Buxbaum *et al* (eds) *Business Law* 347.

1.2. ASPECTS OF SURETYSHIP

In order to understand the circumstances under which a suretyship can be rescinded on the basis of non-disclosure of material facts,¹¹¹ by a bank, I believe that it is necessary briefly, to review the nature of suretyship and the purpose and background to a suretyship relationship. In view of the rising popularity of good faith as a standard of fairness in contract law, where the reasonable expectations of the parties play a dominant role, this purpose and background become very important.

Suretyship is defined as an accessory contract, by which the surety undertakes to the creditor of the principal debtor, primarily that the principal debtor, who remains bound, will perform his obligation to the creditor and, secondarily, that if and so far as the principal debtor fails to do so, the surety will perform it or, failing that, indemnify the creditor.¹¹² This definition contains the heart of a surety's expectation. He expects the principal debtor to perform. Only if the principal debtor does not do so, does the surety expect to perform.¹¹³

Because a surety's obligation is an accessory obligation, a valid¹¹⁴ principal obligation, between

111 Although this thesis is devoted to this particular problem, it must be borne in mind that a surety enjoys a vast array of defences and benefits. The surety may rely upon and plead all the defences which the principal debtor has against the creditor, except those defences which are purely personal to the principal debtor. See Pothier *Obligations* pars 380-381; *Hastie v Dunstan* (1892) 9 SC 449; *Eaton Robins & Co v Nel (2)* (1909) 26 SC 624; *Ideal Finance Corporation v Coetzer* 1970 (3) SA 1 (A); *Standard Bank of SA Ltd v SA Fire Equipment (Pty) Ltd* 1984 (2) SA 693 (C); *Barclays National Bank Ltd v Von Varendorff* 1985 (2) SA 544 (D); *Bankorp Ltd v Leipsig* 1993 (1) SA 247 (W).

The surety can also plead a number of defences peculiar to the contract of suretyship, eg, defences as to the legality of clauses (see *Standard Bank of SA Ltd v Wilkinson* 1993 (3) SA 822 (C); *First National Bank of SA Ltd v Sphinx Fashions CC* 1993 (2) SA 721 (W); *Ex parte Minister of Justice: In re Nedbank Ltd v Abstein Distributors (Pty) Ltd and Others and Donnelly v Barclays National Bank Ltd* 1995 (3) SA 1 (A)), and the benefits of excussion, division, and cession of actions. See Caney *Suretyship* 107 *et seq*; Joubert (ed) 26 *LAWSA* pars 202-206).

112 Caney *Suretyship* 26-27.

113 There is no universally accepted definition of a contract of suretyship, but Caney's definition contains the gist of suretyship. For other definitions, see Grotius *Inleidinge*, Voet 46.1.1; Pothier *Obligations* par 365; De Wet & Van Wyk *Kontraktereg* 391; Joubert (ed) 26 *LAWSA* par 190.

114 The principal debt may not be illegal (see *Albert v Papenfus* 1964 (2) SA 713 (E) at 717 approved in *Lipschitz NO v UDC Bank Ltd* 1979 (1) SA 789 (A); *Brandt v Weber* (1886) 2 SAR 98), forbidden or impossible (see Digest 46.1.11; Digest 46.1.70.5; Voet 46.1.9.11; Van Leeuwen *Censura* 1.4.17.6.; Pothier *Obligations* pars 366 and 395).

the debtor and the creditor is essential, and if a suretyship is not grafted upon such a principal obligation, it is void.¹¹⁵ The suretyship is accessory to the transaction which creates the obligation of the principal debtor.¹¹⁶

In the absence of a valid principal obligation the surety is not bound; therefore, in principle,¹¹⁷ the surety can raise any defence which the principal debtor can raise. More subtly, this means that in the typical contractual case the surety only takes upon himself the risk of a breach of contract by the principal debtor (for invalidity or extinction of the obligation in question).¹¹⁸ This ties in well with the idea of a surety as one who promises that the principal debtor will perform, not simply one who will indemnify the creditor for losses caused by non-performance. Therefore a surety is not bound to a person to whom the principal debtor is not liable, even if the surety has made his promise to that person, for there is no principal obligation between principal and creditor to which the suretyship can accede.¹¹⁹

From the above it is clear that there are at least three parties concerned in the relationship — the creditor, the principal debtor and the surety. There are four obligations: firstly that of the principal debtor to the creditor; secondly, accessory to that, the obligation of the surety to the creditor; thirdly the obligation of the principal debtor to reimburse the surety what he pays the creditor,¹²⁰ fourthly the obligation that falls upon the creditor, namely, to do nothing in his dealings with the principal debtor and with other sureties to the prejudice of the surety.¹²¹

115 Digest 46.1.16; Van Leeuwen *Censura* 1.4.173; Voet 46.1.3; Pothier *Obligations* 366; Joubert (ed) 26 *LAWSA* par 192; *Eaton Robins & Co v Nel (I)* (1909) 26 SC 365; *Imperial Cold Storage & Supply Co Ltd v Julius Weil & Co* 1912 AD 747; *Wiehahn NO v Wouda* 1957 (4) SA 724 (W); *Croxon's Garage (Pty) Ltd v Olivier* 1971 (4) SA 85 (T).

116 Voet 46.1.16.3; Sande 7.11; *Renou v Walcott* (1909) 10 HCG 246; *Dorfman v Perring* 1922 EDL 137; *Schoeman v Moller* 1951 (1) SA 456 (O); *List v Jungers* 1979 (3) SA 106 (A); *Diners Club SA (Pty) Ltd v Durban Engineering (Pty) Ltd* 1980 (3) SA 53 (A).

117 Joubert (ed) 26 *LAWSA* par 201.

118 Lubbe 1984 *THRHR* 383 at 385-386; *Caney Suretyship* 27.

119 Digest 46.1.16; Voet 46.1.3; Van Leeuwen *Censura* 1.4.17.5.

120 When the surety intervenes with the consent or knowledge of the principal debtor, a contract of mandate comes into existence, either expressly or tacitly. See *Rossouw & Rossouw v Hodgson & Others* 1925 AD 97 at 102. If he does so without the knowledge of the debtor, the surety is entitled to be reimbursed on the grounds of *negotiorum gestio*. See Joubert (ed) 26 *LAWSA* par 207; De Vos *Verrykingsaanspreeklikheid* 214-215; Digest 17.1.6.2; Grotius *Inleidinge* 3.3.30-31; Voet 46.1.28; Voet 46.1.31.

121 *Caney Suretyship* 28. To this should be added the duty not to do anything in his dealings with the surety himself, which may prejudice the surety. As we shall see, the contract of

Possibly, in view of the requirement of good faith or at least in terms of a new interpretation thereof, the conduct of the creditor *vis-à-vis* co-sureties, mutual sureties and other creditors of the principal debtor and the surety, may also become relevant. It is possible that a banker may acquire a duty to protect the expectations of a wide range of persons who, in undertaking suretyship obligations, are affected by the bank's conduct.

In this thesis I shall concentrate on the duties of disclosure of material facts and duties to advise, owed by a banker, as creditor, *vis-à-vis* the surety when taking suretyships.

1.3 LEGAL COMPARISON: METHODOLOGY

1.3.1 Comparative possibilities

"Geen hof, ook nie hierdie hof nie, besit die bevoegdheid om ons gemene reg met die reg van enige ander land te vervang nie."¹²²

Notwithstanding this truism, the law of other nations can be implemented to fill gaps in our own law and the value of comparative research is recognized in our law.¹²³ For historical reasons, it was English law in particular which found its way into the South African law.¹²⁴ Insofar as banking law is concerned, it cannot be denied that English law has been applied instead of South

suretyship is not considered to be one of *uberrimae fides* (see *Orlando Hosking v Standard Bank of SA Ltd* (1892) 13 NLR 174; *Mutual and Federal Insurance Co Ltd v Oudtshoorn Municipality* 1985 (1) SA 419 (A) (South Africa); *Hamilton v Watson* (1845) 12 Cl & Fin 109; *London General Omnibus Co Ltd v Holloway* [1912] 2 KB 72; *Cooper v National Provincial Bank* [1946] 1 KB 1; [1945] 2 All ER 641 (England)), but a more prominent role of *bona fides* in our law of contract may lead to stricter duties on the shoulders of the creditor in his dealings with the surety, and the question of non-disclosure of material information is directly affected by this relationship. A question which arises as well is whether a banker owes a more onerous duty to a surety who is also a customer of the bank, than to one who is not.

122 *Trust Bank van Afrika Bpk v Eksteen* 1964 (3) SA 402 (A) at 410-411.

123 For notable comparative research done in South Africa see, eg, Van der Merwe *Vorderingsregte* 1959 (English, American, Dutch, German, Swiss and French Law); Van Heerden *Grondslae* 1961 (German, Dutch, English and American Law); Van Zyl *Saakwaarnemingsaksie* 1970 (French, Dutch, Italian, German, Austrian, Swiss and Hungarian Law); Pauw *Persoonlikheidskrenking* 1976 (German, Swiss, Dutch, French and English Law).

124 For details of the reception of English law at the Cape from 1806 to 1910 and the role of English law in the growth of South African law since 1910, see Van Zyl *Roman Law*; Hosten 1962 *THRHR* 24-26; Zweigert & Kötz *Introduction* 231-235.

African law, even in cases where English law has not been specifically imported by legislation.¹²⁵ Our case law also reflects the assistance obtained from English sources.¹²⁶

Various factors, notably consumer protection measures, are currently impacting on the law of contract and banking, internationally. In South Africa, furthermore, the full impact of the new Constitution will still have to be measured, and in respect of the constitutionality of private-law relationships, much can be learned from other nations. The Constitution of South Africa, in fact, enjoins one to have regard to comparable foreign case law where applicable in interpreting the provisions of the chapter on fundamental rights.¹²⁷

In embarking on comparative research, two main methodological approaches are usually employed in South Africa. The legal historical method investigates the historical origin and development of a specific concept, rule, institution or aspect of South African law. The most important historical sources of our law, according to traditional thought, are Roman and Roman-

125 In an article entitled "The Law of Banking in South Africa" 1904 *SALJ* 355, Morice went so far as to say:

"The law of South Africa is identical with English law in most matters that belong properly to banking. Where the one does not borrow from the other, both are derived from the Law Merchant."

Further on in his article, however, it becomes clear that there are important differences between the two legal systems.

More cautious is Willis *Banking* 20-21 who states:

"Mention has already been made of the fact that our banking practice derives from England...It is therefore hardly surprising that where our law is silent on a matter appertaining to banking practice, the decisions of the English courts have had strong persuasive authority."

126 Apart from the numerous cases in regard to negotiable instruments, see, eg, *Cargo Motor Corporation Ltd v Tofalanos Transport Ltd* 1972 (1) SA 186 (W) (the decision whether to enforce a contract, performance to be effected through a bank as agent, in contravention of Zambian exchange control laws, Zambia being a "friendly foreign state"); *Rousseau NO v Standard Bank of SA Ltd* 1976 (4) SA 104 (C) (to determine the relationship between a banker and customer); *Trust Bank of Africa Ltd v Senekal* 1977 (2) SA 587 (W) (in order to decide whether an overdraft is normally payable on demand); *Ensor NO v Nedbank Ltd* 1978 (3) SA 110 (D) (to define the banker client relationship); *Big Dutchman (South Africa) (Pty)Ltd v Barclays National Bank Ltd* 1979 (3) SA 267 (W) (in order to determine the duty of banks to check their mandates).

127 This should be done with circumspection because of the differing contexts within which foreign constitutions were drafted and operate, and the danger of unnecessarily importing doctrines associated with those constitutions into an inappropriate South African setting. See the comments of Kroon J in *Qozoleni v Minister of Law and Order and Another* 1994 (1) BCLR 75 (E); *Van der Vyver* 1994 *SALJ* 19 at 23-24.

Dutch Law.¹²⁸ Legal historical research in South Africa would therefore entail at least a study of Roman-Dutch law (embracing the development of Roman law in Europe from the 12th century up to its reception in the Netherlands, and the subsequent development in the Netherlands of Roman-Dutch law, up to its codification in the nineteenth century),¹²⁹ as well as a study of the development of Roman-Dutch law in South Africa.¹³⁰

The legal comparative method, on the other hand, investigates corresponding or similar concepts, rules, institutions and aspects of other legal systems.¹³¹ Legal comparison can be made horizontally, that is, it merely takes note of the current legal position in a foreign system or, vertically, that is, the subject is analyzed historically. Comparative law studies legal systems coexistent in space, legal history studies systems consecutive in time.

1.3.2 Choice of comparative method

In this thesis I shall make use of legal comparison, rather than historical analysis. Where I do

128 Hosten *et al Introduction* 129 *et seq* and at 220; Hahlo & Kahn *System* 139 at 303. There is no uniformity about what exactly in Roman-Dutch law should be considered as South African common law. The traditional orthodox view of our courts is that Roman-Dutch law as South African common law is limited to the law of the province of Holland and is only found in the writers on this area of the law. See, eg, *Du Plessis NO v Strauss* 1988 (2) SA 105 (A); *Bank of Lisbon and South Africa Ltd v De Ornelas & Another* 1988 (3) SA 580 (A). Some jurists support the view that our common law is the whole European *ius commune* and is not limited to the portion that prevailed in Holland. (See Visser 1986 *THRHR* 127 at 135; Scott 1985 *De Jure* 122 at 124-125; Zimmermann 1986 *SALJ* 259 at 270; Du Plessis & Olivier 1988 *De Jure* 371-378).

129 See Van Zyl 1972 *THRHR* 20 *et seq*.

130 English law has played a particularly influential role in South African law. Opinions differ about the exact nature and reach of the influence of English law on the development of Roman-Dutch law. See Hahlo & Kahn *System* 584 and further, and Zimmermann 1986 *SALJ* 259 at 260. It is fairly generally accepted that at least some English legal rules became part of South African law. See Hosten *et al Introduction* 197 and further; Scott 1985 *De Jure* 122 at 130-131. Some (see, eg, Zimmermann 1986 *SALJ* 259 at 274 *et seq*; Visser 1986 *THRHR* 127 at 129) even feel that English law is, or has become part of our common law. Be that as it may, English law cannot be ignored as a historical source of our law, at least as far as it has been received into our law. (See Zweigert & Kötz *Introduction* 235.) South African Courts have over the years referred to and greatly relied on the decisions of their English counterparts in order to adapt "to the changing and complicated conditions of modern society" (per Innes *Autobiography* 329 in a tribute to Lord De Villiers). On the reliance of our courts on English law, see Girvin 1994 *SALJ* 112 at 121; Girvin 1988 *SALJ* 479 at 481; Cameron 1982 *SALJ* 38 at 51.

131 Ebert *Rechtsvergleichung* 21 distinguishes between "micro" (in the sense used here) and "macro" comparison. Macro comparison consists of comparing legal systems or groups of legal systems. See also Zweigert & Kötz *Introduction* 4-5.

sketch a historical background, it is more for the purpose of establishing a trend, which may affect the banker-surety relationship.

The reason for electing to use the comparative method is firstly practical. The scope of the thesis makes it impossible to make use of the legal historical method.

Secondly, concepts such as "reasonableness", "fairness", "unconscionability" and "good faith", fundamentally affect the problem posed in this thesis. The problems addressed therefore relate to substantive law, and thus procedural differences between the various systems compared do not play such an important role. The problem relates to subjective rights, and not so much to the processes with which they are enforced.¹³²

Thirdly, the scope of and the possible solutions to the problems modern-day bankers face when taking suretyships, will be determined to a large extent by the theoretical and philosophical views on the modern function, purpose, and sphere of influence of the law of contracts (and delict) in general and the rules in regard to illegality or *geoorloofdheid* and the role of the *boni mores* in particular. Although a study of the legal historical background can contribute to better insight into the problem, I believe that the comparative method is more relevant for an evaluation of the problem.

In the fourth place, modern problems like duties of disclosure or non-disclosure, duties to advise, the consequences of unfairness in contract in general,¹³³ and consumer protection and suretyship defences¹³⁴ in particular, are common to all Western legal systems. In most of these systems the aforesaid modern problems have enjoyed the attention of academics, the judiciary and the legislature for decades. Inasmuch as our contract law stands poised¹³⁵ to adopt formally a criterion of fairness in contract, much can be learned from the experience of Western systems. The insights gained can be used in the evaluation of our own legal position and can serve as

132 This, of course, does not mean that procedural aspects are unimportant as far as the future of suretyship is concerned. Modern credit legislation makes particular use of procedural steps which have to be followed in "consumer" litigation and pre-litigation steps.

133 See Bernitz 1973 *Scandinavian Studies in Law* 11 (Scandinavia); Sealy 1978 *Cambridge LJ* 15 (England); Kessenich-Hoogendam *Aansprakelijkheid v* (The Netherlands). For a discussion of the topic in German law see Bunte 1981 *AcP* 31; Wolf/Horn/Lindacher *AGB Gesetz*. In the USA, see Squillante 1970 *Albany LR* 297; Cellini & Wertz 1967 *Tulane LR* 193; Leff 1967 *University of Pennsylvania LR* 485.

134 Cohen 1993 *William & Mary LR* 1025; Heitner & Frank 1990 *California Real Property Journal* 1.

135 See the activities of the SA Law Commission *Unreasonable Stipulations*.

indicators for the future development thereof.¹³⁶

1.3.3 Comparative material

Obviously, the choice of legal systems to be compared is important.¹³⁷ For South Africa, with its hybrid legal system,¹³⁸ with Continental as well as common-law elements, it would appear to be essential to compare at least one legal system from each of the two legal families.¹³⁹

I have decided to compare developments in three common-law countries, to wit England, the USA¹⁴⁰ and Australia.¹⁴¹

From the Roman-German countries I have elected to investigate developments in the Netherlands¹⁴² and Germany.¹⁴³

136 Van Zyl *Regsvergelyking* 18-21.

137 In regard to the importance and grouping and classification of the various legal systems in legal families, see Wigmore *Legal Systems*; Zweigert & Kötz *Introduction* 63-73; Lawson 1982 *Hastings Int'l & Comparative LR* 85; Malström 1969 *Scandinavian Studies in Law* 127; Arminjon *et al Traité* 42 *et seq.*

138 See Van Blerk 1982 *SALJ* 365; Cameron 1982 *SALJ* 38 at 43-44; Zimmermann 1986 *SALJ* 259 at 260; Fagan in Zimmermann & Visser (eds) *Southern Cross* 33-64; Hahlo & Kahn *System* 218; Zweigert & Kötz *Introduction* 235.

139 It is obviously a requirement that the systems must be capable of comparison. See Van Zyl *Regsvergelyking* 39; Zweigert & Kötz *Introduction* 34.

140 As the main representative systems of the Anglo-American family, an investigation into the treatment of the problem of non-disclosure in contract and the quest for an effective suretyship, in these countries, is important.

141 The Australians have tackled the problem of unfair contracts in a determined way and interesting developments in that regard have taken place in recent years. The Australians place great emphasis on the prohibition of misleading or deceptive conduct, duties of disclosure and the insistence upon the obtaining of independent advice by contracting parties who may suffer from some inequality in the bargaining process. These are issues which I consider vital if suretyship is to remain an acceptable and viable form of security, hence the inclusion of the Australian legal system in the analysis.

142 For the South African lawyer, with a strong Roman-Dutch tradition, it is important to observe recent Dutch developments more closely. See Van Zyl *Regsvergelyking* 105.

143 German private law has been codified. The Bürgerliches Gesetzbuch, in regard to spirit, content and technique shows strong Roman characteristics and the systematics of the Pandectists are strongly reflected therein. Important recent legislation in regard to standard contract terms (the Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen of 1976) and the rise of duties of disclosure and warning in banking law, make a study of developments in Germany essential.

The origin and development of the European Economic Community (EEC) have brought the legal systems of its European member States in line with one another on a large number of mutually important issues. The questions of unfairness in contract, and non-disclosure, at least as far as consumers are concerned, are some of these issues, and I have therefore included a brief look at developments in regard to non-disclosure in consumer contracts in the selected jurisdictions of the EEC as well.

1.4 SUMMARY OF CHAPTERS 2, 3, 4, 6, 7 AND 8: DISCLOSURE PRINCIPLES: A LEGAL COMPARISON

In these chapters, a comparison is made between general banking background and disclosure principles, particularly relating to suretyship, as practised in England, the USA, Australia, Germany, the Netherlands and South Africa.

1.5 *EXCURSUS*: INDEPENDENT LEGAL ADVICE AND DISCLOSURE PROBLEMS: AUSTRALIAN DEVELOPMENTS

In the case law, reference has often been made to the possibility that disclosure problems can be obviated by advising the intending surety to obtain independent advice. In the *excursus*, which forms chapter 5 of the thesis, I shall investigate developments in this field in Australia in an endeavour to ascertain how helpful this referral is in difficult non-disclosure situations.

1.6 SUMMARY OF CHAPTER 9: CONCLUSION: ANTICIPATED REFORMS IN THE LAW OF SURETYSHIP

In chapter 9, the various modern trends in contract law, particularly relating to non-disclosure, are summarized and I shall endeavour to distil a few general principles of unconscionability that lawyers internationally appear to abhor. I shall demonstrate how these trends negatively affect suretyships and render them virtually valueless.

After posing the problems, suggestions will be made about the recommended conduct involved in taking suretyships, in order to ensure their validity.

CHAPTER 2: THE BANKER'S DUTIES OF DISCLOSURE AND ADVICE TO CUSTOMERS AND SURETIES: ENGLAND

2.1 BANKING LAW: BACKGROUND

2.1.1 Banker-customer relationship

The legal content of the banker-customer relationship was the subject of a review by the Review Committee on Banking Law and Practice set up by the British Government in 1987 in response to the political pressures generated by a bank collapse.¹ The Committee under the chairmanship of Professor RB Jack reported in 1989,² and its recommendations resulted in significant changes in practice and a few statutory changes in the law. In particular, codes of banking practice³ have sought to spell out specifically the duties of banks toward their customers, not merely in terms of legal obligations, but in terms of best banking practice. This may be seen as part of a trend toward a recognition of the social responsibilities inherent in the conduct of banking in a modern economy.⁴ The challenge for the banker is to reconcile these responsibilities, as well as to comply with banking regulation, with the commercial imperative of maintaining a financially sound and competitive business.

The banking relationship between a bank and its customer is likely to include a range of separate contracts, depending on the nature of the business transacted between them. Loan agreements, security transactions, applications to open letters of credit, safe-custody agreements and the like will constitute separate, and separately documented, contracts. The term "banker-customer relationship" is based on contract and is generally taken to refer to the specific legal relationship

1 Bank of Credit and Commerce International SA, popularly known as Bank of Crooks and Criminals International in view of the frauds discovered after liquidation. Another famous bank collapse during this period was that of Barings. These are not unique examples. Insider fraud has featured in the collapse of banking institutions around the world. See Goodhart *Financial System* 372-410; Clark 1976 *Yale LJ* 1 at 12-13; Swire 1992 *Duke LJ* 469 at 505-512.

2 Review Committee *Banking Services*.

3 Code of Banking Practice (2) and (3).

4 The activities of the Banking Ombudsman also affect banking practice. In this regard, see Clark 1994 *JFRC* 195; Roberts 1995 *BJIBL* 385; Morris 1992 *LMCLQ* 227; Seneviratane *et al* 1994 *CJQ* 253.

generated by the opening and operation of a bank account.⁵ A feature of English banking practice is that the legal content of this relationship is usually not spelt out in a comprehensive written contract between the parties when the account is opened; rather, it has been defined over the years in the case law. The basic principle is that the relationship created by the depositing of money with a bank, by a customer, is that of debtor and creditor, with a super-added obligation on the part of the bank to honour the customer's cheques if the account is in credit.⁶ Money, when paid into a bank, ceases to be the money of the depositor; it is the bank's money to deal with as its own.⁷ One consequence of this is that upon the bank's insolvency the depositor's rights are generally those of unsecured creditors, even in the case of a "trust" account.⁸

There are, however, complexities inherent in the banker-customer relationship which distinguish it from the ordinary relationship of debtor and creditor. In the leading case of *Joachimson v Swiss Bank Corporation*⁹ the Court of Appeal analyzed the nature of the contract between a bank and its customer when a current account is opened. Atkin LJ rejected the view that the contract consists of a simple contract of loan by customer to bank, with added obligations on the bank's part. He said that the relationship consists of one contract involving obligations on both sides. The bank's promise to repay is treated as localized at the branch where the account is kept, because it is only there that the precise liabilities are known.¹⁰ It is a promise to pay on demand during banking hours. It is a term of the contract that the bank will not cease to do business with the customer except upon reasonable notice. The customer on his part undertakes to exercise reasonable care in executing his payment orders so as not to mislead the bank or facilitate forgery. The bank is not liable for repayment to the customer until the customer demands payment from the bank at the branch at which the account is kept.¹¹

5 *Foley v Hill* (1848) 2 HLC 28; *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110; *Arab Bank Ltd v Barclays Bank (DC & O)* [1954] AC 495; *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd* [1986] AC 80.

6 *London Joint Stock Bank Ltd v MacMillan & Arthur* [1918] AC 777 at 789; *Selangor United Rubber Estates Ltd v Cradock (3)* [1968] 2 All ER 1073 at 1118.

7 *Foley v Hill* (1848) 2 HLC 28; *Lipkin Gorman (A Firm) v Karpnale Ltd* [1992] 4 All ER 512; [1991] 2 AC 548 at 574.

8 *Space Investments Ltd v Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd* [1986] 1 WLR 1072; [1986] 3 All ER 75.

9 [1921] 3 KB 110.

10 This judgment was, of course, given before the advent of central computerized accounting systems.

11 *Ibid*, at 127. The demand must be one which the bank is obliged to comply with; *Libyan Arab Foreign Bank v Banker's Trust Co* [1989] QB 728 at 749.

This statement of the parties' rights and obligations still summarizes the basic position in English law, and has been applied by the courts in various different contexts.¹² In subsequent cases, obligations additional to those stated have been recognized, such as the bank's duty to keep its customers' affairs confidential,¹³ and the paying bank's duty of care when making payments on its customers' behalf.¹⁴

Recently banks have issued codes of practice applicable to certain classes of customer, which seek to restate or supplement these principles. The Code of Banking Practice (3),¹⁵ contains a code of practice to be observed by banks, building societies and card issuers when dealing with personal customers, so that a customer may have a clear explanation of the terms upon which services are offered, and proper information as to charges and interest. The effect, if any, of the code on the legal content of the banker-customer relationship has yet to be determined.¹⁶

The *Joachimson*¹⁷ case concerned a single bank account. An analysis of the relationship can be difficult when more than one account is held by the same customer, as was the case in the *Libyan Arab Foreign Bank* litigation.¹⁸ This arose out of the sanctions imposed on Libya by the USA in January 1986, freezing Libyan assets within the USA and also dollar deposits held for Libyans by US banks outside the USA. Although the precise legal analysis differed, it was held in both cases that it is the general rule that the law governing a bank account is the law of the place where the account is kept (in the absence of agreement to the contrary). It was recognised that under modern conditions it may not be strictly accurate to speak of the branch where the account

12 See, eg, *Arab Bank Ltd v Barclays Bank (DC & O)* [1954] AC 495; *Hart v Sangster* [1957] Ch 329; [1957] 2 All ER 708.

13 See, eg, *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461; *Seager v Copydex Ltd* [1967] 1 WLR 923 at 931; *Attorney-General v Guardian Newspapers Ltd (No 2)* [1990] 1 AC 109.

14 *Westminster Bank Ltd v Hilton* (1926) 135 LT 358 at 362; *Barclays Bank plc v Quincecare Ltd and Another* [1992] 4 All ER 363.

15 Code of Banking Practice (3), revised edition effective from 31 March 1999. For a full discussion, see Roberts 1995 *BJIBL* 385; Black 1996 *MLR* 24.

16 The Code of Banking Practice is described as being "voluntary". That does not mean that it will have no contractual effect. The promissory nature of the code seems to introduce new legal incidents to the banker/customer relationship. See Warne *Litigation* 31.

17 [1921] 3 KB 110.

18 *Libyan Arab Foreign Bank v Banker's Trust Co* [1989] 1 QB 728; *Libyan Arab Foreign Bank v Manufacturers Hanover Trust Co (No 2)* [1989] 1 Lloyd's Rep 608.

is "kept" in that banks no longer depend on books in which they write entries; they have terminals by which they give instructions; and the computer itself with its magnetic tape, disk or some other device may physically be located elsewhere. Nevertheless, it should not be difficult to decide where an account is kept for the purpose of ascertaining the governing law.¹⁹

The banker-customer relationship is not normally a fiduciary relationship.²⁰ It may, however, become so, as will be seen hereunder in the discussion of common-law disclosure principles and fiduciary principles arising from multi-functional banking.

2.1.2 The multi-functional bank

English law does not prescribe or limit the activities that banks may conduct, nor is there a Glass-Steagall²¹ type barrier between banking and securities business in England. Nevertheless, until the mid 1980s, banks did circumscribe their activities,²² and their exclusion from the securities business was reinforced by a Stock Exchange rule book that prevented outsiders from taking a controlling interest in member firms.²³

This and other restrictions were abolished in the series of reforms which culminated in "the Big Bang" in 1986.²⁴ The reforms in part reflected, and in part contributed to, the movement towards the financial conglomerate that aimed to provide its customers with an extended range of banking

19 Note the provisions of the Rome Convention on the Law Applicable to Contractual Obligations of 1980, given force of law in the United Kingdom on 1 April 1991 by the Contracts (Applicable Law) Act of 1990, in terms of which the basic rule is that the contract is governed by the law of the country with which it is most closely connected.

20 *Morrison v Bank of New Zealand* [1991] 3 NZLR 291 at 295 (New Zealand); *James v Australia and New Zealand Banking Group Ltd* (1986) 64 ALR 347 (Australia); *Waryk v Bank of Montreal* (1991) 85 DLR (4th) 514 (Canada); *Burmah Oil Ltd v Governor of the Bank of England* (1981) 125 Sol J 528; *The Times*, 4 July 1981; *Kelly v Cooper* [1993] AC 205; *Clark Boyce v Mouat* [1994] 1 AC 428 (England).

21 The US Glass-Steagall Act of 1933 serves to separate the core banking business of a bank from securities activities. See *Investment Company Institute v Camp* 401 US 617 (1971) at 630-633. See Blair *et al Financial Services Act* 134-144 for a discussion of the risks and abuses of a combined investment and commercial bank.

22 See Perkins 1971 *Banking LJ* 483 at 486.

23 See, eg, Dale *Deregulation* 6; Gower 1988 *MLR* 1 at 2-5.

24 The changing by the Stock Exchange of its rules to remove important restrictions, particularly permission to outside bodies to acquire a percentage of a member firm. See Gower 1988 *MLR* 1 at 2-5.

and financial services within the one group. Its emergence has had considerable regulatory implications, because the regulation of financial institutions as it has developed in the United Kingdom over the past few years has been on a functional rather than on an institutional basis. Thus, a bank's deposit-taking business was until recently regulated by the Bank of England in terms of the Banking Act of 1987. But a bank carrying on investment business within the United Kingdom is also within the regulatory regime established by the Financial Services Act of 1986. Separate authorizations are required. Most banks that need it have obtained authorization by joining one of the self-regulatory organizations (SROs) set up in terms of the Act to regulate the investment services industry.²⁵ Under the EC (Investment Services in the Security Field Directive),²⁶ host countries must draw up conduct-of-business rules incorporating the principle of avoiding conflicts of interest and, when they exist, ensuring fair treatment for customers.²⁷

This cumbersome system is in the process of being fundamentally reformed. A single financial regulator (the Financial Services Authority) has been formed, and powers of banking supervision have been vested in it in terms of the Bank of England Act of 1998.²⁸ Further legislation (the Financial Services and Markets Bill) will complete the process of unification, and a much improved regulatory system should emerge as a result.²⁹

A major problem that has arisen as a result of multi-functioning banks, is that of conflicts of interest. Although it is nothing new in the financial field,³⁰ conglomerates combining banking and securities business in the same group increase the risk of generating conflicts of interest. The policy aim is to achieve a reasonable balance between the interests of clients, who rightly expect that a firm acting for them will not have a conflict with either its own or another client's interests, and what is (apparently) the operational reality that the conduct of a modern financial services

25 Primarily the Securities and Futures Authority (SFA) and the Investment Management Regulatory Organisation (IMRO). In terms of the Rules of the SFA and IMRO, a bank must not, generally speaking, advise or deal in the exercise of a discretion where it has a material interest in the transaction, or where it has a relationship which gives rise to a conflict. See Cranston *Banking Law* 29 and Cranston (ed) *European Banking Law* 17.

26 EC Directive 93/22/EEC: [1993] OJ L141/27 s 11(1).

27 See Cranston (ed) *Single Market* 202.

28 Bank of England Act of 1998.

29 See HM Treasury *Financial Regulatory Reform*.

30 See, generally, Blair *et al* *Financial Services Act* 134-135; Criminal Justice Act of 1993. This Act replaces previous legislation and gives effect to the EC Directive (Insider Dealing) 89/592/EEC: [1989] OJ L 334/30. See Hopt & Wymeersch (eds) *Insider Dealing* 221-231.

business will inevitably give rise to some conflicts of interest. Difficult legal questions arise about whether such conflicts must be avoided or whether they can be "managed", and if they can be managed, how this should be done. These issues are presently far from being resolved.³¹

One quite long-established means of "managing" conflicts of interest is the so-called Chinese Wall. In essence, this is an arrangement by which different parts of a business are compartmentalized to avoid the leakage of sensitive information from one part to the other.³²

The effectiveness of the Chinese Wall must be judged against fiduciary law. As the Law Commission³³ has noted:

"Broadly speaking, a fiduciary relationship is one in which a person undertakes to act on behalf of or for the benefit of another, often as an intermediary with a discretion or power which affects the interests of the other who depends on the fiduciary for information and advice."

A fiduciary is one who owes special duties because of the nature of his position.³⁴ An agent is a fiduciary with regard to his principal. Thus a fiduciary relationship is capable of arising³⁵ between corporate financier and client, stockbroker and client, insurance broker and client and investment adviser and client. Other examples of fiduciary relationships are those between trustee

31 The Law Commission published a consultation paper to address these issues in 1992. See Law Commission *Fiduciary Duties*.

32 The Law Commission *Rules* par 2.16, broadly defines Chinese Walls as being procedures for restricting flows of information within an organization to ensure that information which is confidential to one department is not improperly communicated (whether deliberately or inadvertently) to other departments in the organization.

33 Law Commission *Fiduciary Duties* par 1.3.

34 See, eg, *Re Coomber*, *Coomber v Coomber* [1911] 1 Ch 723 at 728-729; *Reading v R* [1949] 2 KB 232 at 236; *Boardman v Phipps* [1967] 2 AC 46; [1966] 3 All ER 721 affirming *Phipps v Boardman* [1965] Ch 992.

35 Fiduciary duties can be imposed outside the law of trust and agency. A duty of confidence between the parties or an assumption of responsibility to act in the other's interests, has been suggested as the basis for doing so. See, eg, *White v Jones* [1995] AC 207 at 270; Glover 1995 *Bond LR* 50; Waters 1986 *Can Bar Rev* 37; Curtis 1987 *Loyola LALR* 795.

and beneficiary,³⁶ solicitor and client,³⁷ director and company³⁸ and between partners. A fiduciary relationship can also arise by virtue of the nature of special circumstances, for example because a relationship of "confidence" exists between the parties.³⁹

The duties which the law generally imposes on a fiduciary may be summarized as follows:⁴⁰

- (1) He must not place himself in a position where his own interest conflicts with that of his customer.⁴¹
- (2) He must not profit from his position at the expense of his customer.⁴²
- (3) He owes undivided loyalty to his customer, and therefore must not place himself in a position where this duty owed towards one customer conflicts with the duty that he owes to another customer.⁴³
- (4) A consequence is that a fiduciary must make available to a customer all the information⁴⁴ in his possession that is relevant to the customer for the benefit of the customer, and not for his own advantage or for the benefit of any other person.

It is difficult to generalize as to the types of factual situations in which banks will owe fiduciary

36 *Beningfield v Baxter* (1866) 12 App Cas 167; *Ellis v Barker* (1871) LR 7 Ch App 104.

37 *Wright v Carter* [1903] 1 Ch 27; *Moody v Cox and Hatt* [1917] 2 Ch 71; *Wintle v Nye* [1959] 1 All ER 552.

38 *Parker v M'Kenna* (1874) LR 10 Ch App 96; *Kaye v Croydon Tramways Co* [1898] 1 Ch 358; *Clarkson v Davies* [1923] AC 100 *Regal (Hastings) v Gulliver* [1942] 1 All ER 378.

39 See, eg, *Gibson v Jeyes* (1801) 6 Ves Jun 266; *Tate v Williamson* (1866) LR 2 Ch App 55; *Lloyds Bank Ltd v Bundy* [1975] 1 QB 326; *Coleman v Myers* [1977] 2 NZLR 225.

40 Law Commission *Fiduciary Duties* par 1.4.

41 *Aberdeen Railways Ltd v Blaikie Brothers* (1854) 1 Macq 461; [1843-1860] All ER Rep 249; *Nocton v Lord Ashburton* [1914] AC 932.

42 *Tate v Williamson* (1866) LR 2 Ch App 55.

43 Since, eg, multiple retainers are contemplated on the part of security dealers in a bank, it has been suggested that they cannot be obliged to disclose to a customer, inside information given to them by another customer for whom they also act. See *Kelly v Cooper* [1993] AC 205 at 214.

44 *Brickenden v London Loan & Savings Co and Another* [1934] 3 DLR 465; Cranston 1990 *J of Business Law* 163 at 164; *Collins Contract* 196; *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371 at 385.

duties to customers.⁴⁵ However in many cases a crucial issue will be whether the bank is providing advice to the customer. If the bank is not providing advice to the customer or is not in such a relationship with the customer that it is expected to provide advice, the courts are reluctant to impose fiduciary duties on the bank.⁴⁶ Finn has indicated that, given the general recognition that banks are commercial entities with an obvious self-interest in the business they transact, he would only expect fiduciary duties to be owed by a bank to a customer in three distinct situations:⁴⁷

- (1) where the course of the relationship can found the expectation, not only that advice will be given, but that, where necessary, advice contrary to the bank's interests will be given; or
- (2) where the bank has created the assumption that it is advising, or the expectation that it will advise in the customer's interest in a matter, because the bank's own interest therein is represented as being formal, nominal or technical; or
- (3) where the bank, though expected to act in its own interest in the actual dealing *inter se*, has created the expectation that it will advise otherwise in the customer's interests, for example on the wisdom of an investment proposal in respect of which a loan application is made.

45 Indeed it seems clear that a person can owe fiduciary duties in connection with certain areas of activity for a customer, but not in connection with others. In broad terms there are two situations where the common-law courts have imposed fiduciary duties upon banks outside trust and agency. Firstly, where the bank has assumed the role of financial adviser as promotor of a particular scheme and the customer relies on the decisions being made by the bank, to the bank's knowledge and indeed has placed complete faith in the bank. See *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371; *Hodgkinson v Simms* [1994] 3 SCR 377. Secondly, a duty is imposed where the bank has led the customer to believe that the bank will act in the customer's interest in advising it on an investment. See *Woods v Martins Bank Ltd* [1958] 3 All ER 166; see, also, *Commonwealth Bank of Australia and Another v Smith and Another* (1991) 102 ALR 453 (Australia); *Hayward v Bank of Nova Scotia* (1984) 45 OR (2d) 542; (1985) 51 OR (2d) 193 (Canada); *Collins Contract* 138.

46 Generally speaking, a bank is not undertaking to prefer the customer's interest to its own. Moreover, as a matter of policy there is a reluctance to overlay ordinary arm's length commercial relationships with fiduciary duties. See *Kelly v Cooper* [1993] AC 205 (England); *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 (Australia); *LAC Minerals Ltd v International Corona Resources Ltd* (1989) 61 DLR (4th) 14 (Canada); *DHL International (NZ) Ltd v Richmond* [1993] 3 NZLR 10 (New Zealand). This is because, in these situations, the parties are said to have adequate opportunity to prescribe their own mutual obligations, and the contractual remedies available to them to obtain compensation for any breach of those obligations should be sufficient. See Finn (ed) *Commercial Relationships* 15.

47 See Finn in an article entitled "Fiduciary Law and the Modern Commercial World" in McKendrick (ed) *Fiduciary* 11-12.

Parker Hood reaches a similar conclusion,⁴⁸ albeit in the specific context in which banks as lenders will be under fiduciary obligations. He concludes that the most likely situation is where the lender takes on the role of adviser to the borrower and is in the position where the result of this situation is a conflict of interest. Similarly, he provides three common instances of this scenario:

- (1) where it is clear that the borrowers are relying on the lender for guidance;⁴⁹
- (2) where the lender acts for both the vendor and the purchaser in a sale transaction or has them as customers, leading to a conflict of interest, particularly when the vendor has an overdraft with the lender;⁵⁰
- (3) where the lender fails to disclose material facts to the borrower or advise generally in the context of the type of situation referred to in the previous point.⁵¹

The key question will concern the role which the bank has taken in the customer's affairs⁵² and whether that gives rise to a reasonable expectation on the part of the customer that the bank should put the customer's interest before its own (and that of its other customers) and that the customer can therefore relax its consideration of its own position in the belief that the bank is taking care of this.⁵³ It is on this basis that the question of advice is thought to be so crucial in that it takes the customer into the areas described above by both Finn and Parker Hood. Thus in a situation where a customer approaches a bank for advice and receives that advice, he will reasonably expect the advice he receives to reflect his own best interests and not those of the

48 See Cranston (ed) *Risk* 23-24.

49 *Commonwealth Bank of Australia and Another v Smith and Another* (1991) 102 ALR 453 at 476; *Catt and Others v Marac Australia Ltd* (1986) 9 NSWLR 639.

50 See, also, *Woods v Martins Bank Ltd* [1958] 3 All ER 166 (England); *Commonwealth Bank of Australia and Another v Smith and Another* (1991) 102 ALR 453 (Australia); *Hayward v Bank of Nova Scotia* (1985) 51 OR (2d) 193; *McBean v Bank of Nova Scotia* (1981) 15 BLR 296; *Standard Investments Ltd v Canadian Imperial Bank of Commerce* (1985) 22 DLR (4th) 410; *Guertin v Royal Bank of Canada* (1984) 1 DLR (4th) 68; Waters 1986 *Can Bar Rev* 37; Ogilvie 1985 *Ottawa LR* 263 (Canada).

51 See, eg, *Standard Investments Ltd v Canadian Imperial Bank of Commerce* (1985) 22 DLR (4th) 410 (Canada); *Commonwealth Bank of Australia and Another v Smith and Another* (1991) 102 ALR 453 (Australia).

52 See Austin 1986 *OJLS* 444 at 446.

53 See Finn in an article in Youdan (ed) *Equity* 46-47, entitled "The Fiduciary Principle", cited with approval in the Canadian case of *LAC Minerals Ltd v International Corona Resources Ltd* (1989) 61 DLR (4th) 14 at 29; Finn 1989 *UNSWLJ* 76 at 93; Gautreau 1989 *Can Bar Rev* 1.

bank or another customer, and he will reasonably expect the bank not to act in a way which is inconsistent with his interests. Fiduciary duties will be imposed on the bank in such situations to prevent the bank from so acting or to provide the customer with an appropriate remedy in the event of the bank's so acting. Examples follow of situations where the courts have indicated that this has occurred or will occur:

- where a bank gives advice to its customer about a transaction, in which there is a serious conflict of interest between the bank and its customer, such as a bank guarantee to be given by one customer in relation to the existing indebtedness of another customer;⁵⁴
- where a bank gives investment advice or other advice to a customer in relation to financial services.⁵⁵

Two aspects of this topic need to be mentioned here. Firstly, where the borrower exercises his own independent judgment on a matter, the lender will not be liable as a fiduciary.⁵⁶ Secondly, there is a distinction between a lender's providing information and giving advice.⁵⁷ It is only in the second situation that a lender will be liable as a fiduciary.

Certain techniques have been developed in the USA and the United Kingdom to prevent or manage conflicts:

- (1) Chinese Walls as described above;⁵⁸
- (2) restricted lists and watch lists;
- (3) disclosure to customers.

A Chinese Wall isolates the trading side of the firm from the investment banking side. A

54 *Woods v Martins Bank Ltd* [1958] 3 All ER 166; *Lloyds Bank Ltd v Bundy* [1975] 1 QB 326; *National Westminster Bank plc v Morgan* [1985] AC 686.

55 Law Commission *Rules* pars 2.4.3 to 2.4.17; *LAC Minerals Ltd v International Corona Resources Ltd* (1989) 61 DLR (4th) 14; *Indata Equipment Supplies Ltd (t/a Autofleet) v ACL Ltd* [1998] 1 BCLC 412.

56 Finn in Youdan (ed) *Equity* 50; See, also, the US case of *Steinberg v Northwestern National Bank* 307 Minn 487 238 NW 2d 218.

57 *James v Australia and New Zealand Banking Group Ltd* (1986) 64 ALR 347 at 369 (Australia); *Royal Bank Trust Co (Trinidad) Ltd v Pampellone* [1987] 1 Lloyd's Rep 218 (England).

58 Law Commission *Fiduciary Duties* par 2.16; Poser 1988 9 *Michigan Yearbook of International Legal Studies* 91; Lipton & Mazur 1975 *NYU LR* 459.

restricted list prohibits recommendations to customers relating to a particular security or the solicitation of customer orders to purchase or sell a particular security, and prohibits trading for the firm's own account in the security. Another type of restricted list enables the firm to prevent activities such as the issuance of a research recommendation concerning a security. Firms frequently use a watch list to monitor trading activity to determine whether any leaks in the Chinese Wall have occurred.⁵⁹

An alternative or additional technique is the disclosure to the client of an actual or potential conflict of interest, and the obtaining of the customer's consent (in writing) to the firm continuing to act. In *Prince Jefri Bolkiah v KPMG (A Firm)*⁶⁰ Lord Millett stated that where a firm wished to undertake a transaction/assignment which was in direct conflict with the interests of the customer, only the express consent of the customer would convert the duty of confidentiality into the lesser duty to take reasonable steps to protect that confidentiality. In support of this approach, Lord Millett cited the fundamental principle of equity, that a fiduciary may not put his own interests or those of another client before those of his principal.

A general disclosure to a customer of the firm's intention to operate Chinese Walls as an established part of the firm's organizational structure may be sufficient for some purposes, but is less reliable than an express disclosure of specific circumstances. In practice, as the Law Commission has noted,⁶¹ the requirement that the disclosure to the customer be full and that consent be fully informed may make it impracticable for the bank to rely on disclosure as a way of routinely avoiding the consequences of a conflict of interest. First seeking and obtaining consent may not be practical in every situation, and secondly, and perhaps more importantly, attempts to gain advance consent in contractual agreements may founder because they would not be specific enough to cater for every situation and hence to convince a court that fully informed consent has been obtained.

Whether a Chinese Wall is effective enough in law to prevent a conflict of interest arising, or at least to relieve a firm of the consequences of such a conflict where one has arisen, has been much debated. There is little modern English case law on this matter. But in two recent cases concerning solicitors, some scepticism was expressed by the courts as to the effectiveness of

59 Lipton & Mazur 1975 *NYU LR* 459 at 466-468; Brudney 1979 *Harvard LR* 322; Warne *Litigation* 46-47; Cranston (ed) *European Banking Law* 19.

60 [1999] 1 All ER 517.

61 Law Commission *Fiduciary Duties* pars 2.12 to 2.15.

Chinese Walls, one judge doubting whether an impregnable wall can ever be created.⁶²

However, it is possible to argue that rules that apply to solicitors should not necessarily apply in the financial field. Indeed, in the financial services field there is statutory recognition of the practice. Section 48 (2) (h) of the Financial Services Act of 1986, (which provides for the making of conduct-of-business rules) enacts that such rules may make provision enabling or requiring information obtained by an authorised person in the course of his carrying on one part of his business to be withheld by him from persons with whom he deals in the course of his carrying on another part, and for that purpose enabling or requiring persons employed in one part of that business to withhold information from those employed in another part. Rules to this effect have been promulgated.⁶³ Judicial recognition of the potential efficacy of Chinese Walls for managing conflicts of interest within financial services firms has only come recently. In *Prince Jefri Bolkiah v KPMG (A Firm)*⁶⁴ the House of Lords, while considering the efficacy of Chinese Walls within a major accounting firm, endorsed the "good practice [in the financial industry which] requires there to be established institutional arrangements designed to protect the flow of information between separate departments".

The effect of the above provisions of the Financial Services Act of 1986 and the Core Rules on the general law relating to fiduciaries as it applies in the financial context is unclear. The Law Commission "inclines to the view"⁶⁵ that section 48 (2) (h) of the Financial Services Act of 1986, authorizes modification of the private-law rights and duties of those dealing with persons authorised in terms of the Act, albeit within its limited sphere. Its provisional view is that fiduciary law should take account of rules made by regulatory bodies which operate in the public-law sphere, either because there is statutory authority to make rules to modify common law and equitable obligations or because the court should take account of reasonable regulatory rules in ascertaining the precise content of the common law or equitable duty.⁶⁶ It is believed that such

62 *Re A Firm of Solicitors* [1992] 1 All ER 353 at 363; see, also, *Lee (David) & Co (Lincoln) Ltd v Coward Chance (A Firm) and Others* [1991] Ch 259; *Mortgage Express Ltd v Bowerman & Partners (A Firm)* The Times, 19 May 1994. See, however, *Prince Jefri Bolkiah v KPMG (A Firm)* [1999] 1 All ER 517.

63 Cranston *Banking Law* 28 shows as examples, the Core Conduct of Business Rules, r 36, as reproduced in the self-regulatory organizations (SRO) Rules, and the Investment Management Regulatory Organization (IMRO) Rules, Chapter 1.4, r 4.2(1).

64 [1999] 1 All ER 517.

65 Law Commission *Rules* 238.

66 *Ibid*, at 242.

an approach would commend itself to the courts.⁶⁷ If that is correct, then it may be predicted that a properly implemented Chinese Wall may be effective in certain circumstances to prevent what would otherwise be a conflict of interest arising, or at least may relieve a firm of what would otherwise be the legal consequences of such a conflict.

2.1.3 Banker's confidentiality

English law holds that certain confidential relationships, such as those between lawyer and client and doctor and patient, give rise to a duty not to disclose information acquired in confidence.⁶⁸ In the leading case of *Tournier v National Provincial and Union Bank of England*⁶⁹ it was held by the Court of Appeal that a similar prohibition applies to the banker-customer relationship.⁷⁰ It is an implied term of the contract⁷¹ between them that the bank is under a duty to abstain from disclosing information about its customer's affairs without the customer's consent.⁷² This is generally known as the bank's duty of confidentiality, or secrecy.⁷³ It also applies to prevent disclosure between one separate juridical entity in a group and another.⁷⁴

67 See *Prince Jefri Bolkiah v KPMG (A Firm)* [1999] 1 All ER 517.

68 *Allcard v Skinner* (1887) 36 Ch D 145; *Parry-Jones v The Law Society* [1968] 1 All ER 177 at 180; *Lloyds Bank Ltd v Bundy* [1975] 1 QB 326; *English v Dedham Vale Properties Ltd* [1978] 1 All ER 382; *Chitty Contracts* 424; *Collins Contract* 197.

69 [1924] 1 KB 461; See, also, *Christofi v Barclays Bank plc* [1998] 2 All ER 484 (England); Posner 1978 *Georgia LR* 393; Wacks 1990 *VandJTrans L* 653 at 656-658 (USA).

70 When the matter of secrecy had been litigated some half a century before the *Tournier* case, [1924] 1 KB 461, the courts implied that, while expected, the observance of secrecy by a bank was a matter of moral, not legal, obligation. See, eg, *Tassell v Cooper* (1850) 9 CB 509; *Hardy v Veasey* (1868) LR 3 Ex 107; cf *Foster v Bank of London* (1862) 3 F & F 214.

71 It may also arise in equity, see *Seager v Copydex Ltd* [1967] 1 WLR 923 at 931, Lord Denning MR; *Attorney-General v Guardian Newspapers Ltd (No 2)* [1990] 1 AC 109, or in negligence under the principles enunciated in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465. See *Vita Health Co (1985) Ltd v Toronto-Dominion Bank* (1993) 51 CPR (3d) 72 and cf *Spring v Guardian Assurance plc* [1994] WLR 354.

72 The *Tournier* case, *ibid*, [1924] 1 KB 461 at 484.

73 See, also, Walter & Ehrlich 1989 *ALJ* 404; Paget's *Banking* 10 257-264; Waters (ed) *Equity* Ch 8; Cranston (ed) *European Banking Law* 15; Effros (ed) *Legal Issues* 239-240.

74 *Bank of Tokyo Ltd v Karoon* [1987] AC 45 at 53-54; Blair *et al Financial Services Act* 135 *et seq*.

Information will be considered confidential if it satisfies three characteristics:⁷⁵

- (1) The information transferred was not in the public domain.
- (2) The circumstances of the transfer are such that the recipient is under a duty to the confider with respect to the information.
- (3) The information has been used for a purpose other than that for which it was intended.

In the *Tournier*⁷⁶ case the Court was unanimous in holding that the duty is not an absolute, but a qualified one. The qualifications were classified under four heads,⁷⁷ namely:

- (1) where disclosure is under compulsion by law;⁷⁸
- (2) where there is a duty to the public to make disclosure;⁷⁹
- (3) where the interests of the bank require disclosure,⁸⁰
- (4) where the disclosure is made by the express or implied consent of the customer.⁸¹

75 *Coco v AN Clark (Engineers) Ltd* [1969] RPC 41 at 47; *LAC Minerals Ltd v International Corona Resources Ltd* (1989) 61 DLR (4th) 14 (Canada); *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 (Australia); *Thomas Marshall (Exports) Ltd v Guinle* [1978] 3 All ER 193; [1979] 1 Ch 227 at 248 and *Attorney-General v Guardian Newspapers Ltd (No 2)* [1990] 1 AC 109 (England).

76 [1924] 1 KB 461.

77 The *Tournier* case, *ibid*, [1924] 1 KB 461 at 473.

78 See, eg, the Companies Act of 1985 (as amended); Banker's Book Evidence Act of 1879; Drug Trafficking Offences Act of 1986; *Bankers Trust Company v Shapira* [1980] 3 All ER 353; *Barclays Bank plc (t/a Barclaycard) v Taylor* [1989] 1 WLR 1066; [1989] 3 All ER 563; *Robertson v Canadian Imperial Bank of Commerce* [1994] 1 WLR 1493; [1995] 1 All ER 824.

79 *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] 1 QB 728 at 770-771; *Price Waterhouse (A Firm) v BCCI Holdings (Luxembourg) SA* [1992] 1 All ER 778; *El Jawhary v Bank of Credit and Commerce International SA* [1993] BCLC 396.

80 *Bank of Tokyo Ltd v Karoon* [1987] 1 AC 45. The Review Committee *Banking Services* 35-37 considered this qualification as vague and suggested that the interests of the bank should be specifically defined.

81 This category is most relevant to bank references, particularly when a reference is given without the express consent of the customer. In view of the English Code of Banking Practice (2) and (3) which determines that, before there is disclosure of the customer's details, the customer's consent should be obtained, the scope for lender liability in this area should be reduced. Unauthorized disclosure by the bank gives rise to a cause of action in favour of the customer for damages or compensation in equity for losses suffered.

There are a growing⁸² number of instances in which the "compulsion by law" qualification applies.⁸³ Thus, a bank must provide information pursuant to an inspection order by the court in terms of the Bankers' Books Evidence Act of 1879. However "law" appears to refer to English law, so that a foreign *subpoena* to produce documents in a foreign court will not fall within the ambit of English law.⁸⁴ More recent examples of legislation under which information must be provided include the Police and Criminal Evidence Act of 1984 and the Drug Trafficking Act of 1994 which, together with the Money Laundering Regulations of 1993, place substantial duties on banks in respect of both the opening and operation of accounts, to prevent money laundering. The effect of s 98 of the Criminal Justice Act of 1988 is that a bank may disclose to the police its suspicion or belief that property has been obtained in connection with the commission of an indictable offence, without breach of its duty of confidentiality. In *Barclays Bank plc (t/a Barclaycard) v Taylor*⁸⁵ it was held that a banker need not advise the customer of proposed disclosures of information under compulsion of statute and need not to be seen as resisting the demand for disclosure.

There is little authority concerning "duty to the public to disclose"; one case indicates that this qualification might include disclosure by a bank to the central bank, of sensitive information.⁸⁶

The interests of the bank will require disclosure when, for example, it states the details of the account in legal proceedings to recover a customer's indebtedness.⁸⁷

82 *Warne Litigation* 283 describes it as a "torrent" of legislation in recent years. In England, there are now in excess of 20 statutes which require or permit disclosure by the banks of confidential customer information.

83 See, eg, the Companies Act of 1985 (as amended); Banker's Book Evidence Act of 1879; Drug Trafficking Offences Act of 1986; *Bankers Trust v Shapira* [1980] 3 All ER 353; *Barclays Bank plc (t/a Barclaycard) v Taylor* [1989] 3 All ER 563; *Robertson v Canadian Imperial Bank of Commerce* [1995] 1 All ER 824.

84 *XAG and Others v A Bank* [1983] 2 All ER 464.

85 [1989] 3 All ER 563; As Lord Diplock LJ put it in one case, the overriding duty to disclose is a duty to comply with the law of the land. See *Parry-Jones v The Law Society* [1968] 1 All ER 177.

86 *Libyan Arab Foreign Bank v Banker's Trust Co* [1989] 1 QB 728 at 770-771; *Price Waterhouse (A Firm) v BCCI Holdings (Luxembourg) SA* [1992] 1 All ER 778; *El Jawhary v Bank of Credit and Commerce International SA* [1993] BCLC 396.

87 See *Sunderland v Barclays Bank Ltd* (1938) 5 LDAB 163; *The Times*, 24 and 25 November 1938; *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461 at 473.

The fourth qualification concerns disclosure made with the express or implied consent of the customer. Implied consent may justify the well-established practice by which banks give credit references concerning customers at the request of other banks without asking on each occasion for the customer's express consent.⁸⁸ Reporting in 1989, the Review Committee on Banking Services Law and Practice⁸⁹ recommended that a bank should be able to rely on implied consent only if could show that the customer was aware of the purpose for which the consent was required, and advised that he was free to withhold his consent. This recommendation has not been adopted.⁹⁰

The Review Committee regarded the duty of confidentiality as being at the heart of the banker-customer relationship,⁹¹ and was concerned that this confidentiality was being gradually eroded.⁹² The Government's response was that broader public policy issues often overrode the need to preserve confidentiality. It is submitted that although there are plainly many instances in which the duty must be treated as subordinate to the public interest, the Committee was right to stress the desirability of preserving it where possible.

The Review Committee's report has not been entirely without practical results. It appears that banks have routinely circulated information about their customers within the group for the purpose of marketing non-banking services. The Code of Banking Practice⁹³ now states that banks will observe a strict duty of confidentiality about their customers' (and former customers') personal financial affairs and, in the absence of express consent, will not disclose details of customers' accounts or their names and addresses to any third party, including other companies in the same group, other than in the four exceptional cases permitted by the law.

88 In *Tournier v National Provincial Union Bank of England* [1924] 1 KB 461, Aitken LJ, speculated, without deciding, that banker's references are given with the implied consent of the customer. This is a controversial issue, as can be seen from the discussion in the Review Committee *Banking Services* par 6.26 *et seq.* A leading commentator on the English law of breach of confidence suggests that the duty's precise legal source in the common law is secondary to the underlying notion; he argues for the existence of a *sui generis* action. See Gurry *Breach of Confidence* 58; see, also, Goff & Jones *Restitution* 683-686.

89 Hereinafter referred to as the Review Committee *Banking Services*.

90 Review Committee *Banking Services* pars 6.26 *et seq.* As regards personal customers, the Code of Banking Practice (2) states that, on request, banks will explain how the system of banker's references works.

91 Review Committee *Banking Services* par 5.26.

92 *Ibid.*, at par 5.08.

93 Code of Banking Practice (2) par 9.1.

2.1.4 Banker's liability for advice

When a bank advises a customer on financial matters it must, of course, do so while recognizing that there is no general duty that banks have to advise their customers. Thus, it has been held that in general a bank does not owe a customer a duty to advise on the prudence of borrowing,⁹⁴ tax implications,⁹⁵ and that a bank's duty of care does not extend to requiring it to advise the customer of the risks involved in the collecting of cheques.⁹⁶

Liability for negligent advice may be founded in contract or in tort.⁹⁷ A legal duty to advise may arise out of a misrepresentation (including a failure to speak or act and conduct capable of giving

94 *Williams and Glyn's Bank Ltd v Barnes* [1981] Com LR 205; *Lloyds Bank plc v Cobb* (unreported, December 18, 1991, CA) per Scott LJ noted in [1992] JBL 419; *Lipkin Gorman (A Firm) v Karpnale Ltd* [1989] 1 WLR 1340 at 1356; [1992] 4 All ER 512 (England); *Redmond v Allied Irish Bank plc* [1987] 2 FTLR 264 at 266 (Ireland); *Weitzman v Hendon* (1989) 61 DLR (4th) 525 at 547 (Canada). The "neighbourhood principle" enunciated in *Donoghue v Stevenson* [1932] AC 562, could not be extended to a lending transaction, where moneys were lent as requested. See, in general, Andrew [1989] JIBL 101 at 104; Nestell (1990) ALJ 776.

95 *Schioler v Westminster Bank Ltd* [1970] 3 All ER 177.

96 In *Redmond v Allied Irish Bank plc* [1987] 2 FTLR 264 Saville J drew a distinction between a duty to advise and a duty to take reasonable care in ascertaining, interpreting and acting in accordance with the customer's instructions. The undoubted existence of the latter duty did not imply a duty to advise as to the wisdom of what the customer instructed the bank to do. This approach was confirmed in the decision in *Honourable Society of the Middle Temple v Lloyds Bank plc* [1999] 1 All ER 193, where Rix J applied Saville J's reasoning in the *Redmond* case, *ibid*, to the banker-customer relationship between a domestic bank and a foreign correspondent bank, commenting that, if anything, a customer bank should be in a better position to look after itself. Moreover, he accepted the submission that an English clearing bank has no duty to its foreign correspondent banks to advise them of every aspect of English law, just as it does not expect to be advised by its correspondent banks of the foreign banking law to be observed in all the countries of the world.

97 Liability in tort and contract are separate and distinct. There can be an overlapping, particularly in cases of negligent misrepresentation, and particularly in the precontractual situation. See *Esso Petroleum Co Ltd v Mardon* [1976] 2 All ER 5; *Howard Marine and Dredging Co Ltd v A Ogden & Sons (Excavations) Ltd* [1978] 2 All ER 1134; *Midland Bank Trust Co Ltd v Hett Stubbs and Kemp* [1979] Ch 384. In regard to concurrent liability, the House of Lords recently ruled in *Henderson and Others v Merrett Syndicates Ltd and Others* [1994] 3 WLR 761, (see, also, [1995] 2 AC 145) that where there is an assumption of responsibility, in terms of the principle enunciated in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465, which is not inconsistent with, or excluded by, an existing contractual chain or structure between the parties, there can be concurrent liability in contract and tort.

rise to an estoppel).⁹⁸ A duty may also arise where there has been a voluntary assumption of responsibility to advise, and reliance on that assumption.⁹⁹ Finally, a duty may arise from a fiduciary relationship,¹⁰⁰ or through regulation.¹⁰¹

Reference must here be made to the third edition of the Banking Code.¹⁰² The first two editions of the code used language consistent with a public declaration of good intentions, rather than evidencing an intention to affect the bank's legal relationships with its relevant customers. The third edition of the Code, however, is expressed rather differently. It begins with a number of "Key Commitments" expressed in unequivocally promissory language, for example:

"We, the subscribers to the Code, promise that we will:

- * act fairly and reasonably in all our dealings with you;
- * give you information on our services and products in plain language, and offer help if there is any aspect which you do not understand;
- * help you to choose a service or product to fit your needs;
- * help you to understand the financial implications of:
 - a mortgage;
 - other borrowing;
 - savings and investment products;
- * consider cases of financial difficulty and mortgage arrears sympathetically and positively."

This promissory language is continued throughout the text. These "promises" seem to introduce new legal incidents to the banker-customer relationship. It remains to be seen whether the Code will be found in practice to increase the number of claims against banks for failing to give advice, and if it does, what proportion of such claims will be successful.¹⁰³

98 *Chitty Contracts* 368.

99 *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465; *Box v Midland Bank plc* [1979] 2 Lloyds Rep 391.

100 *Woods v Martins Bank Ltd* [1958] 3 All ER 166 (England); *Hayward v Bank of Nova Scotia* (1984) 45 OR (2d) 542 (Canada); *Catt and Others v Marac Australia Ltd* (1986) 9 NSWLR 639; *Commonwealth Bank of Australia and Another v Smith and Another* (1991) 102 ALR 453 at 476 (Australia).

101 Eg, in terms of the Financial Services Act of 1986.

102 Code of Banking Practice (3), effective from July 1, 1997.

103 See Warne *Litigation* 31.

Although there are many situations in which banks owe no duty to advise they very often do so. Once a bank has taken it upon itself to give advice, whether or not it had a duty to do so, it is difficult to avoid the implication of a duty to advise with reasonable skill and care¹⁰⁴ (that is the care and skill of a reasonable bank in carrying on its advisory duties), unless perhaps the advice is so general or the circumstances are such that it could not have been reasonably expected that the customer would act upon it.

It is sometimes suggested that a bank is not liable for negligent advice unless the advice was specifically requested by the customer. There is no basis for such a view. The fact that the bank has accepted a request for advice may be cogent evidence that it has assumed responsibility for the advice it gives, but a request is in no sense a condition precedent. The Court of Appeal has now held that an antecedent request is not necessary where the advice given is within the scope of the bank's business.¹⁰⁵

In order to determine the scope of the bank's business, its advertisements and other publications (not including confidential internal instructions) may all be taken into account. Such publications frequently invite customers to consider the bank as a source of financial and commercial advice of various kinds. This was a feature of the well-known case of *Verity v Lloyds Bank plc*.¹⁰⁶ In that case the plaintiffs wished to buy a property with a view to making improvements, and then to sell it at a profit. As customers of the defendant bank they had seen its pamphlet entitled "Starting

104 See, eg, *Cornish v Midland Bank plc (Humes third party)* [1985] 3 All ER 513 at 520. A duty of reasonable care and skill for anyone providing a service (including giving advice) runs through contract, tort and fiduciary law. In a banking law context, the duty is to exercise the care and skill of a reasonable bank in carrying out the particular activity concerned. See, eg, *Barclays Bank plc v Quincecare Ltd and Another* [1992] 4 All ER 363; *Lipkin Gorman (A Firm) v Karpnale Ltd* [1989] 1 WLR 1340. Very occasionally it is stated explicitly as a standard, as in the Uniform Customs and Practices for Documentary Credits, which are regularly incorporated by reference into letter-of-credit contracts. See UCP 500 art 13 (a). Section 13 of the Supply of Goods and Services Act of 1982 implies a term to this effect in contracts for the supply of a service in the course of a business. Mostly, however, the duty of reasonable care and skill is a duty imposed as a matter of common law.

After the challenge to concurrent liability in contract and tort posed by the banking case of *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd* [1986] AC 80, it is now settled that a claimant may seek compensation for economic loss caused through the failure to exercise reasonable care and skill in both contract and tort, where the assumption of responsibility is not inconsistent with, or excluded by, an existing contractual chain or structure between the parties. See *Henderson and Others v Merrett Syndicates Ltd and Others* [1995] 2 AC 145.

105 *Morgan v Lloyds Bank plc* [1998] Lloyd's Rep 73.

106 [1995] CLC 1557.

a Business", which proclaimed among other things: "We don't help only with money. Our advice is tailor-made, confidential and free." They approached their bank manager for advice and to raise the necessary finance. The manager went with them to inspect two properties. He expressed reservations about the first, but he advised them that the second was financially viable and encouraged them to proceed with it. For several foreseeable reasons, the project went spectacularly wrong. The judge held that the plaintiffs had made it clear to the bank manager that they were seeking his advice on whether the project was a "sensible thing for them to do", and that the manager had responded to this request by agreeing to advise them on the viability of the project and to assist them in setting it up. He found that if the manager had exercised reasonable care and skill in advising the plaintiffs, he would have told them plainly that the project was not a sensible thing for them to do and that they should forget about it. The plaintiffs would not then have entered into the transaction and would not have suffered the losses which they did suffer.

The *Verity*¹⁰⁷ case decides no new principle of law. It illustrates the way in which a bank's literature may be relevant in determining the scope of its business, although on the facts the bank might well have been liable even without the bank's literature advertising this kind of assistance. The manager had gone to extraordinary lengths to involve himself in his customer's project. It would have been difficult for the bank to argue that the manager did not have apparent authority to act as he did. The case may well have been decided in the same way even in the absence of any promotional literature offering general financial advice.

It is important to keep in mind the distinction between claims based on a failure to advise and claims based on negligent advice. Where it is alleged that the bank has failed to advise on a particular topic mentioned in the bank's promotional literature the bank's answer may well be to say that no such advice was requested. In *James v Barclays Bank plc*¹⁰⁸ the bank's literature advertised the availability of a comprehensive range of advisory services to farmers. Striking out the plaintiff's notice of appeal, Millet LJ stated that:

"although the promotional literature put in front of us shows that the bank would no doubt have given comprehensive financial advice to the appellants if they had sought it, it does not suggest for a moment that the bank was willing to undertake the quite different obligations of general financial adviser so as to become responsible for volunteering advice from time to time even though it was not sought".¹⁰⁹

107 *Verity v Lloyds Bank plc* [1995] CLC 1557.

108 [1995] 4 Bank LR 131.

109 *Ibid*, at 135.

Liability for negligent advice may be founded in contract or in tort.¹¹⁰ Where the plaintiff is a customer, the claim will generally be made in contract. Where the plaintiff is not a customer, but a prospective customer or guarantor, the claim will be made in tort. The basis of liability will be the bank's voluntary assumption of responsibility for the advice given, on the principle in *Hedley Byrne & Co Ltd v Heller & Partners Ltd*.¹¹¹ Of interest in this regard is *Box v Midland Bank plc*.¹¹² In that case the plaintiff applied for a loan of £ 45,000 from the defendant bank. The defendant's manager said that the application would have to be approved by his head office, but carelessly indicated that this was a mere formality when in fact there was never the slightest possibility that the facility would be approved. The plaintiff incurred irrecoverable expenses in reliance on the manager's statements and succeeded in a claim for damages against the bank.

Much of the recent case law has concerned the nature of a bank's duty to advise in the case of third-party security, particularly where the security is to be given by the principal debtor's wife, or some other person closely related to him. It is clear that, in general, a creditor does not owe any legal duty to a proposed surety to explain to the surety the effect of the proposed suretyship transaction or the effect of any security proposed to be given.¹¹³ This applies notwithstanding the fact that the internal rules of many (or most) banks have for a long time contained instructions to the effect that a proposed surety should receive such an explanation, or be told to obtain independent legal advice.

There are good reasons for this course because, unless a bank has advised the proposed surety to take independent legal advice as to the nature of the transaction, it risks finding itself fixed with any undue influence that has been exerted by the debtor to obtain the security, or with any

110 English Courts, whilst not imposing greater liability in tort than in contract, when there is a contract between the parties giving rise to liability (see *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd* [1986] AC 80) are now more ready to allow concurrent liability provided the imposition of liability in tort is not excluded by the contractual structure. See *Spring v Guardian Assurance plc* [1994] 3 WLR 354; *Henderson and Others v Merrett Syndicates Ltd and Others* [1995] 2 AC 145. The Courts, however, it would appear, will rarely award punitive damages: which are tortious, and not contractual.

111 [1964] AC 465.

112 [1979] 2 Lloyds Rep 390.

113 *O'Hara v Allied Irish Banks Ltd* [1985] BCLC 52 at 53; *Barclays Bank plc v Khaira and Another* [1992] 1 WLR 623; *Chetwynd-Talbot v Midland Bank Ltd* 132 NLJ 901. It has been said, *obiter*, that such a duty may be owed by a bank where the surety is the bank's customer. See *Cornish v Midland Bank plc (Humes, third party)* [1985] 3 All ER 513 at 522-523.

misrepresentation that has been made by the debtor to the surety.¹¹⁴ It has been held that a bank is so affected where the debtor acted as its agent in obtaining the security, and where it was on notice of the undue influence or misrepresentation.¹¹⁵

Thus, it was held that if a creditor, or potential creditor, of a husband desires to obtain, by way of security for the husband's indebtedness, a guarantee from the husband's wife or a charge on the property of his wife, and if the creditor entrusts to the husband himself the task of obtaining the execution of the relevant document by the wife, then the creditor can be in no better position than the husband himself, and the creditor cannot enforce the guarantee or the security against the wife if it is established that the execution of the document by the wife was procured through the undue influence of the husband, and the wife had no independent advice.¹¹⁶ The same principle applies in the case of a husband who in similar circumstances procures the execution of the document by giving his wife a deliberately false explanation.¹¹⁷

In the leading case of *Barclays Bank plc v O'Brien and Another*¹¹⁸ much of the old law was swept away. The House of Lords held that the applicable principle in terms of which a lender incurs liability for the wrongdoing of a third party (thereby preventing the enforcement of a security) is that of notice. The court held that in certain situations, such as that which arises when a couple lives together,¹¹⁹ constructive notice will exist unless the bank has taken certain steps to see that

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- 114 The advantages and pitfalls of independent advice will be discussed in the *excursus* to this thesis.
- 115 *National Westminster Bank plc v Morgan* [1985] AC 686; *Bank of Credit and Commerce International SA v Aboody and Another* [1990] 1 QB 923 at 979.
- 116 *Kingsnorth Trust Ltd v Bell and Another* [1986] 1 WLR 119; *Coldunell v Gallon* [1986] 1 All ER 429; *Midland Bank plc v Perry and Perry* [1988] 1 FLR 161; *Bank of Baroda v Shah* [1988] 3 All ER 24; *Bank of Credit and Commerce International SA v Aboody and Another* [1990] 1 QB 923.
- 117 *Kingsnorth Trust Ltd v Bell and Others* [1986] 1 All ER 423 at 427.
- 118 [1993] 4 All ER 417; [1994] 1 AC 180. This case was not followed in Australia as will be discussed in the Australian Chapter of this thesis. For a more detailed discussion of this important case see, eg, Stallworthy 1994 *JIBL* 118; Gross & Wolfson 1994 *BJIBFL* 265 (in which reference is made to the following unreported cases; *Allied Irish Bank v Byrne* [1995] 1 FCR 430; *Bank Melli Iran v Samadi-Rad* (Unreported, February 9, 1994)); Harrison 1993 *SolJ* 1126, and cf *Midland Bank plc v Serter* [1995] 1 FLR 1034.
- 119 The relationship must be of a close emotional or economic nature, may be heterosexual or homosexual, and need not have involved cohabitation. See *Massey v Midland Bank plc* [1995] 1 All ER 929; Hooley 1995 *LMCLQ* 346; Stallworthy 1994 *JIBL* 118; Berg [1994] *LMCLQ* 34.

the proposed surety was fairly apprised of his or her legal position.¹²⁰ There have been a large number of decisions by the Court of Appeal since then, and it is clear that a bank will normally avoid difficulties in enforcing a guarantee or other security by recommending to the proposed surety that he or she take independent legal advice.¹²¹

As far as personal customers are concerned, the Mortgage Code of Practice of 1997 states that banks will advise private individuals proposing to give them a guarantee or other security for another person's liabilities, that by giving the guarantee or third-party security they might become liable instead of or as well as that other person, and that they should take independent legal advice. Guarantees and other third-party security forms will contain a clear and prominent notice to this effect. Unlimited guarantees are no longer taken.

120 In the *O'Brien* case, *ibid.*, [1993] 4 All ER 417 at 431-432, the Court went so far as to insist that the bank call in the wife for a private meeting, in the absence of the husband, where she is told of the extent of her liability, the risks, and where she should be urged to obtain independent advice.

121 It would appear as if the English Courts place great faith in solicitors and expect that, regardless of who is paying the fee, solicitors will regard themselves as owing an exclusive duty to the person being advised and the advice they give will be appropriate. See *Bank of Baroda v Rayarel* [1995] 2 FLR 376; *Midland Bank plc v Sertter* [1995] 1 FLR 1034.

2.2 DISCLOSURE PRINCIPLES: ENGLISH COMMON LAW

2.2.1 The role of good faith in English contract law

In England, in all transactions and relations known to the law, the parties owe each other a general duty of truthfulness.¹²² Any departure from this duty constitutes, under certain conditions,

122 There is no general duty in English law to negotiate nor to perform contracts in good faith, although, of course, ideas of good faith are often incorporated into the law through specific legal doctrines like mistake, or implied terms. See Atiyah *Contract* 266; Zimmermann & Whittaker (eds) *Good Faith* 45-47. There are, however, to be found, in old as well as modern English cases, a number of assertions inconsistent with the view that there is no duty of disclosure, or of good faith. Thus, in *Mellish v Motteaux* (1792) Peake 156, Lord Kenyon said:

"In contracts of all kinds, it is of the highest importance that courts of law should compel the observance of honesty and good faith."

Similar *dicta* can be found in *Blisset v Daniel* (1853) 10 Hare 493 at 522; *British Equitable Insurance Co v Great Western Railway Co* (1868) 38 LJ Ch 132 at 135. In *Phillips v Homfray*, *Fothergill v Phillips* (1871) LR 6 Ch App 770 at 778, Lord Hatherley LC said:

"This court requires the utmost good faith between buyer and seller, and will not specifically enforce a contract which is not entirely according to good faith."

In respect of decisions prior to 1865, the English Reports references of the cases have been included in the bibliography.

Some modern Canadian cases have asserted that the vendor of a house has a duty to reveal material facts, at any rate if dangerous to the purchaser's health. See *Rowley v Isley* (1951) 3 DLR 766; *McGrath v McLean* (1979) 95 DLR (3d) 144 at 151.

A recent English case, *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] QB 433 at 445 makes reference to the duty of good faith, but states that English law has, characteristically, committed itself to no such overriding principle, but has developed piecemeal solutions in response to demonstrated problems of unfairness.

Despite these suggestions, however, the general position against a duty of disclosure has been reaffirmed in recent English and Commonwealth cases. See *Stephenson v Toronto-Dominion Bank* (1989) 68 OR (2d) 118; *Queen v Cognos* (1990) 69 DLR (4th) 288 (Canada); *Banque Financière de la Cité SA v Westgate Insurance Co Ltd* sub nom *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1990] 2 All ER 947; *Walford v Miles* [1992] 2 AC 128 (England).

Collins *Contract* 169 points out that the Courts are reluctant to acknowledge a general principle of good faith. His objection is that the meaning of the idea is obscure. It tends to function, as pointed out by Summers 1968 *Virginia LR* 195, as a negative concept in practice. Collins *Contract* 169-170, argues that the sources of pre-contractual obligations can be usefully conceived as deriving from a general principle, namely a duty to negotiate with care. Be that as it may, in regard to consumer contracts, the concept of good faith will play an increasingly larger role in English law in accordance with European Union

a misrepresentation which is actionable at the suit of the person who has been misled. English law has traditionally taken the view that it is not the duty of the parties to a proposed contract to give information to each other.¹²³ Each party must make up his own mind and exercise his own judgment in deciding whether to contract or not, and it is not the duty of either party to put before the other facts of which he has knowledge and which may influence the other in deciding whether to enter into the contract or not.¹²⁴ There are also specific types of transaction and relation, where the law recognizes that the parties are obliged not merely to state truly whatever is stated, but also to divulge with candour and completeness, facts, which, in other cases, there would be no obligations to disclose at all. There are two principal classes of such cases. In the first of these, the duty has its origin and justification in the nature of the transaction into which the parties are about to enter. The parties need as yet be in no relationship one with the other; it is the nature of the contemplated transaction, and this alone, which generates a duty of disclosure between them.¹²⁵ In the second class the duty of disclosure does not depend at all on the nature of the transaction — this is, at most, of secondary importance only, and often of no significance at all. In this class the duty is generated by a relationship of confidence, or influence, or advantage, existing between the parties, laying upon one of them the duty of disclosing to the other all material facts.¹²⁶

Generally, the law requires no more from one party to a transaction, than to speak the truth, if

commitments. See EC Directive (Unfair Terms in Consumer Contracts) 93/13 EEC:[1993] OJ L95/29.

- 123 Collins *Contract* 171 states that the law imposes a duty of care on parties to negotiations for a contract when they make statements to one another. The duty requires that statements of fact are made with reasonable care in the light of the specialized knowledge and expertise of the representor.
- 124 See Atiyah *Contract* 265; *Fox v Mackreth* (1788) 2 Bro CC 400; *Bell v Lever Brothers Ltd* [1932] AC 161.
- 125 In certain contracts where, from the very necessity of the case, one party alone possesses full knowledge of all the material facts, the law requires him to show *uberrimae fides*. See Cheshire *Contract* 302; *Bell v Lever Brothers Ltd* [1932] AC 161; *MacKender v Feldia AG* [1967] 2 QB 590. This obligation is particularly common in insurance cases. See, eg, *Lambert v Co-operative Insurance Society* [1975] 2 Lloyds Rep 485; *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1994] 3 All ER 581.
- 126 Cheshire *Contract* 307 states that this group is classified as "Constructive Fraud". Whenever the relation between the parties to a contract is of a confidential or fiduciary nature, the person in whom the confidence is reposed and who thus possesses influence over the other cannot hold that other to the contract unless he satisfies the court that it is advantageous to the other party and that he has disclosed all material facts. See Cheshire *Contract* 307-308; *Tate v Williamson* (1866) LR 2 Ch App 55 at 61; *Moody v Cox and Hatt* [1917] 2 Ch 71 at 88; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134n.

anything at all is said; in the special situations dealt with in this thesis the law exacts not merely a deliverance of "the truth and nothing but the truth", but a full revelation of "the whole truth".¹²⁷

2.2.2 Important definitions: disclosure

English law has traditionally taken the view that it is not the duty of the parties to a proposed contract to give information to each other.¹²⁸ Mere silence does not amount to concealment.¹²⁹ Each party must make up his own mind and exercise his own judgment in deciding whether to contract or not, and it is not the duty of either party to put before the other facts of which he has knowledge and which may influence the other in deciding whether to enter into the contract or not.¹³⁰ In the commercial sphere this approach is closely associated with the economic basis of English society. The whole essence of trade and business in a free-enterprise society is that parties compete with each other at arms' length, that is, on a footing of equality. Each party is entitled to make use of what information he has in order to obtain the best bargain he can get; neither party is under any obligation to assist the other party. In a sense all this is of the essence of freedom of contract and free enterprise, and it is doubtful whether trade and commerce could operate in the way it does on the basis of any other rule in the ordinary way.¹³¹ That does not mean that English law does not require disclosure under certain circumstances, as will be seen hereunder.¹³² The general pattern of the law requires disclosure of the terms of the contract, and

127 *Re Banister* (1879) 12 Ch D 131 at 136; *Re Marsh and Earl Granville* (1882) 24 Ch D 11 at 17.

128 *Ward v Hobbs* (1878) 4 App Cas 13; *Percival v Wright* [1902] 2 Ch 421; but cf *Hurley v Dyke* [1979] RTR 265.

129 "Aliud est celare, aliud tacere; neque ego nunc te celo, si tibi non dico, quae natura deorum sit, qui sit finis bonorum, quae tibi plus prodesent cognita quam tritici vilitas; sed non, quicquid tibi audire utile est, idem mihi dicere necesse est." Cicero *De Officiis* Book 3 ch 13. Translated, the passage states that:

"It is one thing to conceal, not to reveal is quite a different thing. At this present moment I am not concealing from you, even if I am not revealing to you, the nature of the gods or the highest good; and to know these secrets would be of more advantage to you than to know that the price of wheat was down. But I am under no obligation to tell you everything that it may be to your interest to be told."

130 See, eg, *Carter v Boehm* (1766) 3 Burr 1905 at 1910; *Cornfoot v Fowke* (1840) 6 M & W 358 at 380; *Turner v Green* [1895] 2 Ch 205 at 208; *Coleman v Myers* [1977] 2 NZLR 225.

131 Atiyah *Contract* 265; *Smith v Hughes* (1871) LR 6 QB 597; *Banque Financière de la Cité SA v Westgate Insurance Co Ltd* sub nom *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1990] 2 All ER 947.

132 Sub par 2.2.5 *et seq, infra*.

failure to do so will render the contract unenforceable either as a whole or in part.¹³³ The law sometimes requires disclosure of facts other than the terms of the contract as well. The principal legal technique for creating duties of disclosure seems to comprise a development of the law of misrepresentation and reliance upon the implication of terms into contracts.¹³⁴ There are exceptions to the general rule that there is no duty to disclose, namely where the contract is within the class termed *uberrimae fidei*, where there is a fiduciary relationship between the parties, and where failure to disclose some fact distorts a positive representation.¹³⁵ Regulation, of course, may also provide for disclosure.¹³⁶

By disclosure is meant the communication (to the person entitled to the information) of material existing facts and past events;¹³⁷ It must be exact, complete, explicit and unambiguous. The disclosure must be "full and fair".¹³⁸ A "partial or imperfect" revelation of the facts,¹³⁹ or a "half-disclosure"¹⁴⁰ will not do.

Besides being exact and complete, the disclosure must be made in terms which are clear and unambiguous. The party on whom the obligation lies must not leave the other party to put two and two together. He must put them together himself, and call them four.¹⁴¹ Failing to do so

133 See, eg, *Scriven Brothers & Co v Hindley & Co* [1913] 3 KB 564; *Olley v Marlborough Court Ltd* [1949] 1 All ER 127; *Thornton v Shoe Lane Parking Ltd* [1971] 1 All ER 686; *Hollier v Rambler Motors (AMC) Ltd* [1972] 1 All ER 399.

134 Collins *Contract* 190; Harris & Tallon (eds) *Contract Law* 166.

135 Chitty *Contracts* 339.

136 See, eg, the Unfair Terms in Consumer Contracts Regulation of 1994.

137 "Facts" and "circumstances" are often used as convertible terms. See *Carter v Boehm* (1766) 3 Burr 1905; *Bridges v Hunter* (1813) 1 M & S 15; *Gordon v Gordon* (1821) 3 Swans 400.

138 See, eg, *Bowles v Stewart* (1803) 1 Sch & Lef 209 at 226.

139 *Greenwood v Greenwood* (1863) 2 De GJ & S 28 at 42-43; *Traill v Baring* (1864) 33 LJ Ch 521; *With v O'Flanagan* [1936] Ch 575; *Goldsmith v Rodger* [1962] 2 Lloyds Rep 249.

140 *Jenkins v Hiles* (1802) 6 Ves Jun 646; *Walker v Symonds* (1818) 3 Swan 1 at 73; *Rickards v Murdoch* (1830) 10 B & C 527; *Re Madrid Bank, Ex parte Williams* (1866) LR 2 Eq 216; *Wright v Carter* [1903] 1 Ch 27; *Bartram & Sons v Lloyd* (1904) 90 LT 357 at 359; *R v Bishirgian* [1936] 1 All ER 586 at 591.

141 *Bates v Hewitt* (1867) LR 2 QB 595; *Nicholson v Power* (1869) 20 LT 580; *Gandy v Adelaide Marine Insurance Co* (1871) LR 6 QB 746; *Leigh v Adams* (1871) 25 LT 566.

amounts to a non-disclosure of a particularly disingenuous type.¹⁴² Illustrations are frequent of the failure of such expedients for the purpose of withholding material facts, whilst insuring in advance against the consequences of so doing, as ambiguous conditions and particulars of sale in contracts between vendor and purchaser,¹⁴³ tricky waiver clauses in prospectuses of companies,¹⁴⁴ and other similar pretences of candour without its reality.¹⁴⁵

2.2.3 Important definitions: materiality; inducement

Where the law imposes a duty of disclosure, that disclosure, must be full and precise, clear and unambiguous. But it extends only to facts and circumstances,¹⁴⁶ and only to such facts and circumstances as are material in the particular case. This is clearly stated or assumed in all the authorities.¹⁴⁷

The duty of disclosure which the law imposes extends only to facts and circumstances which are material.¹⁴⁸ Any fact or circumstance is deemed sufficiently material to be disclosed, which, if disclosed would on a fair consideration of the evidence have influenced a reasonable prudent person in the decision whether to enter into the transaction contemplated or in deciding upon

142 *Greenwood v Greenwood* (1863) 2 De GJ & S 28 at 42-43; *Gluckstein v Barnes* [1900] AC 240.

143 *Brandling v Plummer* (1854) 2 Drewry 427; *Smith v Harrison* (1857) 26 LJ Ch 412; *Re Banister* (1879) 12 Ch D 131; *Re Marsh and Earl Granville* (1882) 24 Ch D 11.

144 *Greenwood v Leather Shod Wheel Co* [1900] 1 Ch 421 at 431; *Cackett v Keswick* [1902] 2 Ch 456; *Watts v Bucknall* [1903] 1 Ch 766.

145 *Coulson v Allison* (1860) 2 De GF & J 521; *Oelkers v Ellis* [1914] 2 KB 139.

146 "Fact" and "circumstance" are often used as convertible terms. The latter expression has the advantage over the former of suggesting the idea of relevancy to the transaction in hand, circumstances being neither more nor less than surrounding facts. "Circumstances", rather than "facts" are referred to in many of the judgments relating to the duty of disclosure, eg, in those of Mansfield CJ in *Carter v Boehm* (1766) 3 Burr 1905, of Lord Ellenborough CJ in *Bridges v Hunter* (1813) 1 M & S 15 at 18, of Lord Eldon LC in *Gordon v Gordon* (1821) 3 Swans 400 at 473, of Leach VC in *Selsey (Lord) v Rhoades* (1824) 2 Sim & St 41 at 49-50.

147 See, eg, *Murphy v O'Shea* (1845) 2 Jo & Lat 422; *Dunne v English* (1874) LR 18 Eq 524; *Ionides v Pender* (1874) LR 9 QB 531; *The Bedouin* [1894] P 1.

148 See, eg, the decision of Lord Halsbury in *Seaton v Burnand, Burnand v Seaton* [1900] AC 135.

terms,¹⁴⁹ having regard to the class and character of the transaction contemplated.¹⁵⁰

- 149 The currently accepted statement of the rule as set out above is taken from the decision of the Judicial Committee in *Mutual Life Insurance Co of New York v Ontario Metal Products Co Ltd* [1925] AC 344 at 351, a life insurance case in which the actual words of the Judicial Committee were:

"It is a question of fact in every case whether if the matters concealed or misrepresented had been truly disclosed they would, on a fair consideration of the evidence, have influenced a reasonable insurer to decline the risk or to have stipulated for a higher premium."

The word "prudent" in the proposition in the text above does not appear in the judgment in *Mutual Life Insurance Co of New York v Ontario Metal Products Co Ltd* [1925] AC 344. It appears however, in many of the supporting cases, and it is to be noticed that it appears also in the statutory provisions both of s 18(2) of the English Marine Insurance Act of 1906, where mention is made of the "the judgment of the prudent insurer", and of s 10(5) of the English Road Traffic Act of 1934. The cases also use the words frequently. See, eg, the judgment of Lord Robertson in *Zurich General Accident & Liability Insurance Co v Leven and Another* 1940 SC 407; *Becker v Marshall* (1922) 12 Lloyds Rep 413 and that of Rowlatt J in *North British Fishing Boat Insurance Co v Starr* (1922) 13 Lloyds Rep 206 at 210.

See, also, the expressions in the following cases: Sir James Mansfield CJ in *Wills v Glover* (1804) 1 Bos PNR 14 at 16 ("an opportunity of exercising their judgment in settling the premium"); Gibbs CJ in *Durrell v Bederley* (1816) Holt NP 283 at 286 and Holroyd J of *Berthon v Loughman* (1817) 2 Stark 258 at 259 ("whether particular facts if disclosed to an underwriter would...make a difference as to the amount of premium"); Lord Tenterden CJ in *Rickards v Murdock* (1830) 10 B & C 527 at 540 ("would have influenced the mind of the underwriter in deciding upon what terms he would accept the risk"); Rolfe B in *Dalglish v Jarvie* (1850) 2 Mac & G 231 at 243-244 ("anything that may affect the rate of premium which the underwriter may require"); Cockburn CJ in *Bates v Hewitt* (1867) LR 2 QB 595 at 604-605 ("all matters which will enable him to determine the extent of the risk against which he undertakes to guarantee the assured"); The Court of Queen's Bench of *Ionides v Pender* (1874) LR 9 QB 531 at 539 ("...all should be disclosed which would affect the judgment of a rational underwriter governing himself by the principles and calculations on which underwriters do in practice act, seems to us a sound one"); and the legislature in s 18 (2) of the English Marine Insurance Act of 1906 ("every circumstance is material which would influence the judgment of a prudent insurer in fixing the premium or determining whether he will take the risk").

See, also, the following four modern cases — *Glicksman v Lancashire and General Assurance Co Ltd* [1925] 2 KB 593 affirmed subsequently in the House of Lords [1927] AC 139; *Zurich General Accident and Liability Insurance Co Ltd v Morrison* [1947] 2 KB 53; *Godfrey v Britannic Assurance Co Ltd* [1963] 2 Lloyds Rep 515; *Lee v British Law Insurance Co Ltd* [1972] 2 Lloyds Rep 49.

- 150 See Spencer Bower *Non-Disclosure* 33 n3 and *Ionides v Pender* (1874) LR 9 QB 531, one of the leading cases on this subject. Blackburn J delivering the judgment of the Court of Queen's Bench said at 538:

"it was argued before us that the nature of the risk (that is as to the strength and seaworthy qualities of the *Da Capo* and the probability of encountering storms on the voyage and so forth) was not in the least affected by the amount at which the goods were valued: which was no doubt true."

Trifling details need not be disclosed, as being not sufficiently weighty to influence the judgment of the person entitled to disclosure.¹⁵¹

It is not necessary for the party entitled to disclosure to prove that he was actually induced by the non-disclosure to enter into the contract. It is enough for materiality if the fact, if disclosed, would have been likely to influence a prudent person in entering into, or declining to enter into, a transaction of the kind proposed, or to require an amendment of the terms proposed.¹⁵² If it is shown that disclosure would have "given him pause", this will be sufficient.¹⁵³

The belief of any of the parties to a proposed transaction as to the materiality or non-materiality of any undisclosed fact or circumstance, is quite unimportant. Materiality is not a matter to be tested subjectively, by inquiring whether the party owing a duty of disclosure believes the particular fact or circumstance to be material or not.¹⁵⁴ If a material fact or circumstance is known to the person owing the duty of disclosure, he is bound to disclose it whether he believes it to be

The Court, however, agreed that for the establishment of materiality it was enough that non-disclosure would affect the judgment of an underwriter governing himself by the rules on which underwriters act.

See, also, *Tate v Hyslop* (1885) 15 QBD 368 at 376:

"The authorities show that the materiality is not as to the risk, but as to whether it would influence the underwriters in entering upon the insurance or the terms on which they would insure."

151 See, eg, *Morrison v Muspratt* (1827) 4 Bing 60; *Perrins v Marine and General Traveller's Insurance Society* (1859) 2 E & E 317.

152 *Jennings v Broughton* (1854) 5 De GM & G 126 at 130; *Smith v Chadwick* (1884) 9 App Cas 187.

153 See *Traill v Baring* (1864) 4 De G J & S 318 at 330 where Turner LJ says:

"it is impossible to say what course the plaintiffs might have pursued, whether they would or would not have accepted the policy. They might have done so, but it is equally clear that they might not and we cannot say whether they would or would not; but it was to them that the communication should have been made, in order that they might exercise their option upon the subject."

See, also, *William Pickersgill & Sons Ltd v London and Provincial Marine and General Insurance Co Ltd* [1912] 3 KB 614 at 619; *Mutual Life Insurance Co of New York v Ontario Metal Products Co Ltd* [1925] AC 344; *Zurich General Accident and Liability Insurance Co Ltd v Morrison* [1947] 2 KB 53.

154 *Greenhill v Federal Insurance Co Ltd* [1927] 1 KB 65; *Looker v Law Union and Rock Insurance Co Ltd* [1928] 1 KB 554.

material or not.¹⁵⁵

The materiality of a fact or circumstance is always a question of fact, or perhaps one of mixed fact and law; if a fact is shown by evidence to be material, no belief, however genuine, by the person under a duty to disclose it can make it immaterial;¹⁵⁶ on the other hand, if it is not shown to be material, no belief by the person entitled to its disclosure can make it so.¹⁵⁷

The cases contain numerous *dicta* indicating that the asking of questions may be taken into account, together with the other facts, to assist in the determination of materiality.¹⁵⁸ The asking of a question, it is submitted, therefore leaves the party contending for materiality in a better position than if no question had been asked. On the other hand, if no question is asked, the court may by that very fact be assisted to a conclusion in favour of non-materiality; for, if it did not occur to the party entitled to disclosure to make any inquiry, it may be a matter of difficulty to conclude that the point was one which might have influenced a reasonable person against entering into the contract proposed, or persuaded him to ask for better terms. Insurance companies also run the risk of the contention that matters they do not ask questions about are not

155 *McNair J in Roselodge Ltd (formerly "Rose" Diamond Products Ltd) v Castle* [1966] 2 Lloyds Rep 113, citing *Brownlie v Campbell* (1880) 5 App Cas 925 and *Joel v Law Union and Crown Insurance Co Ltd* [1908] 2 KB 863:

"The disclosure must be of all that you ought to have realised to be material, and not of that only which you did in fact realise to be so."

156 *Lindenau v Desborough* (1828) 8 B & C 586 at 592; *Brownlie v Campbell* (1880) 5 App Cas 925 at 954; *Joel v Law Union and Crown Insurance Co* [1908] 2 KB 863; *Godfrey v Britannic Assurance Co Ltd* [1963] 2 Lloyds Rep 515 at 529, ("it is also well established that the opinion of the assured whether a particular fact is material is irrelevant").

157 See *Haywood v Rodgers* (1804) 4 East 590 where Lord Ellenborough C J at 597 speaks of the "almost absolute impossibility for the assured to state...everything which, if stated might have been deemed, in the judgment of the underwriter material to the question".

See, also, *Beachey v Brown* (1860) E B & E 796 at 803:

"I do not think that non-disclosure of a fact which is material in the mind of the defendant is enough."

In this case, the defendant was setting up non-disclosure as an answer to an action for breach of promise of marriage.

158 *Dawsons Ltd v Bonnin* [1922] 2 AC 413; *Roselodge Ltd (formerly "Rose" Diamond Products Ltd) v Castle* [1966] 2 Lloyds Rep 113.

material, or, that if they were, they would ask questions about them.¹⁵⁹

If materiality is disputed, it must be for the court to decide the question on the facts of the particular case; it will be a matter of law whether the particular undisclosed fact or circumstance is capable of being material¹⁶⁰ and one of mixed fact and law,¹⁶¹ whether in the particular circumstances of the case before the court it is material.

2.2.4 Important definitions: knowledge

It would be illogical and unfair indeed to penalize a party, by ordering or allowing the avoidance of the contract into which he has entered, or by rejecting a claim by him for moneys due under that contract, because of his non-disclosure of a material fact, if that fact had been unknown to him. English law requires accordingly that in an action for avoidance of a contract, or in the presentation of a defence to a claim for moneys due under that contract, on the ground of non-disclosure, it is necessary for the party complaining to prove strongly not only the existence of the undisclosed material fact, but also that the party owing a duty to disclose that fact, knew of it at the time when the contract was concluded.¹⁶² It must, however, be emphasized that this

159 *Newsholme Brothers v Road Transport and General Insurance Co Ltd* [1929] 2 KB 356 at 363. See, also, *Seaton v Heath* [1899] 1 QB 782; *Glicksman v Lancashire and General Assurance Co Ltd* [1925] 2 KB 593, and on appeal [1927] AC 139.

160 *Dawsons Ltd v Bonnin* [1922] 2 AC 413 is an example of the court's deciding, at an early stage of the judgment that a fact was not material — but this did not assist the non-disclosing party, for the case was determined on another aspect of the facts, namely that certain facts had been warranted and that therefore no question of materiality arose. See, also, *Zurich General Accident and Liability Insurance Co v Leven and Another* 1940 SC 406, where Lord Normand said, at 416:

"a conviction 20 years old with an impeccable record between the date of the conviction and the date of the signature on the form would by all reasonable people be regarded as immaterial."

161 *Roselodge Ltd (formerly "Rose" Diamond Products Ltd) v Castle* [1966] 2 Lloyds Rep 113.

162 There must be knowledge on the part of the person with a duty of disclosure, of the non-disclosed fact. So Fletcher Moulton LJ in *Joel v Law Union and Crown Insurance Co* [1908] 2 KB 863 says at 884:

"But in my opinion there is a point here which often is not sufficiently kept in mind. The duty is a duty to disclose, and you cannot disclose what you do not know."

These words must, however, be read subject to the important proposition that knowledge may be either actual or imputed: See *Greenhill v Federal Insurance Co Ltd* [1927] 1 KB 65 at 66-67. See further *Godfrey v Britannic Assurance Co Ltd* (1963) 2 Lloyds Rep 515

knowledge may be actual or presumptive.

Similar considerations apply to the knowledge of the party complaining of non-disclosure. His action or defence cannot succeed unless he is able to show (the onus being in this regard upon him) that he did not know of the existence of the undisclosed fact.¹⁶³

Knowledge may be either a fact to be established by evidence, like any other fact,¹⁶⁴ or it may be deemed in law to have existed¹⁶⁵ without proof as a fact. The former class of knowledge is usually called "actual" knowledge or notice, although the epithet has been extended by some authorities to certain species of the other class: the latter has been termed "constructive", "imputed", or "presumed", knowledge or notice.

Actual knowledge or notice, in the above sense, when alleged, must be strictly proved as a fact by evidence. That is to say, the fact of which the actual knowledge is alleged must be shown to have been personally, and not vicariously, known to the person to whom it is attributed,¹⁶⁶ and actually present to his mind at the material date.¹⁶⁷

at 529.

163 *Stikeman v Dawson* (1847) 1 De G & Sm 90 at 101-108; *Foley v Tabor* (1861) 2 F & F 663 at 672.

164 *Saffron Walden Second Benefit Building Society v Rayner* (1880) 14 Ch D 406.

165 He must disclose not only every material circumstance of which he has actual knowledge, but every material circumstance that he ought to know — per Roskill J in *Godfrey v Britannic Assurance Co Ltd* [1963] 2 Lloyd's Rep 515 at 529. See, also, *Greenhill v Federal Insurance Co Ltd* [1927] 1 KB 65.

166 *Saffron Walden Second Benefit Building Society v Rayner* (1880) 14 Ch D 406 at 410-412, and at 414-418.

167 In *Bates v Hewitt* (1867) LR 2 QB 595, it was pointed out by Cockburn CJ at 605, that the party charged had failed to prove that the party complaining knew that the SS "Georgia", the subject of the policy, had been the notorious Confederate cruiser of that name, it appearing that though he had at one time known the history of the Confederate "Georgia", he had, at the date of the insurance, forgotten it, so that the knowledge in question was not then present to his mind, and it was the duty of the party charged to bring home to him such information as would enable him to identify the vessel, in which duty he had failed. See *Ellis v Rogers* (1884), 29 Ch D 661 a vendor and purchaser case, where the purchaser knew of the restrictive covenants, the suppression of which he complained of, but did not know or believe that they were operative at the time: per Cotton LJ, at 671; *Nocton v Lord Ashburton* [1914] AC 932, per Lord Dunedin at 962, a solicitor and client case; in Australia, see *Re Cronk and Slatery's Contract* [1915] VLR 272 where a purchaser's vendor and purchaser summons failed when it was shown that he had been personally aware of the true position, though it had not been mentioned in the agreement for sale and purchase.

Presumptive knowledge consists of five species, which may be stated broadly as follows.¹⁶⁸

- (1) Facts of public notoriety, and rules and principles of general application in ordinary life, are presumed without proof to be within the knowledge of both parties.
- (2) The law presumes, without proof, knowledge of all facts which, in the course of his business, the party ought to be acquainted with.
- (3) From the proved actual knowledge of a fact by an agent, the law infers, without proof, a knowledge of that fact on the part of his principal.
- (4) From the proved actual knowledge by a party of a fact, the law infers, without proof, a knowledge by that party of any further fact to which the actual knowledge of the first fact would naturally have led, or which such inquiries as were reasonable under the circumstances, would have elicited.
- (5) By virtue of certain enactments, the legislature imputes knowledge of certain facts to the persons, and under the conditions, prescribed.¹⁶⁹

For the purpose of the duty of disclosure, any party to a contract or transaction is presumed to be acquainted with all matters of general notoriety,¹⁷⁰ whether the notoriety extends to the entire community, or only to a class or section of the public, if the class or section is one to which the

168 See Spencer Bower *Non-Disclosure* 56.

169 The first two of these classes, in relation to marine insurance, are dealt with in *Carter v Boehm* (1766) 3 Burr 1905 at 1910-1911; also by Cockburn CJ at 605- 607, Mellor J at 609- 610, and Shee J, at 610- 611 of *Bates v Hewitt* (1867) LR 2 QB 595; by Cockburn CJ at 757 of *Gandy v Adelaide Marine Insurance Co* (1871) LR 6 QB 746; and in s 18 of the English Marine Insurance Act of 1906. The third and fourth are summarily described by Lore Eldon LC at 120 of *Hiern v Mill* (1806) 13 Ves Jun 114.

170 See s (3)(b) of the Marine Insurance Act of 1906, whereby it is provided that:

"the insurer is presumed to know matters of common notoriety of knowledge."

It is true that in the corresponding provision in this Act relating to the presumed knowledge of the assured — s 18 (1) — there is no express mention of such matters, but they are probably intended to be included in the general phrase: "every circumstance which, in the ordinary course of business, ought to be known to him".

See Spencer Bower *Non-Disclosure* 57.

party to whom the knowledge is imputed belongs,¹⁷¹ or to a locality or district, if it is one in which the party to whom the local knowledge is ascribed either carries on business or resides, as the case may be.¹⁷²

Almost from the time when the rules as to presumptive knowledge began to assume a definite shape and form, the Judges who had invented and established these rules began to discern their perilous possibilities and potency.¹⁷³ Though here and there in the decisions protests can be found against any attempt to emasculate them,¹⁷⁴ the main current of judicial authority set in favour of vigilance, if not of jealous restriction, and warnings from eminent judges frequently enough appear¹⁷⁵ against any further extension of a doctrine which, even admitting it to be "based on

171 In *Durrell v Bederley* (1816) Holt NP 283, a marine insurance case, "the current knowledge of Jersey", as to a French frigate which had made captures on that coast, was imputed to the plaintiff who was the party charged (for he carried on his business there), but was not imputed to the party complaining, the underwriter in London, for "the underwriters could know nothing of it", per Gibbs CJ at 286. See, also, *Harrower v Hutchinson* (1870) LR 5 QB 584 at 591-593, as to the presumption of an underwriter's knowledge of the local regulations of foreign States. Again, in *Edwards v Meyrick* (1842) 2 Hare 60 at 73-75, a solicitor and client case, Wigram VC pointed out that the solicitor was not bound to call his client's attention to the speculative possibility that a railway, which in the district where the parties resided was known to be in contemplation, might improve the value of the land which was the subject of the action.

172 See, eg, *Bowles v Round* (1800) 5 Ves Jun 508; *Brandling v Plummer* (1854) 2 Drewry 427 at 431; *Pimm v Lewis* (1862) 2 F & F 778; *Ashburner v Sewell* [1891] 3 Ch 405; *Hales v Reliance Fire and Accident Corporation Ltd* [1960] 2 Lloyds Rep 391.

173 Spencer Bower *Non-Disclosure* 80.

174 Thus Turner LJ, in *Wilson v Hart* (1866) LR 1 Ch App 463 at 467 says:

"I am not by any means inclined to extend the doctrine of constructive notice, but on the other hand I am as little inclined to fritter away the principles of the Court by refusing to apply them to cases to which they properly extend."

To the same effect are the observations of Kekewich J, in *Davis v Hutchings* [1907] 1 Ch 356 at 361

175 Such as Lord St Leonards in *Roddy v Williams* (1845) 3 Jo & Lat 1 at 29; Lord Cranworth LC in *Ware v Lord Egmont* (1854) 4 De GM & G 460 at 473:

"I must not part with this case without expressing my entire concurrence in what has on many occasions of late years fallen from Judges of great eminence on the subject of constructive notice, namely that it is highly inexpedient for Courts of equity to extend this doctrine and to attempt to apply it to cases to which it has not hitherto been held applicable."

See, also, Lord Westbury LC in *Wyllie v Pollen* (1863) 3 De G J & S 596 at 601 who said that he concurred with those Judges who thought that the doctrine of constructive notice ought not to be extended, but ought to be reduced within clear and definite principles. Cf

good sense", is still to be recognised as "subtle and difficult",¹⁷⁶ and "refined"¹⁷⁷ and to be applied with the utmost caution.

2.2.5 Classification of transactions and relations where disclosure is required

2.2.5.1 Introduction

The main categories in which a stricter duty of disclosure may exist than discussed above can be set out in four sub-classes, all of which require disclosure; some involve other duties as well. In the first two of these classes the duty arises exclusively from the nature of the transaction which is under negotiation,¹⁷⁸ or from the character of an application which the disclosing party is making to some independent tribunal or authority. In regard to the remaining two of these classes, the duty of disclosure does not find its source in the nature of the transaction in contemplation between the parties. It will lie upon one of them, whatever the transaction may be into which they are about to enter. The duty arises exclusively from a relationship, either established by legal rule

Allen v Seckham (1897) 11 Ch D 790, per Brett LJ at 795, "the doctrine of constructive notice ought to be narrowly watched, and not enlarged. Indeed anything 'constructive' ought to be narrowly watched because it depends on a fiction"; *English and Scottish Mercantile Investment Co Ltd v Brunton* [1892] 2 QB 700, per Lord Esher MR at 708, who held:

"of late years after the doctrine had been invented and put into form, the Chancery Judges saw that it was being carried much further than had been intended, and they declined to carry it further. In a series of cases Lords Cottenham, Lyndhurst, and Cranworth, Lord Justice Turner, and the late Master of the Rolls, Sir George Jessel have said that the doctrine ought not to be extended one bit further; all the Judges seem to have agreed upon that. In *Allen v Seckham*, I pointed out that the doctrine is a dangerous one..."

See, also, *Bailey v Barnes* (1894) 1 Ch 25; *Molyneux v Hawtrey* [1903] 2 KB 487; *Powell v Browne* (1907) 97 LT 854 at 856:

"the Courts have of late years refused to extend the doctrine of constructive notice which has been put forward here — a doctrine which rests on imputing to a person knowledge which it is admitted he never had. I am speaking of constructive notice of the sort which is suggested here where there is no imputation of want of good faith."

176 See *Kettlewell v Watson* (1882) 21 Ch D 685 at 704.

177 See *Re Cousins* (1886) 31 Ch D 671 at 676; *Re Ashton, Ex parte McGowan* (1891) 64 LT 28 at 29.

178 *Cheshire Contract* 302-307; *Atiyah Contract* 272-274; *Chitty Contracts* 339.

or created by parties themselves, which already existed between them before negotiations began. In these cases, the relationship is such as to cast a duty on that party to ensure that the other is properly informed and advised. Even more may have to be done, for example, the provision of independent advice.¹⁷⁹

The four classes of cases which can be discerned will now be outlined in more detail.

2.2.5.2 Duty of disclosure in contracts *uberrimae fidei*

A positive duty of disclosure of material facts rests upon parties negotiating certain classes of contracts.¹⁸⁰ These are contracts in the negotiation of which one of the parties must, from the very nature of the transaction, have either actual or presumptive knowledge of facts and circumstances which ordinarily are not within the actual or presumptive knowledge of the other party, but the knowledge of which is, or may be, of importance to that other party to enable him to judge of the expedience of entering into the particular contract proposed.¹⁸¹ The contracts discussed here are often called contracts *uberrimae fidei*.¹⁸²

The best-known example is the contract of insurance,¹⁸³ but there are other contracts, not all probably in a strict sense *uberrimae fidei*, that qualify for inclusion in this class, such as contracts to subscribe for shares in a company, releases and compromises, contracts for partnership, contracts to marry and separation deeds.¹⁸⁴ The reluctance of the Courts to extend this stricter duty of disclosure to other contracts, is illustrated by the case of *Bell v Lever Brothers Ltd*.¹⁸⁵

179 *Cheshire Contract* 307-308; *Atiyah Contract* 274-275; *Chitty Contracts* 362-363; *Tate v Williamson* (1866) LR 2 Ch App 55.

180 *Carter v Boehm* (1766) 3 Burr 1905 at 1909; *Bell v Lever Brothers Ltd* [1932] AC 161; *Banque Financière de la Cité v Westgate Insurance Co Ltd* sub nom *Banque Keyser Ullman SA v Skandia (UK) Insurance Co Ltd* [1990] 2 All ER 947.

181 See, eg, *Wainwright v Bland* (1836) 1 M & W, 32; *Cornfoot v Fowke* (1840) 6 M & W 358; *Robinson v Mollett* (1875) LR 7 HL 802; *Ionides v Pender* (1874) LR 9 QB 531; *Brownlie v Campbell* (1880) 5 App Cas 925; *Seaton v Heath* [1899] 1 QB 782..

182 *Chitty Contracts* 390 -398; *Cheshire Contract* 290.

183 See, eg, *Joel v Law Union and Crown Insurance Co* [1908] 2 KB 863; *Lambert v Co-operative Insurance Society* [1975] 2 Lloyd's Rep 485; *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1994] 3 All ER 581; *Woolcott v Sun Alliance and London Insurance Ltd* [1978] 1 All ER 1253.

184 *Cheshire Contract* 293-294; *Chitty Contracts* 394-396.

185 [1932] AC 161.

It is outside the scope of this thesis to examine each and every type of contract that may be classified as requiring *uberrimae fides*, especially in view of the fact that suretyship is not considered to fall in this class.¹⁸⁶

Broadly speaking, there are three classes of cases in which an obligation of disclosure, which does not ordinarily arise at all, or which does not originally arise, may be created by circumstances occurring before or during the negotiation. These are as follows:

- (1) where one of the negotiating parties enters upon the negotiation laden with the duty of revealing his own previous fraud in relation to the subject of the contemplated contract or transaction;¹⁸⁷
- (2) where, during the negotiation, one of the negotiating parties says or does something, or something happens which, having regard to his previous declarations or acts, requires him to speak, in order to correct or remove a delusion created in the mind of the other party, for which he is responsible;¹⁸⁸
- (3) where, in the course of negotiation, one of the parties is asked a question by the other party in respect of any matter, whereupon a duty arises for the first party, if he answers the question at all,¹⁸⁹ to answer it truthfully and fully.¹⁹⁰

186 *Hamilton v Watson* (1845) 12 Cl & Fin 109; *North British Insurance Co v Lloyd* (1854) 10 Exch 523; *Lee v Jones* (1864) 17 CB (NS) 482; *Davies v London and Provincial Marine Insurance Co* (1878) 8 Ch D 469; *London General Omnibus Co Ltd v Holloway* [1912] 2 KB 72; *Cooper v National Provincial Bank Ltd* [1946] 1 KB 1.

187 *Story Jurisprudence* par 384 and 390; *Jones v Bowden* (1813) 4 Taunt 847; *Ormrod v Huth* (1845) 14 M & W 651; *Perens v Johnson* (1857) 3 Sm & G 419; *Horsfall v Thomas* (1862) 1 H & C 90; *Walsham v Stainton* (1863) 1 De GJ & S 678; *Phillips v Homfray*; *Fothergill v Phillips* (1871) 6 Ch App 770; *Moxon v Payne* (1873) LR 8 Ch App 881.

188 *Turner v Harvey* (1821) Jac 169; *Walters v Morgan* (1861) 3 De GF & J 718; *Davies v London and Provincial Marine Insurance Co* (1878) 8 Ch D 469; *Arkwright v Newbold* (1881) 17 Ch D 301; *Coaks v Boswell* (1886) 11 App Cas 232; *Re Edwards to Daniel Sykes & Co Ltd* (1890) 62 LT 445; *Re Hare and O'More's Contract* [1901] 1 Ch 93; *Royal Bank of Scotland v Greenshields* 1914 SC 259; *With v O'Flanagan* [1936] Ch 575.

189 *Coaks v Boswell* (1886) App Cas 232; *London Assurance Co v Mansel* (1879) 11 Ch D 363; *Re Robinson, Ex parte Burrell* (1876) 1 Ch D 537; *Nelthorpe v Holgate* (1844) 1 Coll 203; *Re General Provincial Life Assurance Co Ltd, Ex parte Daintree* (1870) 18 WR 396 at 397.

190 *Harrower v Hutchinson* (1870) LR 5 QB 584; *Re General Provincial Life Assurance Co, Ex parte Daintree* (1870) 18 WR 396; *Mackreth v Walmesley* (1884) 51 LT 19; *The Bedouin* (1894) P 1; [1894] 10 TLR 70; *Westminster Bank Ltd v Cond* (1940) 46 Com Cas 60.

2.2.5.3 Duty of disclosure to court, tribunal or State agencies

The second sub-class consists of cases in which a person is injuriously affected by, and has a right of complaint and relief in respect of, another person's breach of a duty of disclosure owed by him, primarily or immediately to the court,¹⁹¹ the State,¹⁹² or a class of third persons,¹⁹³ and only indirectly to the party complaining.

2.2.5.4 Duty of disclosure in relations of confidence

The duty of disclosure in relations of confidence, is owed directly to the person who complains of its non-fulfilment. It may arise under conditions of a wholly different character. Here, there is no question of a contractual relationship between the parties: a fiduciary relation (whether contractual, or implied or "resulting")¹⁹⁴ is assumed to be already established, which relation involves an obligation, during its existence, of complete candour and good faith toward the one who has placed it.¹⁹⁵

Modern theory and judicial practice do not attempt to ascribe any specific legal meaning to the term "fiduciary". Sealy, in a leading article on the subject, observes:¹⁹⁶

"[T]he word 'fiduciary' we find is not definitive of a single class of relationship to which a fixed set of rules and principles apply. Each equitable remedy is available only in a

191 *Brooke v Lord Mostyn* (1865) 2 De GJ & Sm 373; *Priestman v Thomas* (1884) 9 PD 210; *Boswell v Coaks (No 2)* (1894) 6 R 167; *Cole v Langford* [1898] 2 QB 36; *Sturrock v Littlejohn* (1898) 68 LJ QB 165; *White v Ivory* (1900) *The Times* 27 April; *Brink's-MAT Ltd v Elcombe and Others* [1988] 3 All ER 188; *The Nordglint* [1988] 2 All ER 531.

192 *Alton Woods' Case* (1600) 1 Co Rep 40b; *R v Butler* (1685) 3 Lev 220; *Hill v Thompson* (1818) 8 Taunt 375; *R v Wheeler* (1819) 2 B & Ald 345; *Alcock v Cooke* [1824-34] All ER Rep 497; *Eastern Archipelago Co v R* (1853) 2 EL & BL 856; *Great Eastern Railway Co v Goldsmid* (1884) 9 App Cas 927; *City of Vancouver v Vancouver Lumber Co* [1911] AC 711.

193 Such as creditors in negotiations for composition arrangements.

194 Spencer Bower *Non-Disclosure* 303.

195 The distinction between the two classes of case is emphasized by Fry J in *Davies v London and Provincial Marine Insurance Co* (1878) 8 Ch D 469 at 474-475 and by Scrutton LJ in *Moody v Cox and Hatt* [1917] 2 Ch 71 at 88.

196 Sealy 1962 *Cambridge LJ* 69 at 73 and also at 68-72 for the history of the use of this expression.

limited number of fiduciary situations; and the mere statement that John is in a fiduciary relationship towards me means no more than that in some respect his position is trustee-like;¹⁹⁷ it does not warrant the inference that any particular fiduciary principle or remedy can be applied."

It would be a misuse of the term "fiduciary", then, to infer from the fact that that label could be attached to a particular relationship, the existence of some specific duty on the fiduciary's part. As Fletcher Moulton LJ says, in a passage, which has been frequently cited by the courts since.¹⁹⁸

"Fiduciary relations are of many different types: they extend from the relation of myself to an errand boy who is bound to bring back my change up to the most intimate and confidential relations which could possibly exist between one party and another where the one is wholly in the hands of the other because of his intimate trust in him. All of these are cases of fiduciary relations, and the courts have again and again, in cases where there has been fiduciary relation, interfered and set aside acts which, between persons in a wholly independent position, would have been perfectly valid. Thereupon in some minds there arises the idea that if there is any fiduciary relation whatever any of these types of interference is warranted by it. They conclude that every type of fiduciary relation justifies every kind of interference. Of course that is absurd. The nature of the fiduciary relation must be such that it justifies the interference. There is no class of case in which one ought more carefully to bear in mind the facts of the case, when one reads the judgment of the court on those facts, than cases which relate to fiduciary and confidential relations and the action of the court with regard to them."

It follows that the word "fiduciary" is not of itself a constituent part of any specific legal rule. Therefore, there is no point in attempting to establish a legal definition for it.¹⁹⁹

197 Cf *Re West of England and South Wales District Bank, Ex parte Dale & Co* (1879) 11 Ch D 772 at 778 where Fry J described a fiduciary relationship as one:

"in respect of which if a wrong arise, the same remedy exists as against the wrongdoer on behalf of the principal as would exist against a trustee on behalf of the *cestui que trust*."

198 *Re Coomber, Coomber v Coomber* [1911] 1 Ch 723 at 728-729. This passage is also influential in Australia; *Jenyns v Public Curator (Qld)* (1953) 90 CLR 113 at 132-133; in Canada, *Glover v Glover* [1951] 1 DLR 657 at 663-664; in New Zealand, *Coleman v Myers* [1977] 2 NZLR 225 at 370-371.

199 Spencer Bower *Non-Disclosure* 304.

The matter can be taken further, however, by putting forward a descriptive, rather than prescriptive, formulation. Finn describes a fiduciary in these terms:²⁰⁰

"He is, simply, someone who undertakes to act for or on behalf of another in some particular matter. That undertaking²⁰¹ may be of a general character. It may be specific and limited. It is immaterial that the undertaking is gratuitous. And the undertaking may be officiously assumed without request."²⁰²

Finn goes on to point out that, though the courts have "refrained judiciously" from attempting any such general definition, the above description might be taken as "accurate and workable" in the light of the decisions he discusses. Sealy, dealing with fiduciary obligations more generally, suggests that four broad types of fiduciary relationship have been recognized by the courts.²⁰³

They are;

- (1) where "one person has control of property which ... in the view of a court of equity is the property of another";
- (2) "[w]herever the plaintiff entrusts to the defendant a job to be performed";²⁰⁴
- (3) where a person who holds or controls property for another, acquires as a personal benefit something which the courts regard as an accretion to the property; and
- (4) where the doctrine of undue influence²⁰⁵ applies.

The rule is that he who bargains in matters of advantage with a person placing confidence in him

200 Finn *Fiduciary* 201. Similar descriptions have been used judicially. See *Reading v R* [1949] 2 KB 232 at 236. See, also, Sealy 1962 *Cambridge LJ* 69 at 76; Scott 1949 *California LR* 539 at 540.

201 On the contractual nature of some fiduciary undertakings, see the case of *Nordisk Insulinlaboratorium v Gorgate Products Ltd* [1953] 1 Ch 430 at 442-443.

202 On the assumption of fiduciary duties without the principal's request, see *Lyell v Kennedy* (1889) 14 App Case 437 at 456; *Phipps v Boardman* [1965] Ch 992 at 1017-1018; *English v Dedham Vale Properties Ltd* [1978] 1 All ER 382 at 395-398. In Australia, see *Walden Properties Ltd v Beaver Properties Pty Ltd* [1973] 2 NSWLR 815 at 833.

203 Sealy 1962 *Cambridge LJ* 69 at 74-79. The different duties of these various classes of fiduciaries are further discussed by Sealy at 119.

204 Citing *Reading v R* [1949] 2 KB 232 at 236 per Asquith LJ for the purposes of the law of disclosure, the most significant "job" is that of giving advice, as to the fiduciary character of which see *Tufton v Sporni* [1952] 2 TLR 516 at 521-522 at 531-532; *Godsworthy v Brickell* [1987] 1 Ch 378 at 403.

205 Spencer Bower *Non-Disclosure* 305.

is bound to show that a reasonable use has been made of that confidence.²⁰⁶ To this rule, as the fountainhead, or rather to its principle and reason, all subordinate and derivative rules, and all particular questions, must be referred for interpretation and solution.²⁰⁷

Fiduciary relations in regard to the banker-customer relationship have been discussed above²⁰⁸ and I shall devote no further attention to this aspect here.

2.2.5.5 Duty of disclosure in relations of influence or advantage

There are certain relations which are deemed to give rise to what in English law has in the past been called "undue influence", that is to say, from the existence of which the law presumes that one of the related parties, whom it may be convenient to call "the stronger party", is in a position of ascendancy, predominance or advantage over the other, who may be called "the weaker party".²⁰⁹ The former will then have the responsibility of candour and good faith toward the latter, as regards disclosure and otherwise, in respect of any transaction between them while the relation, and the influence springing therefrom, continues. These relations may exist by nature, independently of human will, such as the parental or quasi-parental relationship,²¹⁰ or may be constituted by the voluntary action of the parties, such as the professional relations of solicitor and client,²¹¹ spiritual director and penitent,²¹² or medical man and patient,²¹³ or may be created

206 *Gibson v Jeyes* (1801) 6 Ves Jun 266 at 278.

207 See *Spencer Bower Non-Disclosure* 306; *McPherson v Watt* (1877) 3 App Cas 254 at 262-263; *Erlanger v New Sombrero Phosphate Co* (1878) 3 App Cas 1218 at 1243; In Australia, see *Elders Trustee and Executor Co Ltd v E G Reeves Pty Ltd* (1987) 78 ALR 193 at 234-238. Similar observations have been made in cases involving self-dealing and the making of secret profits and commissions. See *Greenlaw v King* (1841) 10 LJ Ch 129 at 130; *Benson and Others v Heathorn* (1842) 1 Y & C Ch Cas 326 at 342-343.

208 In sub-chapter 2.1.2 on multi-functional banking.

209 Undue influence implies habitual ascendancy or influence over a weaker mind and if it is present on one occasion it is present on all unless the contrary is shown. See *Tate v Williamson* (1866) LR 2 Ch App 55.

210 *Wright v Vanderplank* (1856) 8 De GM & G 133; *Chambers v Crabbe* (1865) 34 Beav 457; *Powell v Powell* [1900] 1 Ch 243; *London and Westminster Loan & Discount Ltd v Bilton* (1911) 27 TLR 184; *Bruty v Edmundson* (1915) 113 LT 1197; *Lancashire Loans Ltd v Black* [1934] 1 KB 380; *Re Pauling's Settlement Trusts; Younghusband v Coutts & Co* [1964] 1 Ch 303.

211 *Ward v Sharp* (1884) 53 LJ Ch 313; *Rhodes v Bate* (1866) 1 Ch App 252; *Willis v Barron* [1902] AC 271; *Wright v Carter* [1903] 1 Ch 27.

212 *Norton v Rely* (1764) 2 Eden 286; *Nottidge v Prince* (1860) 2 Giff 246; *Allcard v Skinner* (1887) 36 Ch D 145; *Morley v Loughman* [1893] 1 Ch 736; *Roche v Sherrington*

by circumstances and conduct generally.²¹⁴

There are three groups of relations from which an inference or presumption of undue influence arises.²¹⁵ In the first place, there are domestic relations. These include parentage, or quasi-parentage,²¹⁶ where the law has traditionally presumed influence from the nature of the relations alone, and a number of other relationships, such as that of husband and wife, where additional facts and circumstances must be proved before any such inference will be drawn.²¹⁷ Secondly, there are what may be called the professional relations, such as those which exist between solicitor and client,²¹⁸ between spiritual director and penitent or disciple,²¹⁹ and between medical adviser and patient²²⁰ — all of these often being classed together as "recognized", or the "known".²²¹ Thirdly there are the suspected relations, where proof of the relations, not being within either of the two above-mentioned classes, are constituted by the circumstances of the particular case, with particular regard to the confidence the weaker party has in the stronger

[1982] 2 All ER 426.

- 213 *Dent v Bennett* (1839) 4 My & Cr 269; *Pratt v Barker* (1826) 1 Sim 1; *Radcliffe v Price* (1902) 18 TLR 466; *Williams v Johnson* [1937] 4 All ER Annotated 34; *Re CMG* [1970] Ch 574; [1970] 2 All ER 740n; *Claughton v Price* [1997] EGCS 51.
- 214 From a banking law perspective, see *Lloyds Bank Ltd v Bundy* [1975] 1 QB 326; *National Westminster Bank plc v Morgan* [1985] AC 686; *Bank of Credit and Commerce International SA v Aboody and Another* [1992] 4 All ER 955.
- 215 31 Halsbury par 843; *Spencer Bower Non-Disclosure* 521.
- 216 *Wright v Vanderplank* (1856) 8 De GM & G 133; *Berdoe v Dawson* (1865) 34 Beav. 603; *Powell v Powell* [1900] 1 Ch 243; *London and Westminster Loan and Discount Co Ltd v Bilton* (1911) 27 TLR 184; *Lancashire Loans Ltd v Black* [1934] 1 KB 380; *Re Pauling's Settlement Trusts*; *Younghusband v Coutts & Co* [1964] 1 Ch 303.
- 217 *Lloyds Bank Ltd, Re Bomze and Lederman v Bomze* [1931] 1 Ch 289; *Gillman v Gillman* (1946) 201 LT 135; *Zamet v Hyman* [1961] 3 All ER 933; *Midland Bank plc v Shephard* [1988] 3 All ER 17.
- 218 *Rhodes v Bate* (1866) 1 Ch App 252; *Liles v Terry* [1895] 2 QB 679; *Wright v Carter* [1903] 1 Ch 27; *Moody v Cox and Hatt* [1917] 2 Ch 71; *Willis v Barron* [1902] AC 271; *Wintle v Nye* [1959] 1 All ER 552.
- 219 *Huguenin v Baseley* (1807) 14 Ves 273; *Nottidge v Prince* (1860) 2 Giff 246; *Allcard v Skinner* (1887) 36 Ch D 145; *Morley v Loughman* (1893) 1 Ch 736.
- 220 *Dent v Bennett* (1839) 4 My & Cr 269; *Radcliffe v Price* (1902) 18 TLR 466; *Williams v Johnson* [1937] 4 All ER Annotated 34.
- 221 *Hunter v Atkins* (1834) 3 My & K 113 at 135.

party.²²² There are other cases where "actual influence" has been proved by direct evidence.²²³

The question of proof of "actual" influence was recently considered in *Bank of Credit and Commerce International SA v Aboody and Another*²²⁴ where the requirements were restated in these terms:

"[A] person relying on a plea of actual undue influence must show that

- (a) the other party to the transaction (or someone who induced the transaction for his own benefit) had the capacity to influence the claimant;
- (b) the influence was exercised;
- (c) its exercise was undue;
- (d) its exercise brought about the transaction."²²⁵

The decision also held that there would need to be "manifest disadvantage", as well as undue influence before the transaction would be set aside. This requirement was considered by the House of Lords in *CIBC Mortgages plc v Pitt and Another*²²⁶. The Court overruled the decision in the *Aboody*²²⁷ case on this point and held that, where actual undue influence has been proved (as distinct from cases of presumed undue influence), a claimant was not under the further burden of proving that the transaction induced by undue influence was manifestly disadvantageous, but was entitled as of right to have it set aside, since actual undue influence was a species of fraud, and like any other victim of fraud, the victim was entitled to have the transaction set aside as of right.²²⁸

222 Spencer Bower *Non-Disclosure* 521.

223 See, eg, *Bennet v Vade* (1742) 2 Atk 324 at 326; *Hunter v Atkins* (1834) 3 My & K 113 at 134-135 140; *Harrison v Guest* (1855) 6 De GM & G 424 at 432-436; *Williams v Baylee* (1866) LR 1 HL 200; *Mutual Finance Ltd v John Wetton & Sons Ltd* [1937] 2 All ER 657; *Re Craig, Meneces v Middleton* [1971] Ch 95 at 121; *Coldunell Ltd v Gallon* [1986] 1 All ER 429; [1986] QB 1184 at 1195-1196. On the need for complete proof, see *Curson v Belworthy* (1852) 3 HLC 742 at 752;.

224 [1992] 4 All ER 955; [1989] 2 WLR 759.

225 *Bank of Credit and Commerce International, SA v Aboody and Another* [1992] 4 All ER 955; [1989] 2 WLR 759 at 782.

226 [1993] 4 All ER 433.

227 [1992] 4 All ER 955.

228 *CIBC Mortgages plc v Pitt and Another* [1993] 4 All ER 433 at 439.

Evidence of disclosure has a significant role to play, particularly in cases where it is necessary for the stronger party to rebut an inference the court would otherwise make against the transaction. Where the stronger party is trusted to advise the weaker party, or at least speak out if the transaction is not conceived to be in the latter's best interests, proof of full disclosure of material facts including a full account of the effect of the transaction,²²⁹ discussion of the courses of action open to the weaker party, and sound advice on their merits, will help establish that the transaction is procedurally fair.²³⁰ It will not necessarily do so, however, since there is often a possibility of unfair pressure, which cannot be relieved, though it may possibly be ameliorated, by information and advice. In those circumstances, it may be necessary to go further and provide the weaker party with independent advice²³¹ which is always the prudent course anyway,²³² or to show that the transaction itself is a meritorious one, despite the means by which it has been induced.²³³

There are other relationships, called "relations of advantage",²³⁴ of a less well-defined character.

229 *Archer v Hudson* (1846) 15 LJ Ch 211 at 212-213; *Hartopp v Hartopp* (1856) 25 LJ Ch 471; *Toker v Toker* (1863) 3 De GJ & S 487 at 489-490; *Proctor v Robinson* (1866) 15 LT 431 at 432; *Kempson v Ashebee* (1874) 10 Ch App 15 at 20-21 (advice about the invalidity of a prior agreement should have been given); *Bank of Montreal v Stuart* [1911] AC 120; *London and Westminster Loan and Discount Co Ltd v Bilton* (1911) 27 TLR 184; *Kali Bakhsh Singh and Another v Ram Gopal Singh and Another* (1913) 30 TLR 138.

230 See the following cases, where it was said that proper disclosure should have been made. *Hatch v Hatch* (1804) 9 Ves 292 at 296 (value of property and profits from it); *Grosvenor v Sherratt* (1860) 28 Beav 659 at 665-666 (previous offers, value of property and steps which could be taken to improve its value); In *Dawson v Massey* (1809) 1 Ball & B 231 the relation of guardian and ward had ended, but when dealing with the ward the guardian made unfair use of information acquired during the guardianship. See the judgment at 236-237 by Lord Manners LC (IR).

231 See the following cases, where it was said that independent advice was necessary or desirable. *Griffiths v Robins* (1818) 3 Madd 191 at 192 (to rebut claim of misplaced trust and confidence); *Harvey v Mount* (1845) 8 Beav 439 at 452; *Thornber v Sheard* (1850) 12 Beav 589 at 601 (accounts not made available for consideration by independent adviser); *Sercombe v Sanders* (1865) 34 Beav 382 at 386 (to explain transaction and what was best thing to do); *De Witte v Addison* (1899) 80 LT at 209 (to protect against moral pressure as a result of threats by creditors against father); Cf *Powell v Powell* [1900] 1 Ch 243 at 247 per Farwell J, who appears to say that the solicitor, by declining to approve the transaction, may prevent it from occurring, but that view does not represent the law.

232 See *Spencer Bower Non-Disclosure* 570; *Morley v Loughnan* (1893) 1 Ch 736; *Re Coomber, Coomber v Coomber* [1911] 1 Ch 723; *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127.

233 *Chitty Contract* 424.

234 *Spencer Bower Non-Disclosure* 601.

Here courts of equity have from earliest times exercised the same jurisdiction as in cases of undue influence; or, if not, a jurisdiction very close to it, sharing many of its characteristics and its history. Indeed, examples of its exercise will be found, occurring long before the doctrine of "undue influence" as it is known today in English law, became a distinctive principle of equity.²³⁵

In some of these cases, the existence of a relation of advantage will give rise to the presumption that an unfair use has been made of that advantage. In others, that fact will be proved directly, or by employing the ordinary processes of inference. In either event, the courts may then set aside the transaction which results. This jurisdiction, which in modern authoritative texts²³⁶ is described²³⁷ as a jurisdiction to set aside "unconscionable bargains", or as the doctrine of unconscionability,²³⁸ will be discussed in this sub-chapter.

A relation of advantage is one where the stronger party is better able to negotiate favourable terms than the weaker party, because the latter is ignorant, inexperienced, or under stress, or otherwise unable to give effective attention to a transaction which has been proposed. It is not necessarily wrong to enter into a contract, or take a gift from such a person, but if that favourable position is abused by the stronger party and unfair advantage taken, then the court may set the transaction aside.²³⁹

235 See *Wood v Abrey* (1818) 3 Madd 417; *Longmate v Ledger* (1860) 2 Giff 157; *Clark v Malpas* (1862) 4 De GF & J 401; *Baker v Monk* (1864) 4 De GJ & S 388; *Prees v Coke* (1871) LR 6 Ch App 645; *Fry v Lane* (1888) 40 Ch D 312; *Rees v De Bernardy* [1896] 2 Ch 437; *James v Kerr* (1899) 40 Ch D 449.

236 See, eg, *Chitty Contracts* 428-430; *Snell Equity* 545 *et seq.*

237 The term "harsh and unconscionable" was most precisely used by Lord MacNaghten in *Samuel v Newbold* [1906] AC 461 at 470 to cover cases where the transaction alone (without reference to the relations between the parties) is sufficiently unfair to attract equitable intervention. Once extended to cover cases where the relationship is an important factor in the decision, there is no reason to stop at cases of what are here called "relations of advantage"; it is apt to cover a wide range of cases, including those of undue influence and breach of fiduciary duty as well as many other legal doctrines, wherever it is against conscience for the stronger party to enforce the contract. See *Waddams Contracts* Ch 14. By way of contrast, see Tiplady 1983 *MLR* 601 who argues that many of such cases are well able to be resolved without reference to the concept of an "unconscionable" contract or a "harsh and unfair" bargain, at all.

238 *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 125 at 154; *Davis v Duke of Marlborough* (1819) 2 Swans 108; *Samuel v Newbold* [1906] AC 461 at 470; *National Westminster Bank plc v Morgan* [1985] AC 686.

239 See *Buckley v Irwin* [1960] NI 98; In Canada; *Knupp v Bell* (1968) 67 DLR (2d) 256; *Marshall v Canada Permanent Trust Co* (1968) 69 DLR (2d) 260; *Munding v Munding* (1968) 3 DLR (3d) 338.

The reference to "relations of advantage" is not favoured by many modern theorists who tend to emphasize the resulting transaction rather than the relation which brought it about, and hence speak, (as has been said) of "unconscionable" contracts or transactions.²⁴⁰

Though the terms "unfair advantage" or "undue advantage", or simply "advantage", have not hitherto been adopted to indicate any particular legal category, nevertheless their use is well established in the law²⁴¹ to describe the objectionable feature of some cases where the transaction is set aside.

The doctrine of "unfair advantage" depends, as an essential condition to its applicability, on there being an "inequality" between the parties in the sense already indicated; that is to say, in Lord Hardwicke's language,²⁴² there must be both "weakness on one side" and "on the other advantage taken of that weakness".²⁴³ Inequality in any other sense is absolutely irrelevant. A mere disparity in natural qualities, resources,²⁴⁴ or fortuitous advantages, comes to nothing. The inequality must have been a factitious one: a case must be shown of marked cards, loaded dice, or "a little shuffling" of the rapiers.²⁴⁵ It must appear that the stronger party either brought about the unevenness in the conditions, or, finding it ready to hand, utilized and traded on it to extract from

240 See, eg, Waddams 1976 *MLR* 369; Chitty *Contracts* 429-430. The concept of an unconscionable contract is favoured in statutory provisions dealing with unequal bargains, particularly in the area of consumer protection, but these are beyond the scope of the present inquiry because of their focus on the harshness of the contract rather than the means by which it is brought about. See (in respect of credit contracts), Moneylenders Act of 1900 s 1 (now repealed); ss 137-141 of the Consumer Credit Act of 1974 and also (in respect of exemption clauses and other contractual stipulations or reservations) the Unfair Contract Terms Act of 1977. But it cannot be said that the distinction is a very clear one, and it will be noted that the latter Act contains in its 2nd Schedule express provisions allowing the courts to have regard to similar considerations to those taken into account by courts exercising their inherent jurisdiction to deal with relations of advantage.

241 As Spencer Bower *Non-Disclosure* 601 points out, the terms have not yet attained the status of terms of art, in the same way as have the expressions "undue influence" and "fiduciary duty", but they are frequently found in cases dealing with this subject, and are nearly as ancient; see, eg, *Evans v Llewellyn* (1787) 1 Cox CC 333 at 340; *Baker v Monk* (1864) 4 De G J & S 388 at 394; *Clarke v Malpas* (1862) 4 De G F & J 401 at 405; *Rees v De Bernardy* [1896] 2 Ch 437 at 441.

242 *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 125 at 155-157.

243 *Ibid.*

244 *Osmond v Fitzroy* (1731) 3 P Wms 129 at 129-130.

245 Spencer Bower *Non-Disclosure* 608.

the weaker party a gift or contract which would not otherwise have been made.²⁴⁶ Wherever the weaker party has been unable to establish "circumstances and conditions" of the kind contemplated by Lord Hardwicke no relief has been given.²⁴⁷

Though judicial language may have changed, the underlying basis on which the court intervenes appears to remain the same in the twentieth century.²⁴⁸

Two theories are propounded, namely the victimization or fraud approach, and the "inequality of bargaining power" approach to problems in regard to unfair advantage.

In regard to the "victimization" or "fraud", approach the "unfair conduct" which must be established is described as "victimization, which can consist either of the active extortion of a benefit or the passive acceptance of a benefit in unconscionable circumstances".²⁴⁹ The Privy Council's use of the words "passive victimization"²⁵⁰ leave the matter very much open to further legal development and elucidation.²⁵¹

A more ambitious attempt to define the element of inequality of bargaining power in the case, and at the same time to put the doctrine in a wider context, is made by Lord Denning MR in

246 *Multiservice Bookbinding Ltd and Another v Marden* [1979] 1 Ch 84; *Alec Lobb (Garages) Ltd v Total Oil (Great Britain) Ltd* [1985] 1 All ER 303; *Hart v O'Connor* [1985] AC 1000; *Boustany v Pigott* [1993] NPC 75.

247 Proof of these facts failed in *Farmer v Farmer* (1848) 1 HLC 724; *Harrison v Guest* (1860) 8 HLC 481; *Haygarth v Wearing* (1871) LR 12 Eq 320 at 327; *Armstrong v Armstrong* (1873) IR 8 Eq 1; *Henry v Armstrong* (1881) 18 Ch D 668 at 669; *Howes v Bishop* [1909] 2 KB 390 at 398-399.

248 See, eg, the Privy Council decision in *Hart v O'Connor* [1985] AC 1000; *Dyck v Manitoba Snowmobile Association Inc* (1985) 18 DLR (4th) 635.

249 *Hart v O'Connor* [1985] AC 1000 at 1024. The latter form of "victimization", if such it can be called, is well established; see *Baker v Monk* (1864) 4 De G J & S 388; *Earl of Aylesford v Morris* (1873) LR 8 Ch App 484 at 490; *Fry v Lane* (1888) 40 Ch D 312 at 321. In Australia, see *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; (1983) 46 ALR 402 at 422 where Deane J said that in such cases the weakness must be "sufficiently evident to the stronger party to make it *prima facie* 'unfair' or 'unconscientious' that he procure, or accept, the weaker party's assent".

250 The term "victimize" has also been used in respect of undue influence; *Allcard v Skinner* (1887) 36 Ch D 145 at 182; See, also, *Tufton v Sporni* [1952] 2 TLR 516 at 528; *Re Craig, Meneces v Middleton* [1971] Ch 95 at 101-102; *National Westminster Bank plc v Morgan* [1985] AC 686 at 705.

251 Spencer Bower *Non-Disclosure* 611.

*Lloyds Bank Ltd v Bundy*²⁵² where he states, with reference to undue influence cases that:

"Gathering all together, I would suggest that through all these instances there runs a single thread. They rest on 'inequality of bargaining power'. By virtue of it, the English law gives relief to one who, without independent advice, enters into a contract upon terms which are very unfair or transfers property for a consideration which is grossly inadequate, when his bargaining power is grievously impaired by reason of his own needs or desires, or by his own ignorance or infirmity, coupled with undue influences or pressures brought to bear on him by or for the benefit of the other."

Lord Denning's views on this matter excited considerable controversy when they were put forward; later, they met with judicial disapproval.²⁵³

It has been suggested that it might have been more helpful, and certainly would have been more accurate, if Lord Denning had conceded that a contract or transaction need not always be "very unfair" or the consideration "grossly inadequate" before the court will intervene in the various classes of case he mentions.²⁵⁴ While the inequality of the bargain is obviously an important consideration²⁵⁵ it is not always seen as an indispensable prerequisite to a holding of unfair advantage,²⁵⁶ and past decisions are not to be treated as laying down any particular standards of

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- 252 [1975] QB 326. There are several other judgments delivered by Lord Denning MR to the same effect, such as *Arrale v Costain Civil Engineering Ltd* [1976] 1 Lloyds Rep 98 at 102; *Levison v Patent Steam Carpet Cleaning Co Ltd* [1978] QB 69 at 78-79; *Langdale v Danby*, The Times Nov 24, 1981.
- 253 See *National Westminster Bank plc v Morgan* [1985] AC 686; It has been well received in Canada. Waddams *Contracts* 334 points out that it has been followed in a number of cases. The case law which has resulted is assessed not unfavourably by Enman 1987 *Anglo Am LR* 210-214 though he concedes that it is somewhat uneven; and a much less favourable prognosis is offered by Vaver 1988 *Canadian Bus LJ* 40.
- 254 Spencer Bower *Non-Disclosure* 612. In Canada, Lambert J, delivering a concurring judgment in *Harry v Kreutziger* (1978) 95 DLR (3rd) 231 at 241, suggested a wider test namely "whether the transaction, seen as a whole is sufficiently divergent from community standards of commercial morality that it should be rescinded", arguing that this method of expression prevents the "real issue from being obscured by an isolated consideration of a number of separate questions". The problem with that, is that it is not clear from the judgment how "community standards" are to be determined by a judge without resort to introspection based on a consideration of each of the various aspects mentioned above.
- 255 *Nicols v Gould* (1752) 2 Ves Sen 422; *Griffith v Spratley* (1787) 1 Cox Eq Cas 383 at 388-389; *Cresswell v Potter* [1978] 1 WLR 255 at 257.
- 256 In Australia, see *Blomley v Ryan* (1956) 99 CLR 362 at 405, instancing *Cooke v Clayworth* (1811) 18 Ves 12 (though "inadequacy of consideration....will often be a

unfairness or inequality which later courts should follow.²⁵⁷ Lord Denning's formulation thus appears to give undue force to a single and apparently unchangeable element in cases of unconscionability, namely, inequality of exchange.

Lord Denning's statement was strongly criticized as a departure from principle, by Lord Scarman when the latter was delivering the principal speech of the House of Lords in *National Westminster Bank plc v Morgan*,²⁵⁸ although not for the reasons so far put forward. The first of Lord Scarman's objections is that the law of undue influence also applies to transactions by way of gift, where the concept of "inequality of bargaining power" is inappropriate.²⁵⁹ The second objection is that "even in the field of contract I question whether there is any need in modern law to erect a general principle of relief against inequality of bargaining power",²⁶⁰ since in his view this would be to embark on an essentially legislative task, and one where Parliament had itself determined what limits on contractual freedom should be imposed, and what remedies afforded.²⁶¹

Rather than define closely what is meant by "victimization" or "fraud" in an equitable sense, the courts in the nineteenth century often preferred to infer such wrongdoing from a consideration of the surrounding facts of the case, when those facts indicated (by reason of the apparent weakness of one party, and an unexplained benefit received by the other) that some underhand dealing may have taken place. As will be seen, the presumptive process was adopted particularly in cases involving dealings with expectant heirs and others in poverty and want.²⁶² And there

specially important element in cases of this type"); *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 475.

257 In New Zealand, see *Harris v Richardson* [1930] NZLR 890 at 920.

258 [1985] AC 686 at 707-708; 31 Halsbury par 854n2.

259 Although it seems that the principle applied in such cases would not be too dissimilar, and it is likely that a slight change of wording could meet Lord Scarman's objection. See, in Australia, *Johnson v Buttress* (1936) 56 CLR 113 at 126; *Wilton v Farnworth* (1948) 76 CLR 646 at 655.

260 *National Westminster Bank plc v Morgan* [1985] AC 686 at 708.

261 Spencer Bower *Non-Disclosure* 614 n4, finds it surprising that, in this area of law in particular, Lord Scarman should have insisted on so rigorous a division between judicial and legislative lawmaking functions. The doctrine of equitable fraud existed for centuries alongside extensive statutory provisions dealing with usury.

262 *Cheshire Contract* 428; *Fry v Lane* (1888) 40 Ch D 312; *Cresswell v Potter* [1978] 1 WLR 255; *Backhouse v Backhouse* [1978] 1 All ER 1158; *Hart v O'Connor* [1985] AC 1000.

were also some extreme cases where the necessary "circumstances and conditions" were established by mere inference from the enormity of the transaction itself, the provisions and contents of which may be so extravagant and oppressive *ex facie* as to raise a presumption at once against the stronger party, without further enquiry.²⁶³ In approaching this problem by way of a presumption, the courts maintained consistency not only with their treatment of cases of undue influence, but also with the underlying theory of "presumptive" or inferred fraud as stated by Lord Hardwicke in the foundation authority on this subject.²⁶⁴

If satisfactory evidence was given of facts of such a nature as to constitute those classes of relation, the same presumption²⁶⁵ in favour of the weaker party was made, and the same burden of repelling it was at once cast upon the stronger party, as in the case of any of the domestic or professional relations considered in relation to the law of undue influence. The presumption here was of an unconscientious use of power arising out of the circumstances and conditions of the parties contracting. Thus, in *Earl of Aylesford v Morris*,²⁶⁶ the second of the two classical sources for the law of unfair advantage, Lord Selborne LC, dealing with a case of an extortionate bargain entered into with an expectant heir, observes that:

"...when the relative position of the parties is such as *prima facie* to raise this presumption, the transaction cannot stand unless the person claiming the benefit of it is able to repel the presumption by contrary evidence, proving it to have been in point of fact fair, just and reasonable."²⁶⁷

263 *Dunnage v White* (1818) 1 Swans 137 at 150-151; *MacCabe v Hussey* (1831) 5 Bligh NS 715 at 729. The stronger party's difficulties in sustaining the transaction were accentuated, in some of these cases, by false recitals in the relevant deeds; see, also, *Bridgman v Green* (1757) Wilm 58 at 62-64.

264 *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 125.

265 *Hart v O'Connor* [1985] AC 1000.

266 (1873) LR 8 Ch App 484.

267 *Earl of Aylesford v Morris* (1873) LR 8 Ch App 484 at 491. Although Lord Selborne was at this point speaking generally of the doctrine of undue influence, it is clear that he intended his comments to apply equally to cases of expectant heirs. See Spencer Bower *Non-Disclosure* 618. His observations have been followed in decisions of high authority. See *Permanent Trustee Co of New South Wales Ltd v Bridgewater* [1936] 3 All ER 501 at 508 (PC on appeal from Australia, Lord Russell). In Australia, see *Blomley v Ryan* (1956) 99 CLR 362 at 428-429. In Canada, see *Morrison v Coast Finance Ltd* (1965) 55 DLR (2d) 710 noted by Crawford 1966 *Can Bar Rev* 142; *Harry v Kreutziger* (1978) 95 DLR (3rd) 231 at 236. In New Zealand, see *Harris v Richardson* [1930] NZLR 890 at 918.

The courts have no jurisdiction to interfere merely because the transaction is an improvident one.²⁶⁸ Nor is there any established equitable jurisdiction (short of the legal doctrine of frustration) to relieve a party of the harsh consequences of a contract in events which have not been foreseen.²⁶⁹ The central substantive issue is whether the contract or other transaction is in all the circumstances a "fair" one, and "unfairness" usually involves more than inequality of power or exchange: it requires "victimization".²⁷⁰

It is outside the scope of this thesis to discuss particular relations of advantage in detail. Suffice it to say that particular examples of relations of advantage can be considered under two principal headings. The first comprises the courts' ancient jurisdiction over dealing with "catching bargains" made with expectant heirs and others similarly placed.²⁷¹ The second comprises all other types of the taking of unfair advantage.

2.3 APPLICATION OF ENGLISH COMMON-LAW DISCLOSURE PRINCIPLES TO SURETYSHIP

2.3.1 Introduction

The English contract of suretyship, more commonly referred to as a guarantee, has been defined²⁷² as an accessory contract²⁷³ by which the promisor undertakes to be answerable²⁷⁴ to

268 *Clark v Malpas* (1862) 4 De G F & J 401 at 403; *White and Carter (Councils) Ltd v McGregor* [1962] AC 413 at 445; *Bridge v Campbell Discount Co Ltd* [1962] AC 600 at 626; *Burmah Oil Co Ltd v Bank of England* [1980] AC 1090; (1981) 125 Sol J 528; *Alec Lobb (Garages) Ltd v Total Oil (Great Britain) Ltd* [1985] 1 WLR 173 at 182. In New Zealand, see *Brusewitz v Brown* [1923] NZLR 1106 at 1109. The only exception to this rule may exist where the undervalue is very gross. See *Clark v Malpas, ibid*, at 403; *Griffith v Spratley* (1787) 1 Cox Eq Cas 383 at 389.

269 *Multiservice Bookbinding Ltd and Others v Marden* [1979] 1 Ch 84 at 112-113.

270 *Chitty Contract* 431.

271 The prominent case being *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 125. See, also, *Earl of Aylesford v Morris* (1873) LR 8 Ch App 484; *Nevill v Snelling* (1880) 15 Ch D 679.

272 *Mercers Co v New Hampshire Insurance Co* [1992] 3 All ER 57.

273 *Re Stratton, Ex parte Salting* (1883) 25 Ch D 148 at 151; *Moschi v Lep Air Services Ltd* [1973] AC 331 at 347.

274 "Translated into modern legal terminology 'to answer for' is 'to accept liability for'." See *Moschi v Lep Air Services Ltd* [1973] AC 331 at 347.

the promisee for the debt, default or miscarriage²⁷⁵ of another person, whose primary liability to the promisee must exist or be contemplated.²⁷⁶

A contract of suretyship, like any other contract, is liable to be avoided if induced by a material misrepresentation of an existing fact, even if made innocently.²⁷⁷

Misrepresentation may be either written²⁷⁸ or oral.²⁷⁹ It usually consists of the direct assertion by the creditor²⁸⁰ of "fact" which is not fact and which is calculated to influence a person to become a guarantor.²⁸¹ However, it may also consist of statements by the creditor which tell only a misleading part of the truth,²⁸² or arise from the creditor's failure to correct a statement which he believed to be true when he made it, but which he subsequently discovers to be untrue, or a

275 "...'debt, default or miscarriage' is descriptive of failure to perform legal obligations, existing or future, arising from any source, not only from contractual promises, but in any other factual situations capable of giving rise to legal obligations such as those resulting from bailment, tort or unsatisfied judgments". See *Moschi v Lep Air Services Ltd* [1973] AC 331 at 347-348.

276 There must be a principal obligation of some other principal obligor to which the guarantee is to be ancillary and subsidiary. See *Swan v Bank of Scotland* (1836) 10 Bligh NS 627; *Lakeman v Mountstephen* (1874) LR 7 HL 17 at 24-25; *Lougher v Molyneux* [1916] 1 KB 718; *General Surety and Guarantee Co Ltd v Francis Parker Ltd* (1977) 6 BLR 16 at 21.

277 See, in regard to materiality, *Davies v London and Provincial Marine Insurance Co* (1878) 8 Ch D 469; *Bank of New South Wales v Rogers* (1941) 65 CLR 42; in regard to factuality, see *National Bank of New Zealand v Macintosh* (1881) 3 NZLR 217; in regard to fault, see, eg, *Mackenzie v Royal Bank of Canada* [1934] AC 468; the Misrepresentation Act of 1967.

278 *Lee v Jones* (1864) 17 CB (NS) 482.

279 *Blest v Brown* (1862) 4 De GF & J 367.

280 Circumstances in which the creditor will be affected by misrepresentation or other wrongdoing by the principal debtor or other third party, shall be discussed below.

281 *Foster v Mackinnon* (1869) LR 4 CP 704; *Lewis v Clay* (1897) 67 LJQB 244. Thus, if to a question asked by the proposed surety as to the existence of trade debts owing by the principal debtor, the creditor's agent replies in the negative, when in point of fact there is one such debt owing, this amounts to misrepresentation: *Blest v Brown* (1862) 4 De GF & J 367; as does also a gratuitous assertion that an estate is free from incumbrances, other than those specifically mentioned, when in fact there is another and undisclosed incumbrance: see *Willis v Willis* (1850) 17 Sim 218. See, also, *Stone v Compton* (1838) 5 Bing NC 142, a case of a misleading statement that a sum owing by the principal debtor to the creditor had already been paid; *M'Kewan v Thornton* (1861) 2 F & F 594 an alleged misrepresentation as to the state of the principal debtor's account with the creditor bank.

282 *Willis v Willis* (1850) 17 Sim 218; *Lee v Jones* (1864) 17 CB (NS) 482.

statement which was true when made, but which has subsequently become, to his knowledge, untrue.²⁸³ Whether the non-disclosure of a fact amounts to a representation of its non-existence is, in every case, a question of fact dependent upon all the circumstances.²⁸⁴

The primary remedy for misrepresentation is rescission.²⁸⁵ However, rescission may be refused and damages awarded in lieu if it is equitable to do so, having regard to the nature of the misrepresentation and the loss that would be caused by it if the contract were upheld, as well as to the loss which rescission would cause to the other party.²⁸⁶ The right to rescind may be lost by affirmation of the guarantee²⁸⁷ by the fact that the parties cannot be restored to their pre-contractual positions,²⁸⁸ and by the intervention of third-party rights.²⁸⁹ Damages may be awarded for loss caused by misrepresentation.²⁹⁰ There are restrictions on the right to exclude or restrict liability for misrepresentation.²⁹¹

As I have pointed out, in English law non-disclosure is not seen as part of the concept of misrepresentation, but rather as a doctrine with its own rules. An ordinary contract of guarantee,

283 *Davies v London and Provincial Marine Insurance Co* (1878) 8 ChD 469 at 475.

284 *Lee v Jones* (1864) 17 CB (NS) 482; *London General Omnibus Co Ltd v Holloway* [1912] 2 KB 72 at 77. Apart from these cases, mere silence is not in general misrepresentation; see *Fox v Mackreth* (1788) 2 Bro CC 400 on appeal (1791) 2 Cox Eq Cas 320 at 320-321; *Bell v Lever Brothers Ltd* [1932] AC 161 at 227.

285 See, eg, *MacKenzie v Royal Bank of Canada* [1934] AC 468; s 1 of the Misrepresentation Act of 1967 and 20 Halsbury par 123 *et seq.*

286 S 2 (2) of the Misrepresentation Act of 1967. In *Ward v National Bank of New Zealand* (1886) 4 NZLR 35 a guarantor was induced by misrepresentation to give a second guarantee in substitution for the first. The court refused to set the second guarantee aside except on terms that the guarantor restored the creditor bank to the position that it was in before the second guarantee was given.

287 20 Halsbury para 123 .

288 20 Halsbury para 123.

289 20 Halsbury para 123.

290 See s 2 of the the Misrepresentation Act of 1967 and 20 Halsbury par 123. In appropriate circumstances, a misrepresentation may also give rise to a cause of action in the tort of deceit or the tort of negligence; see, eg, *Esso Petroleum Co Ltd v Mardon* [1976] 2 All ER 5.

291 See s 3 of the Misrepresentation Act of 1967 (substituted by s 8(1) of the Unfair Contract Terms Act of 1977); and 20 Halsbury par 123.

unlike a contract of insurance,²⁹² is not a contract *uberrimae fidei*,²⁹³ requiring full disclosure of all material facts by the contracting parties.²⁹⁴

2.3.2 Matters which need not be disclosed

On the basis that an ordinary contract of guarantee is not one *uberrimae fidei*,²⁹⁵ it has been held that a creditor (who had not been specifically asked)²⁹⁶ was under no duty to disclose to an intending surety the fact that the principal debtor was already overdrawn,²⁹⁷ or the extent of that

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- 292 For the principle that insurance is a contract *uberrimae fidei*, see *London Assurance Co v Mansel* (1879) 11 Ch D 363; *Container Transport International Inc and Reliance Group Inc v Oceanus Mutual Underwriting Association (Bermuda) Ltd* [1984] 1 Lloyds Rep 476; *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1993] 1 Lloyds Rep 496.
- 293 It was formerly held that a creditor's duty of disclosure when communicating with a surety was similar to that of a person seeking insurance; *Owen v Homan* (1851) 3 Mac & G 378 at 397 per Lord Truro. But in offering his opinion Lord Truro had failed to notice the celebrated speech in the Lords of Lord Campbell in *Hamilton v Watson* (1845) 12 Cl & Fin 109, as was soon pointed out in the later case of *North British Insurance Co v Lloyd* (1854) 10 Exch 523 in which it was held that a contract of suretyship is not one requiring disclosure of all material facts.
- 294 *Williams v Rawlinson* (1825) 3 Bing 71; *Hamilton v Watson* (1845) 12 CL & Fin 109 at 118-119; *North British Insurance Co v Lloyd* (1854) 10 Exch 523; *Wythes v Labouchere* (1859) 3 De G & J 593; *Lee v Jones* (1864) 17 CB (NS) 482; *Davies v London and Provincial Marine Insurance Co* (1878) 8 Ch D 469 at 475; *London General Omnibus Co Ltd v Holloway* [1912] 2 KB 72 at 81. There is no magic in the use of the word "insurance" or "guarantee". Many contracts may with equal propriety be called by either term, in English law; whether the contract is one requiring *uberrima fides* depends upon its substantial character. See *Seaton v Heath* [1899] 1 QB 782 at 792 per Romer LJ revised, without affecting this point, *sub nom Seaton v Burnand*, *Burnand v Seaton* [1900] AC 135.
- 295 *Hamilton v Watson* (1845) 12 Cl & Fin 109; *Lee v Jones* (1864) 17 CB (NS) 482.
- 296 If the intending guarantor is unacquainted with the risk he is undertaking he should inquire about it; *Seaton v Heath*, *Seaton v Burnand* [1899] 1 QB 782 at 793, per Romer LJ revised without affecting this point, *sub nom Seaton v Burnand*, *Burnand v Seaton* [1900] AC 135. For the creditor's obligation to give proper answers to the guarantor's questions see *Parsons v Barclay & Co Ltd and Goddard* (1910) 103 LT 196; *Westminster Bank Ltd v Cond* (1940) 46 Com Cas 60 at 69.
- 297 As it is not a matter of presumption that a customer's account stands clear at the time the guarantee is given, the surety should inquire about it. See *Kirby v Duke of Marlborough and Another* (1813) 2 M & S 18 at 22. Where a bond is given for the continuance of an old bank account the guarantor will not be discharged by the non-disclosure of the fact of the principal debtor's having a balance against him duly secured at the date of the bond, as it is well known that such accounts are not carried on until the old balance has been secured; *Williams v Rawlinson* (1825) 3 Bing 71 at 77. See, also, *Lloyds Bank Ltd*

overdraft or other indebtedness to the creditor,²⁹⁸ whether the principal debtor is in the habit of overdrawing,²⁹⁹ how the principal debtor's account has been kept,³⁰⁰ the fact that the principal debtor's account has been conducted in an irregular way,³⁰¹ whether the principal debtor has been punctual in his dealings,³⁰² the fact that the creditor bank has dishonoured cheques drawn by the principal debtor,³⁰³ the fact that the principal debtor has previously defaulted,³⁰⁴ the fact that the creditor is suspicious that the principal debtor has been defrauding him,³⁰⁵ the fact that the husband of the principal debtor, who has authority to draw on the account to be guaranteed, is an undischarged bankrupt,³⁰⁶ the fact that the manager of the creditor bank had "taken partial

v Harrison (1925) 4 LDAB 12; *Westminster Bank Ltd v Cond* (1940) 46 Com Cas 60; *Cooper v National Provincial Bank Ltd* [1946] 1 KB 1 (England); *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 455-463 (Australia). But see *Lee v Jones* (1864) 17 CB (NS) 482 where the guarantee was of payments to be made by an agent to his merchant principals, and it was held that non-disclosure of existing arrears was in the circumstances evidence of fraud. It was held, at 505 per Blackburn J:

"It depends whether in such a transaction as that described in the agreement it might or might not naturally be expected that the matters might have allowed a balance of this extent to accumulate and might have allowed the amount to stand unsettled over so long a time."

- 298 *Hamilton v Watson* (1845) 12 Cl & Fin 109; *Royal Bank of Scotland v Greenshields* 1914 SC 259; *London General Omnibus Co Ltd v Holloway* [1912] 2 KB 72. *National Provincial Bank of England Ltd v Glamusk* [1913] 3 KB 335.
- 299 *Hamilton v Watson* (1845) 12 Cl & Fin 109. "No surety asked to guarantee a banking account is entitled to assume that the customer of the bank has not been in the habit of overdrawing; the proper presumption in most instances is that he has been doing so, and wishes to do so again": *London General Omnibus Co Ltd v Holloway* [1912] 2 KB 72 at 83 per Farwell J.
- 300 *Hamilton v Watson* (1845) 12 Cl & Fin 109; *London General Omnibus Co Ltd v Holloway* [1912] 2 KB 72.
- 301 *Cooper v National Provincial Bank Ltd* [1946] 1 KB 1, a case of cheques drawn then countermanded.
- 302 *Hamilton v Watson* (1845) 12 Cl & Fin 109.
- 303 *National Provincial Bank of England Ltd v Glamusk* [1913] 3 KB 335.
- 304 *Roper v Cox* (1882) 10 LR IR 200, a case where the principal debtor was guilty of gross irregularity and delay in paying rent, and substantially in arrears at date of guarantee. See, also, *Home Insurance Co v Holway* (1881) 39 American Reports 179.
- 305 *Bank of Scotland v The Morrison* 1911 SC 593 at 602; *National Provincial Bank of England Ltd v Glamusk* [1913] 3 KB 335 at 339; *Royal Bank of Scotland v Greenshields* 1914 SC 259.
- 306 *Cooper v National Provincial Bank Ltd* [1946] 1 KB 1.

control" of the principal debtor's business,³⁰⁷ whether the principal debtor has performed his promises in an honourable manner,³⁰⁸ the fact that the creditor intends to lend a further substantial sum on the faith of the guarantee,³⁰⁹ or the fact that the guarantee is required because another guarantor wishes to retire.³¹⁰

2.3.3 Where disclosure is required

There are, nevertheless, four circumstances³¹¹ in which the creditor must make disclosure to an intending guarantor:

- (1) where the creditor is asked a specific question,³¹²
- (2) where a bank misleads the guarantor by volunteering only part of the truth;³¹³
- (3) where the guarantor makes a statement in the creditor's presence that demonstrates that he entirely misunderstands the principal debtor's position;³¹⁴ and
- (4) where there is anything that might not naturally be expected to take place between the principal debtor and the creditor, something the surety would not expect to exist.³¹⁵

307 *Lloyds Bank Ltd v Harrison* (1925) 4 LDAB 12 (CA). The bank manager had agreed to give an extended credit to the principal debtor only on terms that he should not buy further stock, but should confine his business to selling his existing stock, and should lay off certain of his employees.

308 *Hamilton v Watson* (1845) 12 Cl & Fin 109.

309 *Westminster Bank Ltd v Cond* (1940) 46 Com Cas 60.

310 *North British Insurance Co v Lloyd* (1854) 10 Exch 523.

311 Apart from statutory compulsion to make disclosure. See eg, s 47 of the Financial Services Act of 1986 which provides that a person who makes a statement, promise or forecast which he knows or realizes is likely to be misleading, false or deceptive, or dishonestly conceals any material facts, for the purpose of inducing another to enter into an investment, commits an offence.

312 *Hamilton v Watson* (1845) 12 Cl & Fin 109; *Royal Bank of Scotland v Greenshields* 1914 SC 259; *Westminster Bank Ltd v Cond* (1940) 46 Com Cas 60.

313 *Royal Bank of Scotland v Greenshields* 1914 SC 259.

314 *Royal Bank of Scotland v Greenshields* 1914 SC 259.

315 *Hamilton v Watson* (1845) 12 Cl & Fin 109 at 119; *National Provincial Bank of England Ltd v Glanusk* [1913] 3 KB 335 at 338; *Lloyds Bank Ltd v Harrison* (1925) 4 LDAB 12 (CA) at 13, per Sir Ernest Pollock MR and at 15-16 per Bankes LJ; *Cooper v National Provincial Bank Ltd* [1946] 1 KB 1; *Levett and Others v Barclays Bank plc* [1995] 2 All ER 615 at 628.

2.3.3.1 The duty to answer questions

It is the duty of a creditor to give a true, honest and accurate answer to any specific question directed to him by an intending guarantor which is in any way material to the giving of the guarantee.³¹⁶ If the creditor's answer is misleading, it may amount to a misrepresentation and so entitle the guarantor to avoid the guarantee.

The questioner must be careful in putting his questions. As Spencer Bower³¹⁷ points out, if the question is too hastily or unskillfully put, it may prove to be disadvantageous to him as the asking of a question on one aspect of a proposed contract may serve as an indication that some other question, which has not been asked, was regarded by the parties as immaterial.

2.3.3.2 Disclosure of special circumstances

The creditor must disclose to an intending guarantor anything which might not naturally be expected to take place between the parties who are concerned in the transaction, namely whether there is a contract between the debtor and the creditor to the effect that the debtor's position is to be different from that which the guarantor might naturally expect.³¹⁸

The omission to mention any such special fact is an implied representation to the intending guarantor that it does not exist,³¹⁹ entitling the guarantor upon discovering the true position to avoid the guarantee.³²⁰

316 *Westminster Bank Ltd v Cond* (1940) 46 Com Cas 60 at 69. The creditor is not obliged to make inquiries in order to answer, merely to answer truthfully from the information which he has. See *Parsons v Barclay & Co Ltd and Goddard* (1910) 103 LT 196.

317 Spencer Bower *Non-Disclosure* 168.

318 *Hamilton v Watson* (1845) 12 Cl & Fin 109 at 119. See, also, *Smith and Others v The Governor and Company of the Bank of Scotland* (1813) 1 Dow 272; *Railton v Matthews* (1844) 10 Cl & Fin 934; *North British Insurance Co v Lloyd* (1854) 10 Exch 523; *Lee v Jones* (1864) 17 CB (NS) 482 at 503-504; *Phillips v Foxall* (1872) LR 7 QB 666; *London General Omnibus Co Ltd v Holloway* [1912] 2 KB 72; *National Provincial Bank of England Ltd v Glanusk* [1913] 3 KB 335 at 338; *Royal Bank of Scotland v Greenshields* 1914 SC 259; *Lloyds Bank Ltd v Harrison* (1925) 4 LDAB 12 at 13, CA per Sir Ernest Pollock MR and at 15-16; *Westminster Bank Ltd v Cond* (1940) 46 Com Cas 60 at 69; *Cooper v National Provincial Bank Ltd* [1946] 1 KB 1 at 6; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 447.

319 See the cases cited in the previous note.

320 *MacKenzie v Royal Bank of Canada* [1934] AC 468.

It depends on the circumstances of each case whether a fact not disclosed is such that it is impliedly represented not to exist.³²¹ In general the guarantor should be informed of every private bargain between the creditor and the principal debtor varying the degree of the guarantor's responsibility,³²² and it may sometimes become necessary even to disclose the existence and nature of an agreement between the creditor and some person other than the principal debtor.³²³

It has been held, for example, that a creditor was obliged to disclose to an intending guarantor the existence of an agreement that part of the advance to be secured by the guarantee was to be applied to repay a pre-existing debt.³²⁴ The guarantor was held to be discharged by the creditor's failure to disclose a further incumbrance, where an estate was conveyed to a person "free from encumbrances" except those set out in a particular schedule, in consideration of that person and his guarantor doing certain things.³²⁵ Where the creditor failed to disclose his understanding with the principal debtor that the promissory note, in which the guarantor had joined the principal debtor, should not be payable for five years, but should bear interest at five per cent *per annum*, secured by a separate promissory note given by the principal debtor, the guarantor was also held to be discharged.³²⁶ Similarly, the guarantor was held to be discharged where the creditor made a secret arrangement to take payment of his debt in full, the guarantee having been given to

321 *Lee v Jones* (1864) 17 CB (NS) 482 at 506; *London General Omnibus Co Ltd v Holloway* [1912] 2 KB 72 especially at 85-88.

322 *Smith and Others v The Governor and Company of the Bank of Scotland* (1813) 1 Dow 272 at 292; *Pidcock v Bishop* (1825) 3 B & C 605; *Stone v Compton* (1838) 5 Bing BC 142 at 157; *Pendlebury v Walker* (1841) 4 Y & C Ex 424; *Railton v Matthews* (1844) 10 Cl & Fin 934; *Hamilton v Watson* (1845) 12 Cl & Fin 109; *Burke v Rogerson* (1866) 14 LT 780; *Mackreth v Walmesley* (1884) 51 LT 19.

323 *Stiff v Eastbourne Local Board* (1886) 19 LT 408. In the case of a surety for payment of part of the purchase money of ships, it has been held that the fact that one of the ships is laden with munitions of war destined for a belligerent port should be disclosed to the surety. *Burke v Rogerson* (1866) 14 LT 780.

324 *Stone v Compton* (1838) 5 Bing NC 142 where the mortgage for the same sum as the guarantee, which was read over to the guarantor, recited that the full sum was being advanced. In fact it had been agreed that part of it should be kept back to pay a pre-existing debt, which the mortgage recited as paid. See, also, *Lee v Jones* (1864) 17 CB (NS) 482 and *Blest v Brown* (1862) 4 De GF & J 367. See *Mackreth v Walmesley* (1884) 51 LT 19 where the creditor was held not to have been obliged to disclose an arrangement made by the principal debtor to pay a debt to another surety with the advance to be guaranteed; *Smith and Others v The Governor and Company of the Bank of Scotland* (1813) 1 Dow 272; *Westminster Bank Ltd v Cond* (1940) 46 Com Cas 60; *Cooper v National Provincial Bank Ltd* [1946] 1 KB 1.

325 *Willis v Willis* (1850) 17 Sim 218 and see *Blest v Brown* (1862) 4 De GF & J 367.

326 *Espey v Lake* (1852) 10 Hare 260.

secure an advance to enable the debtor to pay a composition agreed by the general body of creditors.³²⁷

2.3.3.4 No duty on bank to explain

There is no special obligation upon a person to whom another is about to give a guarantee, to explain the meaning or effect of the guarantee, any more than a person who is taking from another any other species of deed or instrument which is to enure to the benefit of the person taking it, is under such obligation.³²⁸

The fact that the creditor is a bank or other large institution does not impose upon it an obligation to explain, without being asked, the meaning or effect of the guarantee, whether the intending guarantor is a customer of the bank³²⁹ or not.³³⁰ Nor is a bank, unasked, obliged to advise the guarantor on the financial wisdom of the transaction,³³¹ or to recommend the customer to take

327 *Pendlebury v Walker* (1841) 4 Y & C Ex 424.

328 *Small v Currie* (1853) 2 Drewry 102 at 114-115.

329 *Barclays Bank plc v Khaira and Another* [1992] 1 WLR 623, not following the *obiter dictum* of Kerr LJ in *Cornish v Midland Bank plc (Humes, third party)* [1985] 3 All ER 513 at 522-523. See, also, *Chetwynd-Talbot v Midland Bank Ltd* (1982) 132 NLJ 901.

330 *O'Hara v Allied Irish Banks Ltd* [1985] BCLC 52; *Union Bank of Finland v Lelakis* [1995] CLC 27. However, see the new Codes of Banking Practice (2) and (3). The Codes contain provisions to the effect that that banks will advise private individuals, proposing to give them a guarantee or other security for another person's liabilities:

- (a) that by giving the guarantee or other security he or she might become liable instead of or as well as that other person, and
- (b) that he or she should seek independent legal advice before entering into that guarantee or security. In *Lloyds Bank plc v Waterhouse* (1991) 10 Tr LR 161, Woolf LJ referred to Lloyds Bank's similar internal rule as "what I would expect of a responsible financial institution". See, also, Lord Browne-Wilkinson in *Barclays Bank plc v O'Brien and Another* [1994] 1 AC 180 at 197, who referred approvingly to these good banking practices. In *Union Bank of Finland v Lelakis* [1995] CLC 27 the surety defendant argued that Lord Browne-Wilkinson's remarks in the *O'Brien* case [1994] 1 AC 180, supported a general duty to advise prospective sureties, but this submission was rejected. It would seem as if, in principle, the adoption of the Code has not imposed any legal duty to advise a guarantor as to the effect of the proposed transaction. Whether this would remain the case in view of the promissory tone of the third edition of the code, (par 3.14) remains to be seen. It is possible that as par 3.14 is now addressed to the customer and not to the surety, there may be no reason to give it more contractual effect than the corresponding provisions in the two earlier editions.

331 *Midland Bank plc v Hubbard* (Unreported, February 16, 1993, (CA)). See *Schioler v Westminster Bank Ltd* [1970] 2 QB 719; [1970] 3 All ER 177; *Williams and Glynn's*

legal advice.³³²

If, however, the creditor does give the intending guarantor any explanation, it must be sufficiently accurate and complete so as not to be misleading.³³³

2.3.4 Duress

A guarantee procured by duress by the creditor is liable to be set aside.³³⁴ Duress may take the

Bank Ltd v Barnes [1981] Com LR 205; *Redmond v Allied Irish Banks plc* [1987] 2 FTLR 264. Where a guarantee policy is given for the solvency of a surety for the maker of a promissory note, the non-disclosure by the holders of the policy of the rate of interest and the circumstances of the loan obtained by means of the promissory note does not afford any defence to the guarantor in the absence of evidence that these facts were material to the ordinary risk he undertook. See *Seaton v Burnand*, *Burnand v Seaton* [1900] AC 135.

- 332 *Ward v Hobbs* (1878) 4 App Cas 13; *Hurley v Dyke* [1979] RTR 265; *Barclays Bank plc v Khaira and Another* [1992] 1 WLR 623. The question of independent advice brings about its own special problems. In *Levett and Others v Barclays Bank plc* [1995] 2 All ER 615, eg, the bank had arranged for the surety to obtain independent advice, but it was held that this was to no effect as the bank officer did not explain to the solicitor, who was to advise Levett, of a key term in the contract.
- 333 *Cornish v Midland Bank plc (Humes, third party)* [1985] 3 All ER 513. In *Midland Bank plc v Hubbard* (Unreported, February 16, 1993, (CA)) the bank manager told the wife, about to mortgage her home to secure the indebtedness of her husband's company, that the mortgage was to secure borrowing in accordance with arrangements agreed with her husband. He also explained to her what he called the "worst scenario," which was that the bank could take possession of the house and sell it, and said that her rights were removed by signing the charge. Gibson LJ described this explanation as "entirely adequate".
- 334 See, eg, *Mutual Finance Ltd v John Wetton & Sons Ltd* [1937] 2 All ER 657 where a guarantee obtained from a family company by a threat to prosecute a family member, was held voidable. The case was argued and decided as a case of undue influence, on the basis that "the common law doctrine of duress has been superseded by the equitable doctrine of undue influence" (see at 394). See, also, *Williams v Bayley* (1866) LR 1 HL 200; *Kaufman v Gerson* [1904] 1 KB 591; *Société des Hôtels Réunis SA v Hawker* (1913) 29 TLR 578. In *Barton v Armstrong* [1975] 2 All ER 465 the Privy Council described certain deeds as being "void" as a result of duress. However, such contracts are more commonly spoken of as being only voidable — see *Lynch v Director of Public Prosecutions for Northern Ireland* [1975] 1 All ER 913 at 938; *North Ocean Shipping Co Ltd v Hyundai Construction Co Ltd; The Atlantic Baron* [1979] QB 705; [1978] 3 All ER 1170; *Pao On v Lau Yiu Long* [1980] AC 614 at 634; [1979] 3 All ER 65 at 77-78. *Universe Tankships Inc of Monrovia v International Transport Workers Federation and Laughton; The Universe Sentinel* [1983] 1 AC 366 at 383; [1982] 2 All ER 67 at 75.

form of physical coercion,³³⁵ or of any other conduct or threat which the law regards as illegitimate³³⁶ which coerces the will of the guarantor and so vitiates his consent to the guarantee.³³⁷

2.3.5 Undue influence

A guarantee procured by undue influence on the part of the creditor is liable to be set aside.³³⁸

Such undue influence can be either actual undue influence or presumed undue influence.³³⁹ In

335 *Friedberg-Seeley v Klass* (1957) 101 *Sol J* 275; *Barton v Armstrong* [1975] 2 All ER 465.

336 Legitimate commercial pressure can never amount to duress. See *Occidental Worldwide Investment Corporation v Skibs A/S Avanti, Skibs A/S Glarona, Skibs A/S Navalis, The "Siboen" and The "Sibotre"* [1976] 1 Lloyds Rep 293 at 336.

"Now let me say at once that in the vast majority of cases a customer who signs a bank guarantee...cannot get out of it. No bargain will be upset which is the result of the ordinary interplay of forces. There are many hard cases caught by this rule...take the case of a borrower in urgent need of money. He borrows it from the bank at high interest and is guaranteed by a friend. The guarantor gives his bond and gets nothing in return. The common law will not interfere."

per *Lloyds Bank Ltd v Bundy* [1975] 1 QB 326 at 336; [1974] 3 All ER 757 at 763.

337 *Occidental Worldwide Investment Corporation v Skibs A/S Avanti, Skibs A/S Glarona, Skibs A/S Navalis, The "Siboen" and The "Sibotre"* [1976] 1 Lloyds Rep 293 at 336; *North Ocean Shipping Co Ltd v Hyundai Construction Co Ltd; The Atlantic Baron* [1979] QB 705; [1978] 3 All ER 1170; *Syros Shipping Co SA v Elaghill Trading Co; The Proodos C* [1981] 3 All ER 189 at 192; [1980] 2 Lloyds Rep 390 at 393; *Universe Tankships Inc of Monrovia v International Transport Workers Federation and Laughton; The Universe Sentinel* [1983] 1 AC 366; [1982] 2 All ER 67; *B & S Contracts and Design Ltd v Victor Green Publications Ltd* [1984] ICR 419; *Alec Lobb (Garages) Ltd v Total Oil Great Britain Ltd* [1985] 1 All ER 303; *Vantage Navigation Corporation v Suhail and Saud Bahwan Building Materials LLC; The Alev* [1989] 1 Lloyds Rep 138; *Atlas Express Ltd v Kafco (Importers and Distributors) Ltd* [1989] 1 All ER 641; *Dimskal Shipping Co SA v International Transport Workers Federation; The Evia Luck* [1992] 2 AC 152.

338 *Lloyds Bank Ltd v Bundy* [1975] 1 QB 326. *National Westminster Bank plc v Morgan* [1985] AC 686. *Woodstead Finance Ltd v Petrou* [1986] BTLC 267; *Midland Bank plc v Phillips* (Unreported, March 14, 1986, CA).

339 In *Barclays Bank plc v O'Brien and Another* [1993] 4 All ER 417 the House of Lords approved the classification adopted by the Court of Appeal in *Bank of Credit and Commerce International SA v Aboody and Another* [1990] 1 QB 932 at 953; [1992] 4 All ER 955 at 964 under which cases of actual undue influence are referred to as falling into "Class 1" and cases of presumed undue influence into "Class 2". Class 2 is further subdivided into "Class 2A" and "Class 2B".

cases of actual undue influence, it is necessary for the claimant to prove affirmatively that the wrongdoer exerted undue influence on the complainant to persuade him to enter into the transaction.³⁴⁰ In cases of presumed undue influence, the complainant only has to show, in the first instance, that there was a relationship of trust and confidence between the complainant and the wrongdoer of such a nature that it is fair to presume that the wrongdoer abused that relationship in procuring the complainant to enter into the impugned transaction; the burden then shifts to the wrongdoer to prove that the complainant entered into the impugned transaction freely.³⁴¹

2.4 CONSUMER PROTECTION IN A BANKING CONTEXT

English law has been slow to recognize that the customer of a bank needs any protection over and above established rules as to misrepresentation, undue influence and the like. In this, as in other fields, freedom of contract has been the order of the day. But in recent times recession and unprecedented levels of problem domestic debts³⁴² have contributed to growing political pressure for greater sensitivity to the position, not just of the consumer, but also of the small business. As one leading banker has put it, the 1990s will be a caring decade, where the power of the consumer will require banks to be more responsive to the needs of their customers.³⁴³ Its response to these pressures is one of the major challenges presently facing the banking industry.

2.4.1 Case law

English law has not so far recognized an overriding principle of good faith in the making and carrying out of contracts,³⁴⁴ such as the principle existing in many civil-law systems, or that enshrined in the Uniform Commercial Code as enacted in the USA.³⁴⁵ Judicial attempts to limit

340 *Barclays Bank plc v O'Brien and Another* [1993] 4 All ER 417.

341 *Ibid.*, at 423.

342 See Bank of England's Banking Act Report for 1991/1992 at 10, quoted by Cranston (ed) *European Banking Law* 22n52.

343 Lord Alexander of Weedon QC, Chairman of National Westminster Bank plc, Chartered Institute of Bankers, Bristol Lecture, 26 November 1991, quoted in Cranston (ed) *European Banking Law* 22n53.

344 See Zimmermann & Whittaker (eds) *Good Faith* 39; Beatson & Friedmann *Good Faith* 3; Collins *Contract* chapters 13 and 15; *Walford v Miles* [1992] 2 AC 128

345 S 1-203 UCC provides that every contract or duty within the Code imposes an obligation of good faith in its performance or enforcement (reflecting existing case law to the effect that every contract implies good faith and fair dealing between the parties).

the effect of exclusion clauses by developing the "fundamental breach" doctrine came to nothing.³⁴⁶ The courts did develop rules strongly protective of the position of a surety, but these rules are largely ineffective in providing real protection because they are subject to contrary agreement between the parties,³⁴⁷ and are inevitably excluded in standard bank guarantee forms. However, in some circumstances the courts will intervene to strike down onerous contractual terms.³⁴⁸

2.4.2 Statute law

Two statutes need mentioning here. The first is the Consumer Credit Act of 1974, which provides detailed protection for individuals in relation to small credit transactions. The Act provides for the licensing of consumer credit business, and regulates such matters as advertising, canvassing, the form and content of agreements, cooling-off periods, the liability of creditors for breaches by the supplier, and default and termination. There are also provisions relating to credit cards.³⁴⁹

Current account overdrafts granted by banks are exempt from Part V of the Act³⁵⁰ (which provides for the form and content of agreements and cooling-off periods) by virtue of a determination by the Director General of Fair Trading made on 21 December 1989 under s 74 (1) (b) of the Act. To take advantage of the exemption, a bank must inform the Office of Fair Trading in writing of its general intention to grant such overdrafts, and comply with certain conditions as to the provision of information to the borrower concerning the credit limit, interest and charges.

The second is the Unfair Contract Terms Act of 1977, which provides that a person cannot unreasonably exclude liability for negligence. It also provides that where one party deals as consumer, or on the other's written standard terms, the other party cannot unreasonably exclude or restrict his liability for breach of contract. The possible impact of this Act on exclusion clauses routinely adopted by banks in standard form documentation has been little explored in the authorities. In one case it was suggested that a clause in a guarantee making the guarantor liable

346 *Suisse Atlantique Société d' Armement Maritime SA v NV Rotterdamsche Kolen Centrale* [1967] 1 AC 361.

347 *Eg, Perry v National Provincial Bank of England* [1910] 1 Ch 464.

348 *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] QB 433; [1988] 1 All ER 348.

349 For a full discussion, see Goode *Consumer Credit* and see, also, Whitford 1973 *Wisconsin LR* 400 at 423-425.

350 Consumer Credit Act of 1974.

for a sum larger than that of the principal debtor would be unenforceable by virtue of the Act.³⁵¹

In some respects, the Unfair Terms in Consumer Contracts Regulations of 1994 (which implement the EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC; OJ L95/29) are wider in that they apply more generally than just to exclusion clauses. However, they are restricted to consumer contracts. The Regulations also seek to promote the use of plain, intelligible language in standard contract provisions.

Section 137 of the Consumer Credit Act of 1974, empowers the court to reopen a credit agreement so as to do justice between the parties if it finds the credit bargain extortionate. This provision applies to credit agreements generally, not just to those regulated under the Act. A credit bargain is extortionate if it requires the debtor to make payments which are grossly exorbitant, or if it otherwise grossly contravenes ordinary principles of fair dealing.³⁵²

The Office of Fair Trading was set up under the Fair Trading Act of 1973,³⁵³ and has important licensing and administration functions under the Consumer Credit Act of 1974. It also has a watchdog role in relation to consumer affairs generally, and a duty from time to time to pronounce on questions of banking practice.

2.4.3 Alternative dispute resolution

Rights are, of course, of limited value unless they can be enforced. The courts of law are often an unsuitable forum for settling consumer-type disputes between banks and customers, not only because the amounts concerned are comparatively small, but also because an arbiter, having a degree of expertise can be helpful in resolving the dispute fairly. The financial services industry generally has taken considerable strides in the setting up of alternative disputes resolution schemes. These include the Banking Ombudsman, the Investment Ombudsman, the Insurance Ombudsman and Building Society Ombudsman schemes. A common feature of such schemes is that there is a limit of £ 100,000 on what can be awarded; this covers the vast majority of consumer claims. From the complainant's perspective there is the great advantage that using the service normally costs nothing. It is of course essential to the credibility of the schemes that the Ombudsman is seen to be independent.

351 *Standard Chartered Bank Ltd v Walker* [1982] 1 WLR 1410 at 1416.

352 S 138 of the Consumer Credit Act of 1974.

353 Fair Trading Act of 1973.

The Banking Ombudsman's function is to receive complaints relating to the provision of banking services by any member bank (the main UK retail banks are all members) to any individual, and to facilitate the settlement of such complaints by agreement or by the making of recommendations or awards. In making any recommendation or award, the Ombudsman is to have reference to what is fair in all the circumstances, and is to have regard to general principles of good banking practice and any relevant code of practice; the latter now includes the Code of Banking Practice (3), referred to above.

2.4.4 Codes of practice

Probably the most significant recent development has been the adoption of a banking code of practice. The Jack Committee³⁵⁴ recommended that banks should promulgate an agreed code of banking practice to achieve the improvements in banking practice which the Committee recommended should be introduced. After considerable consultation, the British Bankers' Association, the Building Societies Association and the Association for Payment Clearing Services have produced the "Good Banking" code of practice. It will be reviewed at least once every two years and monitored on an annual basis. The code sets out the standard of good banking practice to be observed by banks, building societies and card issuers when dealing with personal customers in the United Kingdom. A sister code is the Mortgage Code issued by the Council of Mortgage Lenders, which seeks to promote best practice in this area.

Some of the provisions of the code relating to transparency, confidentiality and third-party security have already been commented on. There are also important provisions relating to cards (*ie* credit and debit cards). A subject of particular contention is the incidence of liability for unauthorized use. The code limits customers' liability for unauthorized transactions to a maximum save in cases of fraud or gross negligence by the customer. In cases of disputed transactions the burden of proving fraud or gross negligence lies with the card issuer.

It is one of the governing principles of the code that banks will act fairly and reasonably in all their dealings with their customers. It is however non-statutory and not in itself legally binding. The extent to which its provisions may translate into legal rights and liabilities is an open question. It seems unlikely that the courts will ignore it in determining the legal content of the banker-customer relationship. An analogy may perhaps be drawn with s 63C of the Financial Services Act of 1986 which empowers the issuing of codes of practice in that field. It provides that, whilst contravention of such a code does not in itself give rise to liability or invalidate a

354 Review Committee *Banking Services*.

transaction, in determining whether a person's conduct amounts to a breach of the law, contravention of the code may be relied on as tending to establish liability, and compliance relied on as tending to negative liability.

2.5 CONCLUSION

Three important issues emerge from the above survey. Firstly, the relationship between banker and customer has changed dramatically and more and more fiduciary duties toward a customer have arisen. Conflicts of interest, or rather, the prevention thereof will be a major task for the modern banker.³⁵⁵

Secondly, a proliferation of claims alleging a duty to advise and/or negligent advice is expected.³⁵⁶ On a practical level, it is clear that bankers should keep the following in mind:

- Banks should check that their promotional literature conforms with the business they do, and not oversell what they are prepared to do for the customer.
- Staff should be well trained and must understand what advice can and cannot be given by staff at each level of seniority.
- Staff should be careful not to enter into sophisticated transactions with customers unless they know what they are doing.
- Contractual documentation with the customer should exclude liability for pre-contractual representations, the terms to comply with statutory provisions.³⁵⁷

Thirdly, the concept of good faith does not play a major role in English banking law at this point

355 See pars 2.1.1 and 2.1.2.

356 Warne *Litigation* 36.

357 Such as the Unfair Contract Terms Act of 1977, and the EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC: [1993] OJ L95/29.

in time,³⁵⁸ as existing doctrines, relating to a duty of reasonable care and skill,³⁵⁹ are more important. As far as the banker's duty of disclosure to an intending surety is concerned, it is not yet clear what effect the Codes of Banking Practice will have on the common-law position. It is submitted, that in view of the promissory language contained in the third edition of the code,³⁶⁰ its provisions may well override the common law.

358 In *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1988] 1 All ER 348, Bingham LJ, with reference to the concept of good faith, declared that English law has not committed itself to such an overriding principle, but has developed piecemeal solutions in response to demonstrated problems of unfairness. As far as consumers are concerned, the concept of good faith has been imported into English law by virtue of its membership of the European Community. See EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC:[1993] OJ L95/29; Unfair Terms in Consumer Contracts Regulations of 1994 which implements the aforesaid EC Directive.

359 Collins *Contract* 169-170, argues that the sources of pre-contractual obligations can be usefully conceived as deriving from a general principle, namely a duty to negotiate with care.

360 Code of Banking Practice (3).

CHAPTER 3: THE BANKER'S DUTIES OF DISCLOSURE AND ADVICE TO CUSTOMERS AND SURETIES: AUSTRALIA

3.1 THE BANKER-CUSTOMER RELATIONSHIP

In Australian law there is no precise legal definition of the terms "bank" or "banker", despite the attempts by many Courts to provide one.¹ This represents no real problem as the Banking Act 1959 (Cth) allows only incorporated and licensed institutions to function as banks.

There is no statutory definition of the term "customer" of a bank in Australian law. Both the Bills of Exchange Act of 1909 (Cth) (BEA) and the Cheques and Payment Orders Act of 1986 — which are the principal statutes that concern banks — mention the term, but offer no definition.

In the absence of a statutory definition, one must look to judicial decisions to appreciate the legal interpretation of who is a customer of a bank or what the circumstances are that make a person a customer. In the event of a dispute, although a court will take into consideration what ordinary intelligent businessmen understand by "a bank's customer", and hear evidence of experts if necessary, the ultimate decision lies with the court.²

The relationship of banker and customer is normally a contractual relationship.³ The relationship of banker and customer does not arise unless both parties intend to enter into such a relationship.

1 See *United Dominions Trust Ltd v Kirkwood* [1966] 1 All ER 968 (a "Bank" must conduct current accounts, pay cheques drawn on himself, collect cheques); *Bank of Chettinad Ltd v The Commissioner of Income Tax Colombo* [1948] AC 378 at 383 (different shades of meaning); in Australia, see *Bank of New South Wales and Others v The Commonwealth and Others* (1948) 76 CLR 1 (must have wide flexible meaning); *Commercial Banking Co of Sydney Ltd v FCT* (1950) 81 CLR 263 (lending money); *Commissioners of the State Savings Bank of Victoria v Permewan Wright & Co Ltd* (1914) 19 CLR 457 (receiving deposits on loan and lending out); approved in *Melbourne City Council v Commonwealth* (1947) 74 CLR 31 at 63-65.

2 See Tyree *Banking* 30; Weerasooria *Banking Law* par 21.4.

3 *Stewart v Bank of Australasia* (1883) 9 VLR (L) 240; *Aschkenasy v Midland Bank Ltd* (1934) 51 TLR 34; *Burnett v Westminster Bank Ltd* [1965] 3 All ER 81; *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank* [1986] AC 80.

There must be evidence to show that a bank accepted a person as a customer and dealt with that person on that footing.⁴

A person must have some sort of account, either a current or savings account⁵ or some similar relationship to make him or her a customer, for example, a fixed- or term-deposit account.⁶

A person becomes a customer immediately he or she opens an account with a bank even though he or she may never operate on the account. It is not necessary for there to be some regular course of conduct or dealing in the sense of regularly visiting the bank or doing business with it. This appears to be the essential difference between a customer of a shop and the customer of a bank. Some of the early decisions considered the element of use and habit to be the essence of the banker-customer relationship, but now it is well-established that duration is of no significance.⁷

Where a person deals with a bank and both parties contemplate the person's becoming a customer, and a bank account is, in fact, subsequently opened, the relationship of a banker and customer is deemed to have been established from the date the bank accepted the instructions of the would-be customer even though at that time there was no account in existence.⁸

One bank can become a customer of another bank. For instance, if a bank does the business of collecting or clearing cheques for another bank, the latter is the former's customer.⁹

The banker-customer relationship cannot arise where a company account is opened, for purposes

4 *Stewart v Bank of Australia* (1883) 9 VLR (L) 240; *Mathews v Brown & Co* (1894) 10 TLR 386; *Robinson v Midland Bank Ltd* (1925) 41 TLR 402.

5 *Hart v Sangster* [1957] 1 Ch 337; [1957] 2 All ER 208).

6 *Dixon v Bank of New South Wales* (1896) 17 LR (NSW) Eq 355 (Australia); *Lacave & Co v Credit Lyonnais* (1897) 1 QB 148; *Great Western Railway Co v London & County Banking Co* [1901] AC 414 (England); *Warren Metals Ltd v Colonial Catering Co Ltd and Others* [1975] 1 NZLR 273 (New Zealand).

7 *Ladbroke & Co v Todd* [1914-1915] All ER 1134; *Commissioners of Taxation v English Scottish and Australian Bank Ltd* [1920] AC 683 (England); *Kendall v London Bank of Australia* (1918) SR (NSW) 394 (Australia); *Tyree Banking* 29; *Weerasooria Banking Law* par 21.9.

8 *Woods v Martins Bank Ltd* [1959] 1 QB 55; *Chorley Banking* 36.

9 *Importers Company Ltd v Westminster Bank Ltd* [1927] 2 KB 297; *Aschkenasy v Midland Bank Ltd* (1934) 51 TLR 34; *Lloyds Bank Ltd v The Chartered Bank of India Australia and China* [1929] 1 KB 40.

of purchasing of business, on false documents and without authority.¹⁰

An account-holder continues to be a customer of the bank although his or her account may be overdrawn.¹¹ While the normal debtor-creditor relationship can be terminated without notice, a bank cannot close a customer's account, in credit, without reasonable notice to him or her.¹² As far as a debt due to the bank is concerned, and in the absence of specific arrangements to the contrary, the principle is that the debt is not due until demand has been made.¹³

It is established that the contract between a bank and its customer is governed by the law of the place where the account is kept in the absence of an express agreement to the contrary.¹⁴

Customers of banks are not only numerous, but also constitute different categories and types of persons, from adult individuals to minors, from partnership firms to societies, clubs and associations, from one-person proprietary companies to large corporations. The services that the banks offer their customers also vary from investment advice to the financing of overseas trade. Consequently, in modern banking business it is not easy to define the nature of the relationship that exists between a banker and his customer.¹⁵

Indeed, the relationship between the parties must vary according to the facts and circumstances of each case and the type of transaction in question. The relationship can be that of agent and principal when, for instance, the bank collects the proceeds of cheques for and on behalf of its

10 *Marfani & Co Ltd v Midland Bank Ltd* [1967] 3 All ER 967; [1968] 1 WLR 956; *Stoney Stanton Supplies (Coventry) Ltd v Midland Bank Ltd* [1966] 2 Lloyds Rep 373; *Tyree Banking* 31; *Weerasooria Banking Law* par 21.14.

11 *Clark v London & Country Banking Co* [1897] 1 QB 552.

12 *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110; *National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd* [1972] AC 785; [1972] 1 All ER 641; *Prosperity Ltd v Lloyds Bank Ltd* (1923) 39 TLR 372; *Buckingham & Co v The London and Midland Bank Ltd* (1895) 12 TLR 70.

13 *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110; *Re Australia and New Zealand Savings Bank Ltd*; *Mellas v Evriniadis* [1972] VR 690; *Bank of New South Wales v Laing* [1954] AC 135; *Tunstall Brick and Pottery Co v Mercantile Bank of Australia Ltd* (1892) 18 VLR 59.

14 *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] 1 QB 728; *Attock Cement Co Ltd v Romanian Bank of Foreign Trade* [1989] 1 Lloyds Rep 572; *Libyan Arab Foreign Bank v Manufacturers Hanover Trust Co* [1989] 1 Lloyds Rep 608.

15 *Tyree Banking* 23; *Weerasooria Banking Law* par 21.18.

customer.¹⁶ A banker also acts as agent when he or she accepts a customer's instructions in regard to the purchase and sale of stocks and shares.¹⁷

There are many special circumstances which may affect and vary the normal relationship between a banker and his or her customer. The question arises as to the general relationship that exists between the parties. The legal position has been explained as follows:¹⁸

- The banker-customer relationship is a relationship peculiar to banking. The general relationship that exists between the parties is a complex contractual relationship consisting of reciprocal rights and duties founded on the practices and usages prevailing among bankers. The relationship consists of a general contract which is basic to all transactions, together with special transactions or banking services. The general contract is a simple, indivisible contract, though with many facets.¹⁹
- The contract is basically of an implied nature. In Australia (as in England) there is rarely, if ever, a written or even an oral contract setting out the terms and conditions of the relationship.
- Outside the ambit of the current account operation, however, the relationship is subject to special arrangements which are normally reduced to writing. These documents are called "customers' authorities".

Apart from contract, the legal relationship of banker and customer is that of debtor and creditor (the banker being the debtor and the customer the creditor) with the super-added obligation of the banker's having to honour the customer's cheques when there is sufficient credit in his or her account at the bank. The debtor and creditor relationship though at one time doubted, has been firmly established in case law since 1848.²⁰

In *Joachimson v Swiss Bank Corporation*²¹ the Court of Appeal reaffirmed the existence of this

16 *Tyree Banking* 25; *Weerasooria Banking Law* par 21.19.

17 *Weerasooria Banking Law* par 21.19.

18 *Weerasooria Banking Law* par 21.20.

19 The contractual nature of the banker-customer relationship was highlighted in *Burnett v Westminster Bank Ltd* [1965] 3 All ER 81.

20 *Foley v Hill* (1848) 2 HLC 28; and the English Court of Appeal in *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110.

21 [1921] 3 KB 110.

debtor and creditor relationship and its contractual foundation. In *Laing v Bank of New South Wales*²² the Supreme Court of New South Wales approved of the decisions in *Foley v Hill*²³ and the *Joachimson*²⁴ case and held that the primary relationship of banker and customer is that of debtor and creditor. The High Court decision in this case was reversed on appeal by the Privy Council, but not on the question of the debtor-creditor relationship, which the Privy Council confirmed.²⁵

Although the debtor-creditor relationship is the basic principle underlying the law of banking, it is not an exhaustive definition of all the obligations arising out of the relation between banker and customer. Nor does it provide a sufficiently wide formula for the solution of all the problems or the understanding of the business of modern banking. There are a number of implied super-added obligations²⁶ in the relationship between banker and customer that distinguish it from the ordinary case of a loan of money and the normal debtor and creditor relationship.²⁷

The fact that the relationship is contractual means that it may come within the scope of the Contracts Review Act of 1980 (NSW).

3.2 THE MULTI-FUNCTIONAL BANK

Banks are today moving away from traditional deposit taking and lending activities into roles more akin to those of financial supermarkets or conglomerates.²⁸ Modern banking is multi-

22 (1952) 69 WN (NSW) 318.

23 (1848) 2 HLC 28.

24 [1921] 3 KB 110.

25 *Bank of New South Wales v Laing* [1954] AC 135. For further Australian cases acknowledging the debtor-creditor contractual relationship, see *Re City of Melbourne Bank Ltd; Ex parte Ferguson* (1897) 23 VLR 78; *Croton v R* (1967) 117 CLR 326.

26 *Per Banks LJ*, in *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110 at 119 or "peculiar incidents", *per Lord Asquith* in *Bank of New South Wales v Laing* [1954] AC 135 at 138.

27 *Tyree Banking* 27; *Weerasooria Banking Law* par 21.38.

28 See *Weerasooria Banking Law* par 24.1. Before 1980, eg, Westpac Banking Corporation was a bank. It accepted money on deposit, cashed and collected cheques and gave money out on loan. Today it is an insurance company, superannuation fund, investment adviser, stockbroker, travel agent, currency dealer and property investment trust. It has become a financial supermarket and now it even owns a television station! See *Weerasooria Banking Law* par 24.7.

functional and multi-divisional, particularly following partial deregulation of the Australian financial system.²⁹

The law governing the banker-customer relationship was formulated when banks offered only traditional services and a new law is required for the new roles that bankers now play. Indeed, new trends in bank liability are emerging. More and more bank managers and even senior management are seeing the inside of court rooms either as defendants or as witnesses.³⁰

Apart from contract law — the foundation of the banker-customer relationship — banks are being sued in tort law³¹ for negligence where the pitfalls are greater and the scope of liability wider.³² Many equitable doctrines are now often relied on to sue banks. Duress, economic duress, undue influence, unconscionable conduct are favourites especially after the High Court judgment in *Commercial Bank of Australia Ltd v Amadio*.³³

Other artillery aimed at banks is the consumer protection legislation in each Australian jurisdiction, for example, the various Fair Trading Acts³⁴ and Contracts Review Act of 1980 (NSW). The Trade Practices Act of 1974 (Cth) also opened up a Pandora's box of ills and litigation for banks. Section 52 of this Act with its far reaching concept of "misleading and deceptive" conduct has become a real headache for bankers.³⁵

29 Neate *Bank Confidentiality* 61.

30 *Wheeler Grace & Pierucci Pty Ltd v Wright* [1989] ATPR 40-940; *Westpac Banking Corporation v Eltran Pty Ltd* [1987] ATPR 40-802; *Chiarabaglio v Westpac Banking Corporation* [1989] ATPR 40-971.

31 Tyree 1980 *ABLR* 220; *Mutual Life and Citizen's Assurance Co Ltd v Evatt* (1968) 122 CLR 556; *Compafina Bank v Australia and New Zealand Banking Group Ltd and Bennet* (1984) Aust Torts Rep 80-546; *Johns Period Furniture Pty Ltd v Commonwealth Savings Bank of Australia* (1980) 24 SASR 224.

32 The High Court of Australia has expressly adopted the principle that concurrent liability in contract and in tort may exist between parties that are in a contractual or commercial relationship. See *Hawkins v Clayton* (1988) 164 CLR 539 at 575.

33 (1983) 151 CLR 447.

34 S 13 of the Fair Trading Act of 1992 (ACT); s 43 of the Fair Trading Act of 1987 (NSW); s 43 of the Consumer Affairs and Fair Trading Act of 1990 (NT); s 39 of the Fair Trading Act of 1989 (QLD); s 57 of the Fair Trading Act of 1987 (SA); s 15 of the Fair Trading Act of 1990 (Tas); s 11A of the Fair Trading Act of 1985 (Vic); s 11 of the Fair Trading Act of 1987 (WA).

35 Misleading advice in a commercial setting will probably give rise to a contravention of s 52 of the Trade Practices Act of 1974 (Cth) and its Fair Trading Act equivalents. Financial Institutions have already been the target of considerable s 52 litigation. See

Another emerging area of bank liability is the concept of equitable or promissory estoppel. The High Court has gone further than the English courts and in recent landmark cases has held firmly that promissory statements which are clear and unambiguous and on which another has relied to his detriment, are valid and actionable.³⁶

In most situations the relationship between the bank and its customers will be governed by the express or implied terms of a contract. Circumstances can arise where a bank may owe fiduciary duties to a customer,³⁷ or equitable duties of confidence.³⁸

As banking business has expanded beyond the range of traditional banking functions the main trading banks have formed subsidiary organizations to perform these functions.³⁹ The Reserve Bank has established guidelines concerning the relationship of banks to these other organizations in order, particularly, to protect the depositors of the banks.⁴⁰

Australian investment banks are also using Chinese Walls in an attempt to justify representation of conflicting interests. Whilst the courts of Australia⁴¹ and the United Kingdom⁴² have been sceptical about the effectiveness of Chinese Walls in resolving conflicts of interests, such

Bourke v State Bank of New South Wales (1990) 170 CLR 276; *Barton v Westpac Banking Corporation* [1983] ATPR 40-388.

36 *Legione v Hateley* (1983) 152 CLR 406; *Foran and Another v Wright and Another* (1989) 168 CLR 385; *Waltons Stores (Interstate) Ltd v Maher* (1988) 164 CLR 387; *Commonwealth of Australia v Verwayen* (1990) 170 CLR 394; *Silovi Pty Ltd v Barbaro* (1988) 13 NSWLR 466.

37 *Tyree Banking* 24; *Weerasooria Banking Law* par 21.33; *Neate Bank Confidentiality* 63; *Ex parte Melbourne and Metropolitan Board of Works* (1895) 21 VLR 563; *Commonwealth Bank of Australia and Another v Smith and Another* (1991) 102 ALR 453; *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41.

38 *Neate Bank Confidentiality* 62; *Commonwealth v John Fairfax & Sons Ltd* (1980) 147 CLR 39; *Castrol Australia Pty Ltd v Emtech Associates Pty Ltd* (1980) 51 FLR 184; *Stevens Travel Service International Pty Ltd Receivers and Managers Appointed v Qantas Airways Ltd* (1988) 13 NSWLR 331 and *Attorney General v Guardian Newspapers Ltd (No 2)* [1990] 1 AC 109.

39 *Tyree Banking* 11.

40 Reserve Bank Prudential Statement No G1 "Banks' Associations with Non-Banks" quoted in *Tyree Banking* 12.

41 *Mallesons Stephen Jaques v KPMG Peat Marwick* (1990) 4 WAR 357.

42 *David Lee & Co Ltd v Edward Chance* [1990] 3 WLR 1278.

structures are a recognised defence to the insider trading provisions of the Corporations Law,⁴³ and are a well-established part of corporate practice.

3.3 THE BANKER'S DUTY OF CONFIDENTIALITY

3.3.1 The leading decision

The banker's duty of confidentiality is contractual — being an implied term of the contract between the parties.⁴⁴ As is the case in English law, the duty is not absolute, but qualified.⁴⁵ While an exhaustive definition is not possible, its qualifications have been classified and their limits indicated. It was established as far back as 1923 by the English Court of Appeal in *Tournier v National Provincial and Union Bank of England*.⁴⁶

In several Australian High Court cases and other judicial decisions this duty has been recognised and explained.⁴⁷

The *Tournier*⁴⁸ case remains the leading judicial authority on a banker's duty of secrecy.⁴⁹ According to Weaver & Craigie⁵⁰ the *Tournier*⁵¹ case remains the unchallenged authority on the subject and represents one of the most respected and celebrated instances of judicial law making

43 S 1002M.

44 *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461.

45 *Ibid*, at 473.

46 [1924] 1 KB 461.

47 See *Commissioner of Taxation of the Commonwealth of Australia and Others v The Australia and New Zealand Banking Group Ltd* (1979) 143 CLR 499; *Smorgon v Australia and New Zealand Banking Group Ltd*; *Smorgon v Commissioner of Taxation of the Commonwealth of Australia* (1976) 134 CLR 475; *Southwestern Indemnities Ltd v Bank of New South Wales* (1973) 129 CLR 512; *Australian Securities Commission v Zarro and Others* (1991) 6 ACSR 385; *Citibank Ltd v Federal Commissioner of Taxation and Others* (1988) 83 ALR 144; approved by full Federal Court in *Federal Commissioner of Taxation and Others v Citibank Ltd* (1989) 85 ALR 588; *Australia and New Zealand Banking Group Ltd v Ryan* (1968) 88 WN (NSW) (Pt 1) 368.

48 [1924] 1 KB 461.

49 Neate *Bank Confidentiality* 1.

50 Weaver & Craigie *Banker* par 2631.

51 [1924] 1 KB 461.

in the entire field of banking.

Clause 12.1 of the recently introduced Code of Banking Practice⁵² specially acknowledges a bank's general duty of confidentiality towards its customers and incorporates the *Tournier*⁵³ decision as part of the code.

The *Tournier*⁵⁴ case, as to the nature and extent of the banker's duty of secrecy, may be summarised as follows. The confidentiality extends to all information and transactions that go through an account including securities and guarantees, if any. It extends beyond the state of the customer's account, that is, whether there is a debit or credit balance and the amount of the balance. It extends to information obtained from sources other than the customer's actual account — if the occasion upon which the information was obtained arose out of the banking relations of the bank and its customer.⁵⁵ For example, information obtained with a view to assisting the bank in conducting the customer's business or in coming to decisions on the bank's treatment of its customer, would be covered by this duty of secrecy. As Megarry J observed in *Royal Bank of Canada v Inland Revenue Commissioners*:⁵⁶

"[A] banker's duty of secrecy to its customers is not confined to ordinary banking transactions but would extend to any banking transaction which is effected for a customer, ordinary or extraordinary."

3.3.2 Remedies for breach of duty

Wrongful disclosure of information by a bank can result in an action for breach of contract.⁵⁷

52 The Australian Code of Banking Practice was formulated as a result of the House of Representatives Standing Committee on Financial and Public Administration Report of November 1991, entitled "A Pocket Full of Change". See Neate *Bank Confidentiality* 29. The Code of Banking Practice is quoted in full in Weerasooria *Banking Law* par 15.30.

53 [1924] 1 KB 461.

54 *Ibid.*

55 Weaver & Craigie *Banker* par 6590.

56 [1972] 1 Ch 665 at 680; [1972] 1 All ER 225.

57 See, eg, *Commissioner of Taxation of the Commonwealth of Australia and Others v The Australia and New Zealand Banking Group Ltd* (1979) 143 CLR 499 at 522. In the *Tournier* case, *ibid.*, [1924] 1 KB 461, the bank was sued for both slander (defamation) and breach of contract, but since a new trial was ordered it is not known how the award of damages to the customer was calculated.

The banker may also be liable for damages for any resulting defamation,⁵⁸ because as Bankes LJ observed in the *Tournier*⁵⁹ case, the credit of the customer depends very largely upon the strict observance of confidence.

At the time of the *Tournier*⁶⁰ case, (1923), banks operated only their core business of banking and the modern-day concept of subsidiary companies was unknown. In *Bank of Tokyo Ltd v Karoon*⁶¹, the view was expressed that where a bank operated its business through a corporate structure involving a holding company and subsidiaries, disclosure by one company to another may constitute a breach of the duty of secrecy.⁶² Section 12.2 of the Australian Code of Banking Practice permits disclosure of information concerning the customer to a related entity of the bank.

Merchant Banks and Financiers are bound by confidentiality laws. Although a merchant bank, is not a banker in the ordinary sense of that word, however, there is much to be said for the view that a merchant bank has, likewise, a contractual duty of confidence to its clients, that duty being an implied term in the relationship between them.⁶³

There are also certain statutory provisions in some cases, for example the Privacy Act of 1988. Section 36(1) of this Act provides that an individual may complain to the Privacy Commissioner about an act or practice that may interfere with the privacy of the individual.⁶⁴

3.3.3 Qualifications to the *Tournier* rule

3.3.3.1 Introduction

As conceded in the *Tournier*⁶⁵ case, the banker's duty of secrecy is not absolute or all-embracing,

58 Neate *Bank Confidentiality* 3.

59 [1924] 1 KB 461 at 474.

60 [1924] 1 KB 461.

61 [1987] AC 45.

62 See, also, *Bhogal v Punjab National Bank, Basna v Punjab National Bank* [1988] 2 All ER 296.

63 See *Winterton Constructions (Pty) Ltd v Hambros Australia Ltd* [1992] 111 ALR 649.

64 Neate *Bank Confidentiality* 3; Privacy act of 1988 s 36 (1).

65 [1924] 1 KB 461 at 473.

but qualified, and a bank would be justified in making a disclosure concerning its customer's affairs or would be relieved of its obligation of confidentiality in the following circumstances;

- where disclosure is under compulsion of law;⁶⁶
- where there is a duty to the public to disclose;
- where the interests of the bank require disclosure;
- where the disclosure is made with the express or implied consent of the customer.

In the *Tournier*⁶⁷ case, the Court of Appeal conceded that the above classification of the instances where a banker is entitled to disclosure are also not exhaustive. As Atkin LJ said, it is difficult to hit upon a formula which will define the maximum of the obligation of secrecy which is of an implied nature.

3.3.3.2 Disclosure under compulsion of law

Statutory provisions exist in all the Australian jurisdictions relating to the production, proof and inspection of a banker's books in legal proceedings.⁶⁸

The main object of these statutory provisions is to facilitate evidence relating to entries in banker's books, and these provisions were designed to prevent needless expense and trouble and to save the time of bankers and their staff by dispensing as far as possible with the production of the originals of their books and with their personal attendance in courts.⁶⁹ It was also an intolerable inconvenience for bankers to produce in courts books of accounts which were often in daily use.⁷⁰ The provisions enable a party who formerly had the right to issue a summons, to

66 *Sankey v Whitlam* (1978) 142 CLR 1; *Campbell v Tameside Metropolitan Borough Council* [1982] 3 WLR 74; *Trade Practices Commission v Queensland Aggregates (No 2)* (1981) 51 FLR 364.

67 [1924] 1 KB 461.

68 Ss 21-25 of the Evidence Act of 1971 (ACT); ss 44-51 of the Evidence Act of 1898 (NSW) and s 415 of the Crimes Act of 1900 (NSW); ss 83-91 of the Evidence Act of 1977-1984 (Qld) (books of account of any business); ss 46-52 of the Evidence Act of 1929 (SA); ss 33-39 of the Evidence Act of 1910 (Tas); ss 58A-58J of the Evidence Act of 1958 (Vic) (books of account of any business); ss 89-96 of the Evidence Act of 1906 (WA).

69 *Waterhouse v Barker* [1924] 2 KB 759 at 763.

70 *Pollock v Garle* [1898] 1 Ch 1 at 4; see, also, *Re Colonial Bank* (1889) 15 VLR 360; *Elsay v Commissioner of Taxation of the Commonwealth of Australia* (1969) 121 CLR 99.

compel bankers to produce their books and to attend and be examined on them, to obtain an order for permission to inspect and take copies of a banker's books. The legislation was intended to facilitate the proof of, and not to preserve or exclude from evidence banker's books which would otherwise have been available to litigants.⁷¹

Various statutes and statutory regulations, both federal and State, empower public authorities and some professional bodies to call upon bankers (among others) to supply them with information regarding the bank's customers and the bank's affairs.⁷² Certain Victorian Acts are illustrative of State statutes that compel bankers to disclose information.⁷³

The powers given under these statutes must be exercised strictly in accordance with the statute authorising it. It is not every inquiry or demand for information that can be sustained by the statute or statutory regulations under which it is made. For instance s 62 of the Banking Act of 1959 (Cth) compels a bank to furnish to the Reserve Bank of Australia (RBA) any information in respect of its banking business as required by the Reserve Bank, but s 62(2) specifically states that any such direction by the RBA cannot require information to be furnished with respect to the affairs of an individual customer. This and other provisions of the Banking Act of 1959 (Cth)⁷⁴ recognize and uphold the banker's duty of secrecy in respect of his or her customer's account.

Most of the Australian decisions relating to statutory compulsion on banks to disclose information about their customers relate to investigations conducted by the Commissioner of Taxation.⁷⁵ In several cases in the mid-1970s relating to the well-known Smorgan family, the

71 *Re Colonial Bank* (1889) 15 VLR 360 at 362; see, also, *R v Bono* (1913) 29 TLR 635.

72 Instances of commonwealth statutes are:

- (1) Ss 128Q, 263 and 264 of the Income Tax Assessment Act of 1936 (Cth);
- (2) S 39 of the Gift Duty Assessment Act of 1941 (Cth);
- (3) Ss 51, 62 and 69 of the Banking Act of 1959 (Cth);
- (4) S 125 of the Bankruptcy Act of 1966 (Cth);
- (5) S 141 of the Social Services Consolidation Act of 1947 (Cth).

73 Ss 384 and 541 of the Companies (Vic) Code; s 41 of the Gift Duty Act of 1971; s 20 of the Probate Duty Act of 1962; s 44 of the Legal Profession Practice Act of 1958; Estate Agents Act of 1980; and s 36 of the Stamps Act of 1958.

74 See s 61(3) of the Banking Act of 1959 in particular.

75 *Tyree Banking* 105; *Weerasooria Banking Law* par 27.42. S 263 of the Income Tax Assessment Act of 1936 gives the Commissioner at all times full and free access to all buildings, places, books, documents and other papers for any of the purposes of the Act, and the power to make extracts or copies of these documents. For further tax and bank confidentiality cases, see *Simionato Holdings Pty Ltd v FCT (No 2)* (1995) 95 ATC 4720;

High Court had to consider a banker's duty of confidentiality about his or her customer's account *vis-à-vis* the powers of the Commissioner of Taxation to require information from the bank about the customer for income-tax assessment purposes.⁷⁶

The Financial Transaction Reports Act of 1988 (Cth) made several inroads into the banker-customer relationship. One of the major inroads was the modification of the banker's common-law duty of confidentiality by providing him with statutory protection and immunity⁷⁷ if he had to disclose information in terms of the statute (for example, reporting of significant and suspect transactions).

The contractual duty of confidentiality is overridden by the duty of both parties to submit to other legal requirements. The point was made clearly and forcefully by Lord Diplock in *Parry-Jones v The Law Society*⁷⁸ who stated that the duty of confidentiality is overridden by the duty to comply with the law of the land.⁷⁹

3.3.3.3 Disclosure in the public interest

This type of case is extremely rare. In England, one can perhaps refer to the matter of *Libyan Arab Foreign Bank v Bankers Trust Co*⁸⁰ where, it transpired that several hours before the US President issued decrees which had the effect of freezing all Libyan assets held with American institutions, a senior executive of the defendant bank had told the Federal Reserve Bank of New York that "it looked like the Libyans were taking their funds out of the various accounts". The Libyan bank alleged that by this statement, Bankers Trust had breached its duty of confidentiality. In defence, Bankers Trust pleaded;

Industrial Equity Ltd v FCT (1990) 21 ATR 934.

76 See *Smorgon v Australia and New Zealand Banking Group Ltd*; *Smorgon v Commissioner of Taxation of the Commonwealth of Australia* (1976) 134 CLR 475; *Commissioner of Taxation of the Commonwealth of Australia and Others v The Australia and New Zealand Banking Group Ltd* (1979) 143 CLR 499; 23 ALR 480; *Elsev v Commissioner of Taxation of the Commonwealth of Australia* (1969) 121 CLR 99.

77 Ss 16 and 17 of the Financial Transaction Reports Act of 1988 (Cth).

78 [1969] 1 Ch 1 at 9.

79 Other notable statutory inroads into the duty is contained in the Proceeds of Crime Act of 1987; s 155 of the Trade Practices Act of 1974 (Cth); Australian Securities Commission Act of 1989; National Crime Authority Act of 1984; the Bankruptcy Act of 1966.

80 [1989] 1 QB 728.

- implied consent;
- public duty; and
- protection of their own interests which were permitted under the rule in the *Tournier*⁸¹ case.

Staughton J refused to accept that the disclosure was in the bank's interest or had been permitted by the customer, but was willing to reach a "tentative conclusion" that the disclosure was justified by public duty and in any event that the breach of the confidence resulted in no loss to the customer — the Libyan bank.⁸²

Australian Courts have not resolved any of the uncertainty regarding this exception. Sheppard J in *Allied Mills Industries Pty Ltd v Trade Practices Commission (No 1)*,⁸³ when considering the balance between the non-disclosure of private and confidential information and the public interest in the disclosure of iniquity, commented that a bank firstly had to establish whether conduct amounted to an "iniquity".⁸⁴ An iniquity is wider than a crime or misdemeanor.⁸⁵ In this case Sheppard J found that a breach of the Trade Practices Act of 1974 (Cth) was an iniquity although liability was civil only. The breach was held to be an iniquity because the Judge was of the opinion that Parliament had taken a serious view of the importance of the legislation from the standpoint of the public interest.⁸⁶

Chorley⁸⁷ suggests that an example of this qualification might be where the customer's dealings indicated trading with the enemy in time of war. Ellinger⁸⁸ suggests that any supposed duty hereunder is purely cosmetic. Walter & Ehrlich suggest that, where bankers are involved, the judiciary may develop a test to weigh up whether the disclosure was justified and they list several factors which would be relevant to such an assessment.⁸⁹

81 [1924] 1 KB 461.

82 *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] 1 QB 728 at 770-1.

83 (1981) 34 ALR 105.

84 *Ibid*, at 141.

85 *Ibid*, at 141.

86 *Ibid*, at 142.

87 *Banking* 23.

88 *Banking Law* 103.

89 Walter & Ehrlich 1989 ALJ 404 at 416.

3.3.3.4 Disclosure in the interests of the bank

An example of this exception is where a bank is suing or being sued by a customer.⁹⁰ Likewise a disclosure may be made where the bank makes a claim or brings an action against someone other than the customer; for example, against a guarantor of the customer's loan or overdraft.⁹¹

Often customers expressly authorize their bankers to disclose their affairs to third parties. A common example is where a customer gives a third party a banker's reference; that is, he or she requests or authorizes the third party to enquire from his or her bank about his or her creditworthiness and thereby authorizes the bank to answer such enquiry, which may incidentally disclose the state of his or her account. Generally, banks obtain standing orders from their customers to provide such information and in any event disclosure under express consent has not given rise to difficult problems.⁹²

On the other hand a bank may be able to justify a disclosure on the ground that the customer has impliedly consented to it. Such cases are infrequent.⁹³

It is not clear on what ground a banker is entitled to disclose information relating to a customer's account to a guarantor or an intending guarantor. Megrah⁹⁴ favours the view that the customer has impliedly authorised disclosure by introducing the guarantor to the bank. Chorley,⁹⁵ however, doubts whether any disclosure could be based on implied authority. Milnes Holden,⁹⁶ agrees with Lord Chorley and states that the safest course — and, indeed, the usual course — is to arrange a joint meeting between the guarantor, the customer and the banker at which the guarantor may, in the customer's presence, ask for information on any matters concerning the customer's affairs.

When a guarantee has been taken, the guarantor has a right to obtain information as to the

90 *Weaver & Craigie Banker* par 6.670.

91 *Sunderland v Barclays Bank Ltd* (1938) 5 LDAB 163, is an interesting case where a bank successfully defended an action for damages by a customer for wrongful disclosure by pleading, *inter alia*, that the disclosure was in the interest of the bank.

92 *Tyree Banking* 108; *Weerasooria Banking Law* par 27.59.

93 *Sunderland v Barclays Bank Ltd* (1938) 5 LDAB 163.

94 *Paget's Banking Law* 8 173.

95 *Chorley Banking* 23.

96 *History* 72.

account that he has guaranteed, including a general statement about whether the account is being kept in a manner satisfactory to the bank.⁹⁷ A guarantor who has mortgaged property to the bank as collateral security is entitled to demand from the bank information on the balance owing, the rate of interest charged and the amount, if any, realized by the bank in respect of the collateral securities, but he or she is not entitled to obtain from the bank the same full account that the bank is obliged to give its customers. Nor would he be entitled to demand from the bank a copy of the statement relating to the customer's account or information on how many cheques drawn upon the account had been made in favour of a particular payee.⁹⁸

3.3.3.5 Bank references

Bankers' references are memoranda from one bank to another detailing certain financial information about a customer of the advising bank. Although given by a bank to a bank, the characteristic feature of these references is the fact that the information will be passed on to a customer of the receiving bank. The references are often given without the knowledge of the customer whose affairs are being investigated.⁹⁹

The legal basis for the supply of such status opinions is not clear. Judges and textwriters in England are divided in their views and it has often been justified in the interest of the customers, banking practice¹⁰⁰ and implied consent¹⁰¹ of the customer.

97 Neate *Bank Confidentiality* 26-27 argues that such entitlement can be justified on the grounds of the interest of the bank. Normally the problem can be resolved easily. Get the customer's consent.

98 *Ross v Bank of New South Wales* (1928) 28 SR (NSW) 539; *Goodwin v National Bank of Australasia Ltd* (1968) 42 ALJR 110; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.

99 Tyree *Banking* 108-9; Weerasooria *Banking Law* par 30.1.

100 The giving of information as to the financial position of their customers, commonly called a bank "opinion" is part of the everyday business of banking. See Chorley *Banking* 248 and Weaver & Craigie *Banker* par 6680. "It is one of the services which a bank offers to its customer", per Devlin J in *Midland Bank Ltd v Seymour* (1955) 2 Lloyds Rep 1477. In *Parsons v Barclay & Co Ltd and Goddard* (1910) 103 LT 196, Lord Cozens-Hardy MR referred to it as "a very wholesome and useful habit". In *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465, Lord Morris said that the service that a bank performs in giving a reference is not done simply out of a desire to assist commerce. It would discourage the customers of the bank if their deals fell through because the bank had refused to testify to their credit when it was good.

101 Weerasooria *Banking Law* par 22.19 quotes Lord Chorley in his Gilbert Lecture on Banking, 1964 23-24 where he states that the general opinion in banking circles is that when a customer opens his account, he impliedly agrees to his bank supplying references

In Australia, bankers' opinions are attributed to a combination of banking practice and implied consent.¹⁰² In *Commercial Banking Co of Sydney Ltd v RH Brown & Co*¹⁰³ the High Court expressed the view that supplying such opinions is considered a banking usage in Australia. However, bankers' opinions are often given without the knowledge or consent of the customer and if so, there can be no implied consent and it will amount to a breach of the bank's duty of secrecy.¹⁰⁴ As the Supreme Court of Western Australia pointed out in *Brown RH & Co v the Bank of New South Wales and Commercial Banking Co of Sydney Ltd*¹⁰⁵:

"A banker can be faced with a conflict of duties when supplying such a status opinion. On the one hand there is the duty of a banker to maintain secrecy regarding a customer's affairs; on the other, there is the duty owed to a person to whom he supplied information or an opinion as to a client's financial affairs or credit, at least to give an honest opinion, or where a duty of care arises to give a report which observes that duty ... Certainly the bank is not bound to give any opinion whether with its customer's consent or not. But if an answer is given, the person giving it on the bank's behalf (usually the Manager) cannot allow his loyalty to his customer and his regard for the customer's interest, or the bank's own interest in maintaining a profitable relationship, to interfere with the duties which the law imposes on him in making his answer."

In 1990 the Privacy Act of 1988 (Cth), was amended, introducing a Code of Conduct as well. As a result, banks can no longer give credit references about personal/individual customers (as distinct from corporate and commercial references) without informing the customer and obtaining consent to do so.¹⁰⁶ Privacy law which is governed by the Privacy Act of 1988 (Cth)

about him. As Chorley points out, many customers do not know about this practice and they can only be taken as having impliedly agreed to it by its being imported into the contract as a usage of banking business.

- 102 In the *Tournier* case [1924] 1 KB 461 at 486 Lord Aitkin clearly contemplated implied consent.
- 103 (1972) 126 CLR 337 at 348.
- 104 *Weaver & Craigie Banker* par 6680 believe that the practice is as well known as several other practices which are undoubtedly incorporated into the banker-customer contract, eg, the practice that an overdrawn customer is taken to assent to the charging of interest, even though it is extremely unlikely that the customer is aware of the details of the arrangements to which he has consented.
- 105 [1971] WAR 201 at 213. See, also, *Compafina Bank v Australia and New Zealand Banking Group Ltd and Bennet* (1984) Aust Torts Rep 80-546.
- 106 *Neate Bank Confidentiality* 26 points out that in terms of s 12.11 of the Australian Code of Banking Practice, a banker's opinion must comply with the requirements of the Credit

as amended in 1991 and the Credit Reporting Code of Conduct (formed in terms of s 18 of the Privacy Act of 1988 (Cth)) is binding on all credit providers like banks.¹⁰⁷ Section 18 N of the Privacy Act of 1988 (Cth) is the pivotal section and it prescribes rules for the disclosure of any information which has a bearing on an individual's creditworthiness, history, standing or eligibility.¹⁰⁸

Individual customers now also have a right of access to any credit reports which might be in the possession of the bank. According to the Privacy Commissioner, the area covered by s 18N of the Privacy Act of 1988 (Cth) has created problems for the financial sector (including banks) in its interpretation and scope and suitable amendments to the law are envisaged.¹⁰⁹

The common-law liability of a bank for giving a status opinion or credit reference or report may occur in the following ways;

- The customer may allege that the opinion was an unauthorized disclosure of his or her affairs and amounted to a breach of the duty of secrecy.
- Consent, whether express or implied, would only be to giving a fair and accurate report of the customer's financial position. If the report is favourable, it hardly seems possible that the customer could sustain any damage regardless of the accuracy, although the ultimate recipient of the advice might suffer losses.¹¹⁰
- If the report is unfavourable, but accurate, then any damage suffered by the customer would most likely not be recoverable, because the customer would be forced to argue that, but for the accurate report a more favourable (inaccurate) impression of the customer's financial position would have been given to the inquirer. In the words of Weaver & Craigie,¹¹¹ "it seems unlikely that a plaintiff in this position would attract a

reporting Code of Conduct, issued by the Privacy Commissioner under s 18A(1) of the Privacy Act of 1988 (Cth). Under this code, a bank may not give a banker's opinion to another bank without the subject's specific agreement to the disclosure for the particular purpose if the opinion contains information relating to the subject's consumer creditworthiness.

107 Neate *Bank Confidentiality* 33.

108 S 18 N(9) of the Privacy Act of 1988 (Cth).

109 See K. O'Connor, Privacy Commissioner, "Impact of Privacy Act on Financial Institutions", Monash University Seminar on Banking and Finance, Melbourne, 10 November 1992, quoted in Weerasooria *Banking Law* par 30.6.

110 See *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465.

111 Weaver & Craigie *Banker* par 6690.

great deal of sympathy from a court".

There is undoubtedly a duty on the bank to exercise reasonable care and skill in the giving of the reference. If the customer suffers damages as a direct result of inaccurate information carelessly supplied by the advising bank, then there seems no reason why these should not be recoverable in an action for breach of contract.¹¹² The foundation judgments for the tort of negligent misstatement in *Candler v Crane Christmas and Co*¹¹³ and *Hedley Byrne & Co Ltd v Heller & Partners Ltd*¹¹⁴ relied on the closeness and directness of the relationship measured by various indicators as a *prima facie* test on the duty question. The *Hedley Byrne*¹¹⁵ case involved defendant bankers supplying a negative credit reference to a specified identified plaintiff. Proximity was defined in these cases in terms of a special relationship between a plaintiff user and defendant provider. There was a close or special relationship between a plaintiff who had requested advice or information, known or identifiable by the defendant, and to whom the defendant had supplied such advice or information for use specifically by the plaintiff. An analysis of the judgments in the *Hedley Byrne*¹¹⁶ case indicates that the court makes reference to a number of factors upon which it was appropriate to find a duty of care for negligent misstatement, such as a special relationship based on reliance which is both foreseeable and reasonable, a voluntary assumption of responsibility, and a relationship equivalent to contract. These factors are indicators of a close and direct relationship (proximity). There is also frequent reference in the judgments to the notion of proximity.¹¹⁷ Since the *Hedley Byrne*¹¹⁸ case, cases in Australia involving identified users of negligent advice who were the intended recipients have consistently applied closeness and directness of relationship as the *prima facie* yardstick for a duty of care.¹¹⁹

112 *Tyree Banking* 111.

113 [1951] 2 KB 164.

114 [1964] AC 465.

115 [1964] AC 465.

116 [1964] AC 465 at 483;486-487; 502-503; 505;509-511; 514; 528-530.

117 *Ibid*, at 483;505;511 and 514.

118 [1964] AC 465.

119 See, eg, *Mutual Life and Citizens Assurance Co Ltd v Evatt* (1968) 122 CLR 556; *L Shaddock & Associates Pty Ltd and Another v Parramatta City Council (No 1)* (1981) 150 CLR 225. The notion of reliance was referred to in *San Sebastian Pty Ltd and Another v Minister Administering Environmental Planning & Assessment Act 1979 and Another* (1986) 162 CLR 340 as playing "a prominent part in the ascertainment of a relationship of proximity between plaintiff and defendant", where economic loss results

The customer may also have an action in defamation if the report is unfavourable. In such a circumstance, the banker would need to plead justification if the report is accurate, and qualified privilege if it is not. The defence of qualified privilege, although ordinarily available when there is a contractual duty, may not be available since, strictly speaking, there is no contractual duty for the bank to supply a banker's reference.¹²⁰

Except in cases where the person making the inquiry is also a customer of the same bank, there is usually no contractual relationship between the bank giving the status opinion and the third party who requires it and to whom it is communicated.¹²¹ The bank cannot, therefore, be sued by the third party if it refuses to give any information.¹²² If, however, the bank provides an opinion and that opinion turns out to be incorrect and the third party acts on that opinion and suffers loss as a result, the bank will be liable if the opinion was given negligently or fraudulently.¹²³

In order to establish that the opinion was fraudulent it must be proved that the representation was, in fact false, was made knowingly or recklessly, with the intention to deceive and with the intent that it should be acted upon by someone who did act upon it and thereby suffered damage.¹²⁴

In determining the bank's liability for a fraudulent opinion one must bear in mind s 6 of the Statute of Frauds (Amendment) Act of 1828 (UK)¹²⁵ which applies in some Australian jurisdictions.¹²⁶ According to this statutory provision no action may be brought against a person

from negligent misstatement.

120 See Tyree 1980 *ABLR* 220-231.

121 The House of Lords in *Smith v Bush* [1990] 1 AC 831 increased the scope of the duty of care to include a plaintiff who was a known user in a contemplated transaction, although not the intended recipient of the defendant's negligent advice or information. See, also, *Caparo Industries plc v Dickman* [1990] 2 AC 605 at 638-639.

122 Tyree *Banking* 111; Weerasooria *Banking Law* par 30.10.

123 The leading authority is the House of Lords' decision of *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465. A recent Australian case where bankers were sued for both negligent and fraudulent misrepresentation was *Brown RH & Co v The Bank of New South Wales and Commercial Banking Co of Sydney Ltd* [1971] WAR 201.

124 *Derry v Peek* (1889) 14 App Cas 337 approved by the High Court in *Commercial Banking Co of Sydney Ltd v RH Brown & Co* (1972) 126 CLR 337.

125 Better known as Lord Tenterden's Act.

126 Lord Tenterden's Act applies in Australia by reason of the following statutes, eg, s 10 of the Usury, Bills of Lading and Written Memoranda Act of 1902 (NSW); *Evatt v Mutual Life and Citizens Assurance Co* (1967) 87 WN (Pt 2) (NSW) 165, affirmed on this point

who makes a fraudulent representation concerning another person's credit unless such representation is made in writing, and signed by the party to be charged therewith. Thus even if a bank manager gives a false and untrue reference and signs it himself or herself, the bank cannot be held liable because the Act specifically states "signed by the party to be charged therewith".¹²⁷ In the *Hirst*¹²⁸ case the Court of Appeal held that the bank was protected by s 6 as the opinion by the bank manager was held to be insufficient to impose liability upon the bank. The bank manager could have been made personally liable, but he had not been joined as a defendant. In *Swift v Jewsbury and Goddard*,¹²⁹ however, a customer sued a bank for false representation, and added the bank manager as second defendant. The court held that s 6 excluded the bank from liability, but the bank manager who had signed the representation was held to be personally liable to the customer in damages.¹³⁰

A bank giving a status report must give an accurate and honest answer based on facts available and known to the bank. Beyond this there is no duty to obtain information from any outside source and the reply need be based only on information obtained from the account. In *Parsons v Barclay & Co Ltd and Goddard*¹³¹ the court emphatically repudiated the suggestion that when a banker was asked for a reference of this kind it was any part of his duty to make enquiries from outside sources as to the solvency or otherwise of the person asked about or to do anything more than answer the question put to him from what he knew from the books and accounts before him.

In *Mutual Life and Citizens Assurance Co v Evatt*¹³² Lord Diplock, in the Privy Council summed up the legal position as follows:

in (1968) 122 CLR 556) (since repealed); see, also, *Compafina Bank v Australia and New Zealand Banking Group Ltd and Bennet* (1984) Aust Torts Rep 80-546. The Act is in force in South Australia, see *De Garis v Dalgety & Co Ltd* [1915] SALR 102 at 124; and in Victoria, see s 128 of the Instruments Act of 1958 (Vic); *Barrow v Bank of New South Wales*; [1931] VLR 323; and in Western Australia, see Law Reform (Statute of Frauds) Act of 1962 (WA); *Commercial Banking Co of Sydney Ltd v RH Brown & Co* (1972) 126 CLR 336; and in Tasmania, see s 11 of the Mercantile Law Act of 1935 (Tas).

127 See *Hirst v West Riding Union Banking Co Ltd* [1901] 2 KB 560.

128 *Ibid.*

129 (1874) LR 9 QB 301.

130 See, also, *Parsons v Barclay & Co Ltd and Goddard* (1910) 103 LT 196.

131 *Ibid.*

132 (1970) 122 CLR 628.

"A banker giving a gratuitous reference is not required to do his best, for instance, making enquiries from outside sources which are available to him, though this would make his reference more reliable. All he is required to do is to conform to that standard of skill and competence and diligence which is generally shown by persons who carry on the business of providing references of that kind. Equally it is no excuse for him to say that he has done his honest best, if what he does falls below that standard because in fact he lacks the necessary skill and competence to attain to it. The reason why the law requires him to conform to this standard of skill and competence and diligence is that by carrying on a business which includes the giving of references of this kind he has let it be known to the recipient of the reference that he claims to possess that degree of skill and competence and is willing to apply that degree of diligence to the provision of any reference which he supplies in the course of that business, whether gratuitously so far as the recipient is concerned or not. If he supplies the reference the law requires him to make good his claim."¹³³

The matter of *Compafina Bank v Australia and New Zealand Banking Group Ltd and Bennet*¹³⁴ which involved a claim by a Swiss bank against the ANZ Bank for \$5.5 million, is of great importance as far as several legal issues relating to the following are concerned:

- the effect of a bank's letter of introduction;
- a favourable credit report with a disclaimer clause;
- authority of branch managers to issue such references;
- liability of the bank for misrepresentations in such references — both fraudulent and negligent; and
- the assessment of damages for loss suffered by relying on them.

The *Compafina*¹³⁵ case is also a rare case because the bank manager was held personally liable for deceit and the bank held entitled to be indemnified by him.¹³⁶

133 For a similar view see, *Brown RH & Co v The Bank of New South Wales and Commercial Banking Company of Sydney Ltd* [1971] WAR 201.

134 [1984] Aust Torts Rep 80-546.

135 *Ibid.*

136 For further important decisions as to the reasonableness in believing the reference, as well as contributory negligence in relying on the references, see *L Shaddock and Associates Pty Ltd and Another v Parramatta City Council (No 1)* (1981) 150 CLR 225; *JEB Fasteners Ltd v Marks Bloom & Co (A Firm)* [1981] 3 All ER 289.

In the *Compafina*¹³⁷ case the court distinguished between a letter of introduction and an opinion as follows. The purpose of a letter of introduction in the ordinary sense of the word is to make the customer of that branch known to the person to whom the letter is directed as a customer of that branch. A branch manager has no implied authority in a letter of introduction to give an opinion on the customer's general position and character. Where a representation or reference contains a bank's assessment of the character and business ability of a customer such a representation falls quite comfortably within the description of an "opinion". In this case, the letter of introduction signed and given by the manager was quite unusual. It was more in the nature of an opinion. In the court's view a letter of introduction (on an official letterhead) by a manager of one of Australia's largest banks, which spoke so eloquently of the customer's honesty, integrity and business ability, would, no doubt, prove a strong inducement to any institution in deciding to lend the customer money. Indeed, this was the purpose of writing the letter and indeed, this is what actually happened.

A bank may escape liability if it is in effect merely passing on a reference given by another bank, without express or implied endorsement.¹³⁸

The House of Lords in the *Hedley Byrne*¹³⁹ case found that although the defendant had been negligent, there was no liability because of the disclaimer of liability. In Australia, the High Court¹⁴⁰ treated the matter as one that was still open, as the court doubted whether a duty of care imposed by law can be circumvented by a mere reservation. It is, of course, clear that no disclaimer will be effective in the avoidance of liability for advice which is given fraudulently or recklessly.¹⁴¹

3.4 THE BANK'S LIABILITY FOR INVESTMENT ADVICE

In some earlier cases,¹⁴² the courts had to determine a bank's liability for investment advice. In

137 [1984] Aust Torts Rep 80-546.

138 See *Cunningham and Others v National Australia Bank Ltd and Others* (1987) 77 ALR 632; *Global Sportsman Pty Ltd v Mirror Newspapers Pty Ltd* (1984) 2 FCR 82; *Yorke v Ross Lucas* (1985) 158 CLR 661.

139 [1964] AC 465.

140 See *Mutual Life and Citizens' Assurance Co Ltd v Evatt* (1968) 112 CLR 556.

141 *Commercial Banking Co of Sydney Ltd v RH Brown & Co* (1972) 126 CLR 337.

142 Most notably being *Banbury v Bank of Montreal* [1918] AC 626.

*Banbury v Bank of Montreal*¹⁴³ the majority in the House of Lords took the view that advising on investments was not part of the business of banking. In *Barrow v Bank of New South Wales*¹⁴⁴ and *Byrne v Nickel*¹⁴⁵ the decision in the *Banbury*¹⁴⁶ case was relied on by the bank in order to avoid liability.

In the *Barrow*¹⁴⁷ and *Byrne*¹⁴⁸ cases, the respective bank managers, although they were under no obligation to do so, held themselves out as willing to advise. It may happen that the bank holds itself out as a financial adviser and in such a case it would be futile for it to plead afterwards that investment advice was no part of its business. This is exactly what happened in *Woods v Martins Bank Ltd*¹⁴⁹. The plaintiff who had no real business experience asked a branch manager of the defendant bank to act as his financial adviser and the manager replied that the bank would be only too pleased to take care of the plaintiff's financial affairs. Acting on the manager's advice, the plaintiff invested large sums of money in a company, but the investment turned out to be disastrous loss. Unknown to the plaintiff, but well known to the manager, the company in question was heavily indebted to that bank and the bank's head office had been pressing the manager to get the company's overdraft reduced. The plaintiff sued the bank to recover the amount he had lost on the ground of negligent advice. No fraud was alleged because it was admitted that the manager himself honestly believed in the advice he gave.

The bank was held liable. In demolishing the argument that the bank was not liable because it was not within its scope to advise on investments, Salmon J observed that the court cannot do better than to look at the bank's advertisements. The words (in the advertisement) "you may consult your bank manager freely and seek his advice on all matters affecting your financial welfare", seemed to the Judge to be in the widest possible terms. The decision in *Banbury v Bank of Montreal*¹⁵⁰ was distinguished on the ground that the facts in that case were peculiar and there it was admitted without argument, that the bank manager had no general authority to advise.

143 *Ibid.*

144 [1931] VLR 323.

145 [1950] St R Qd 57.

146 [1918] AC 626.

147 [1931] VLR 323.

148 [1950] St R Qd 57.

149 [1959] 1 QB 55.

150 [1918] AC 626.

Salmon J added:

"In any event what may have been true of the *Bank of Montreal* in 1918 is not necessarily true of *Martins Bank* in 1958".¹⁵¹

One of the Court's findings was that the plaintiff had reposed complete confidence in the manager's financial experience and acumen and supposed knowledge and skill in financial affairs. In that situation the manager had created a fiduciary relationship with the customer.

Today, banks, together with their wholly owned subsidiaries and associated companies, openly advertise and compete strongly for several types of investment and financial services. Their role as "money managers" has grown more rapidly and extensively since the deregulation of the financial system in the 1980s and the entry of foreign banks in 1985.¹⁵²

Several judicial decisions relating to banks' foreign loans, and claims against banks for misleading and deceptive conduct in terms of s 52 of the Trade Practices Act of 1974 (Cth) have clearly held that investment and financial advice is part of banking business today.¹⁵³

Specialized divisions of the banks (for example, corporate, international, investment, treasury and global treasury, corporate advisory, merchant banking, capital markets and project finance divisions) now offer several services that may well fall within the ambit of the law relating to a bank's liability for financial and investment advice as discussed in this chapter,

Examples of these areas of activity are:

151 The decision in *Woods v Martin Bank* [1959] 1 QB 55 was expressly approved by the House of Lords in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 at 530 and by the Privy Council in *Mutual Life and Citizens Assurance Co v Evatt* (1970) 122 CLR 628 at 657. Paget's *Banking Law* 8 at 188-9, says of the decision in *Woods v Martins Bank Ltd*:

"The case is of the first importance to bankers, for it takes account of the change which has taken place in banking practice, as evidenced by the advertisements, since the *Banbury* case... The probability is that advising has become part of the business of banking, at any rate of those who advertise to that effect, in which case banks must gauge the responsibility thereby entailed and provide accordingly".

152 *Tyree Banking* 120; *Weerasooria Banking Law* par 30.46.

153 *Barton v Westpac Banking Corporation* [1983] ATPR 40-388; *Westpac Banking Corporation v Eltran Pty Ltd* (1987) 74 ALR 45; *Chiarabaglio v Westpac Banking Corporation* [1989] ATPR 40-971.

- provision and management of portfolios, share units, and investment trusts and superannuation funds;
- reports, advice and valuation of new issues of shares and other notices to shareholders;
- management of securities under custodial care, custodial and settlement services including international custodial facilities for Australians investing in foreign securities;
- advice and reports and implementation of business acquisitions, takeovers, mergers and disposals and general financial advice on such matters;
- advice on capital raising, underwriting of debts and equity issues;
- preparation of financial feasibility studies for project finance and advice on loan structuring for projects and advice on acquisitions and disposals of investments in projects;
- advice on corporate foreign exchange exposures and arranging off-shore finance in foreign currency including syndication.¹⁵⁴

Investment advice is subject to the prohibition of misleading or deceptive conduct.¹⁵⁵ Where a misrepresentation of fact, past or future, is otherwise absent, relief may still be available where the advice given is not underscored by a genuine belief and where there are no reasonable grounds for such advice. Inadequate grounds were found to exist in *Chiarabaglio v Westpac Banking Corporation*¹⁵⁶ where the defendant bank was held liable towards its customer in respect of an overseas currency loan into which it had entered on the advice of the bank. Foster J held that the bank had honestly held the opinion it gave, but that there was no reasonable basis upon which the opinion could be justified. The advice included representations that there was no significant risk in the loan, that hedging an offshore loan was not worthwhile and that the Australian dollar would not devalue against the Japanese yen. Foster J took into account the fact that the customer had limited English and found that he should have been given:

"[A] most careful explanation of offshore borrowing with clear emphasis on the 'open ended' nature of the risks associated with it, together with a clear and detailed exposition of the steps such as short term hedging which the borrower would himself be required to undertake in order to exercise some control over those risks."¹⁵⁷

154 See Weerasooria *Banking Law* pars 30.48 and 30.49.

155 S 52 of the Trade Practices Act of 1974 (Cth).

156 [1989] ATPR 40-971. Affirmed in *Westpac Banking Corporation v Chiarabaglio* [1991] ATPR (Digest) 46-067. See, also, *Dennison v Ace Shohin (Australia) Pty Ltd* [1987] ATPR 40-793).

157 *Chiarabaglio v Westpac Banking Corporation* [1989] ATPR 40-971.

Advice has been held to amount to misleading or deceptive conduct in the context of:

- a statement to a guarantor of an account that the bank's customer was "trading satisfactorily" when the bank knew the customer had a cash-flow problem;¹⁵⁸
- a statement to a customer that the bank would advance money in the future;¹⁵⁹
- a statement that the bank intended to close down an account in respect of which a guarantee was sought and then to terminate the guarantee as soon as a nil balance was achieved in the account;¹⁶⁰
- a statement that a loan would be approved, followed by the subsequent refusal of the loan.¹⁶¹

Representations made in the course of negotiating foreign currency loans have been the subject of a number of recent cases such as the *Chiarabaglio*¹⁶² case. For example, in *Westpac Banking Corporation v Eltran Pty Ltd*¹⁶³ representations made by the defendant bank's officer to the effect that the bank had a competent foreign-currency department which would assist in the management of a loan and that it would act on the customer's instruction concerning hedging when it did not in fact intend to do so, were held to amount to a breach of s 52 of the Trade Practices Act of 1974 (Cth).

The authority of branch managers to advise, and whether such advice will bind the bank, will naturally depend on the particular transaction and the facts of each case. General principles governing the express, implied and ostensible authority of employees, will also apply.¹⁶⁴

158 *Nobile v National Australia Bank Ltd* [1987] ASC 55-580; *Banque Brussels Lambert SA v Australian National Industries Ltd* (1989) 21 NSWLR 502.

159 *Menhaden Pty Ltd v Citibank NA* (1984) 1 FCR 542.

160 *Hamer v Westpac Banking Corporation* [1987] ATPR 40-811.

161 *Westpac Banking Corporation v Eltran Pty Ltd* (1987) 74 ALR 45.

162 [1989] ATPR 40-971. See, also, *Westpac Banking Corporation v Spice* [1990] 12 ATPR 51-386; *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 93 ALR 271; *McEvoy Australia and New Zealand Banking Group Ltd* [1990] Aust Torts Rep 67-690.

163 (1987) 74 ALR 45.

164 Outsiders dealing with a company can assume that the company's business activities and transactions are being properly and duly performed and are not bound to enquire whether the company's internal management has been regular. *Royal British Bank v Turquand* (1856) 6 E & B 327. This common-law assumption is now a statutory assumption by virtue of ss164(2) and (3) of the Corporations Law.

Often bank staff with professed expertise in financial matters (for example, investments, offshore borrowing, etc) take it upon themselves to advise customers with little knowledge of the subject matter. In *Chiarabaglio v Westpac Banking Corporation*¹⁶⁵ Foster J stated that in such cases, the bank officer must realize that he or she could be exercising, to a not inconsiderable degree, the power of persuasion and could thereby cause harm of an economic nature to customers' accepting that information and advice. Moreover, it is reasonable that in the absence of any inquiry on his or her part, such a bank officer should assume that those to whom he or she was imparting information possessed no worthwhile knowledge of the involved subjects being explained and that they would be dependant upon that information and advice in making their decision whether or not to enter into a particular transaction. The approach taken by courts when considering the duty of care in this area of the law is to develop in appropriate cases new categories of liability for negligence.¹⁶⁶

In the context of current judicial decisions, a banker can incur liability towards a customer for negligent financial or investment advice if:

- the customer relied on that advice and suffered loss;
- the banker was aware or ought to have been aware that the customer was going to rely on such advice;
- the advice was given in serious circumstances and not in an informal way or on an informal occasion (for example, in a casual telephone conversation) which would make it unreasonable for the customer to have relied on such advice.¹⁶⁷

Where an opinion was given in good faith, in terms of an opinion honestly held on reasonable grounds, the bank should escape liability.¹⁶⁸ In the absence of special knowledge, the banker has

165 [1989] ATPR 40-971.

166 For cases proposing an incremental development of novel categories of negligence, see *Sutherland Shire Council v Heyman* (1985) 157 CLR 424; *Caparo Industries plc v Dickman and Others* [1990] 2 AC 605; *Murphy v Brentwood District Council* [1991] 1 AC 398.

167 See *L Shaddock & Associates Pty Ltd v Parramatta City Council (No 1)* (1981) 150 CLR 225; *Mohr v Cleaver* [1986] WAR 67; *Royal Bank Trust Co (Trinidad) v Pampellone* [1987] 1 Lloyds Rep 218; *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371.

168 *James v Australia and New Zealand Banking Group Ltd* (1986) 64 ALR 347; *Stanton v Australia and New Zealand Banking Group Ltd* [1987] ATPR 40-755; *Bill Acceptance Corporation Ltd v GWA Ltd* (1983) 78 FLR 171.

no duty to consider the taxation aspects of transactions.¹⁶⁹

3.5 THE BANKER'S DUTY OF DISCLOSURE AND OTHER RELEVANT COMMON-LAW PRINCIPLES

3.5.1 Introduction: rising tide of defences based on unconscionability and misleading conduct

As in most Western countries, Australian banks and other lenders are increasingly being faced with claims by borrowers, guarantors and mortgagors that their contracts with the lender ought to be set aside on the grounds that the contract or the lender's or borrower's conduct in relation to the contract is unfair.¹⁷⁰ In recent times cases in which sureties have applied and obtained relief from their suretyships or mortgages have proliferated. The long list of Australian cases¹⁷¹ setting aside or re-opening suretyships demonstrates that there are many guarantors who have not understood the nature and extent of their obligations under the suretyship and the financial risk represented by the debtor or the project being financed, or who have been misled about this by the debtor or the lender.¹⁷² The cases are also filled with sureties who have been subjected to undue influence¹⁷³ or unfair pressure by the debtor¹⁷⁴ (and, infrequently, the lender) to enter into

169 *Schioler v Westminster Bank Ltd* [1970] 2 QB 719.

170 See Moon 1993 *LJ* 592, an article based on the author's booklet "How to get out of a Contract of Guarantee".

171 See, eg, *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *Bawn v Trade Credits* [1986] NSW Conv R 55-290; *Borg-Warner Acceptance Corporation (Australia) Ltd v Diprose* [1987] NSW Conv R 55-364; *Budget Nominees (Pty) Ltd v Registrar of Titles* [1988] V Conv R 54-311; *Broadlands International Finance Ltd v Sly* [1987] NSW Conv R 55-342; *National Australia Bank Ltd v Nobile and Martelli* [1988] ATPR 40-856; *Money v Westpac Banking Corporation* [1988] ATPR 46-034; *Westpac Banking Corporation v Sugden* [1988] NSW Conv R 55-377; *Nolan v Westpac Banking Corporation* (1989) 51 SASR 496; *Guthrie v Australia and New Zealand Banking Group Ltd* [1989] NSW Conv R 55-463; *Esanda Finance Corporation v Murphy* [1989] ASC 55-703; *Robinson v Australia and New Zealand Banking Group Ltd* [1990] ASC 58-890.

172 For the nugatory effect of a misleading statement by an officer of an intending mortgagee, see *Cook v Bank of New South Wales* [1982] ASC 55-223.

173 See, eg, *Union Bank of Australia Ltd v Whitelaw* (1906) VLR 711; *Robertson v Robertson* [1930] QWN 41; *Bank of New South Wales v Rogers* (1941) 65 CLR 42; *Yerkey v Jones* (1939) 63 CLR 649.

174 Particularly in cases where the wife stood surety for the husband's debts, and he exerted undue influence or unconscionable conduct towards her. See, eg, *Akins v National Australia Bank* (1994) 34 NSWLR 155; *National Australia Bank Ltd v Garcia* (1996) 39 NSWLR 577; *Burke v State Bank of New South Wales Ltd* (1994) 37 NSWLR 53; *Gregg*

the transaction, who did not have the opportunity to reflect on the risks involved or to seek adequate independent advice, who were not informed of defaults and were unaware that a guarantee believed to be for a fixed sum advance was an all-moneys suretyship for now-inflated debts which would exhaust all or most of the surety's assets.

Sureties' allegations of unconscionable conduct have become commonplace in statements of claim or defences and cross-claims in enforcement proceedings.¹⁷⁵ Lenders have received considerable adverse publicity and are uncertain whether their suretyships will stand up to challenge.¹⁷⁶

Naturally, lenders and their advisers are concerned about this trend and have sought to develop procedures in arranging guarantees and securities which will minimize the risk of those transactions being later set aside or modified by the courts.¹⁷⁷ Australian bankers and the various Law Societies are also striving to find a set of procedural steps which, if followed, will make the transaction immune from later challenge.¹⁷⁸ One of the principal elements included in such procedures is that the surety receives independent advice, or at least is urged to take such advice and is given a real opportunity to do so.¹⁷⁹ It is important to note at the outset that the absence of independent advice does not of itself make a transaction unfair.¹⁸⁰ An *excursus* to this thesis will be devoted to a discussion of independent advice by reason of the fact that Australian lawyers

v Tasmanian Trustees Ltd (1997) 143 ALR 328.

- 175 See, eg, *Westpac Banking Corporation v Robinson* [1990] ASC 59-027; *European Asian of Australia Ltd v Kurland and Another* (1985) 8 NSWLR 192; *National Australia Bank Ltd v Nobile & Martelli* [1988] ATPR 40-856; Sneddon 1992 *JBFLP* 92; Sneddon 1990 *UNSWLJ* 302; O'Donovan 1992 *LIJ* 51; Bingham 1996 *LIJ* 42.
- 176 See, eg, O'Donovan 1992 *LIJ* 51-54; *Nolan v Westpac Banking Corporation* (1989) 51 SASR 496; *National Australia Bank Ltd v Nobile and Martelli* [1988] ATPR 40-856; Speirs 1986 *Banking Law Bulletin* 49; Turley 1991 *LIJ* 1039.
- 177 Speirs 1986 *Banking Law Bulletin* 49.
- 178 See ss 17.1-17.7 of the Code of Banking Practice of the Australian Banker's Association, discussed in Neate *Bank Confidentiality* 27.
- 179 See, eg, *Powell v Powell* [1900] 1 Ch 243; *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127; *Yerkey v Jones* (1939) 63 CLR 649; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *Harrison v National Bank of Australasia Ltd* (1928) 23 Tas LR 1.
- 180 See, however, s 44 of the Consumer Transaction Act of 1972 (SA) requiring a lender in Southern Australia to ensure that a prospective guarantor obtains a certificate from a solicitor confirming that the debtor understands the true purport and effect of the guarantee. See O'Donovan 1992 *LIJ* 51 at 52.

have built up a fairly sophisticated body of law on the subject, and it is my contention that the concept may become more important in South African suretyship relations.

Sureties can obtain relief from unfair contracts from several sources. Traditionally, relief from unfair bargains has been obtainable in equity, notably through the doctrines of undue influence and unconscionable conduct. Today relief can also be obtained under statutes such as the Contracts Review Act of 1980 (NSW), certain sections of the Trade Practices Act of 1974 (Cth) which proscribes engaging in unconscionable conduct, and the Uniform Consumer Credit Code¹⁸¹ which is based upon the principle of truth-in-lending which will enable borrowers through adequate disclosure to make informed choices when obtaining credit. Sections of the Trade Practices Act of 1974 (Cth) are often used as an alternative source of relief where the unfair conduct is misleading or deceptive. In those States with Fair Trading Acts certain sections of the Trade Practices Act of 1974 (Cth), are replicated as State law.¹⁸² In addition, the circumstances of a case may permit relief to be obtained on common-law grounds such as misrepresentation,¹⁸³ mistake, undue influence¹⁸⁴ or failing in a duty of disclosure.

The prohibition of misleading or deceptive conduct¹⁸⁵ has largely usurped the role of the general law relating to pre-contractual misrepresentation, whether innocent, negligent or fraudulent. The prohibition of misleading or deceptive conduct is able to provide a remedy in all cases of pre-contractual misrepresentation's occurring in trade or commerce.¹⁸⁶ Consequently, as a general

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- 181 The UCCC replaced existing Credit Acts in each State such as the Credit Act of 1984 (Vic); Credit Act of 1984 (NSW); Credit Ordinance of 1985 (ACT); Credit Act of 1984 (WA) and the Credit Act of 1987 (QLD).
- 182 Thus equivalents of s 52A of the Trade Practices Act of 1974 (Cth) are found in s 11A of the Fair Trading Act of 1985 (Vic), s 43 of the Fair Trading Act of 1987 (NSW), s 57 of the Fair Trading Act of 1987 (SA), s 11 of the Fair Trading Act of 1987 (WA), and s 39 of the Fair Trading Act of 1989 (QLD).
- 183 See *Nolan v Westpac Banking Corporation* (1989) 51 SASR 496; *National Australia Bank Ltd v Nobile and Martelli* [1988] ATPR 40-856.
- 184 *Lloyds Bank Ltd v Bundy* [1974] 3 All ER 757; *National Australia Bank Ltd v Nobile and Martelli* [1988] ATPR 40-856; *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371.
- 185 S 52 of the Trade Practices Act of 1974 (Cth); s 12 of the Fair Trading Act of 1992 (ACT); s 42 of the Fair Trading Act of 1987 (NSW); s 42 of the Consumer Affairs and Fair Trading Act of 1990 (NT); s 38 of the Fair Trading Act of 1989 (QLD); s 56 of the Fair Trading Act of 1987 (SA); s 14 of the Fair Trading Act of 1990 (Tas); s 11 of the Fair Trading Act of 1985 (Vic); s 10 of the Fair Trading Act of 1987 (WA).
- 186 Relief in terms of the Fair Trading Act of 1989 (QLD) is limited to consumer protection, but s 52 of the Trade Practices Act of 1974 (Cth) affords relief in relation to corporate misleading conduct. The relevant provisions of the Fair Trading Act of 1989 (QLD) are:

rule, it is only where the "in trade or commerce" requirement cannot be satisfied, the shorter limitation period of s 52 of the Trade Practices Act of 1974 (Cth) has expired, or where exemplary damages are sought for fraud that the victims of misrepresentation are required to have recourse to the general law.¹⁸⁷ As there are a number of significant advantages in relying upon s 52 and its extensive and flexible remedies, this means that in practice, the general-law misrepresentation actions are almost obsolete.

Two matters of terminology should be explained at this point, which are relevant in regard to Australian suretyships, or guarantees¹⁸⁸ as they are called there. A surety's contract may be one of guarantee or indemnity. In some cases the "surety" is made a co-debtor under the terms of the loan agreement, in others the "surety" is the borrower of record although all parties understand that the proceeds of the loan will be passed as a gift to the "debtor". The terms "debtor" and "surety" will be used in this section of the thesis to denote the substance of the transaction rather than the form. Thus the debtor is the person who receives the principal and direct benefit of the financial accommodation from the lender and the surety is the person who is liable for the debt although he or she does not receive the direct benefit of the financial accommodation.¹⁸⁹ Also, for the sake of brevity, references to guarantees should be treated as including suretyship.

Secondly, reference will often be made to independent advice because of its importance in Australian law.¹⁹⁰ Reference will be made throughout to independent advice without specifying

s 99(3) (damages), s 100(6) (rescission), s 6 (consumer).

- 187 If the misrepresentation is also a term of the contract or of a collateral contract, an action under the general law may be more advantageous as the measure of damages may be more favourable to the applicant. It has been held that exemplary damages are not recoverable in terms of the Trade Practices Act of 1974 (Cth): see *Musca v Astle Corporation Pty Ltd* (1988) 80 ALR 251.
- 188 In Australia and in most English common-law jurisdictions the terms "surety" and "guarantor" are used interchangeably. See O'Donovan & Phillips *Guarantee* 8.
- 189 The degree to which the surety benefits from the transaction are relevant in assessing whether relief ought to be granted. Thus in cases of undue influence it may be necessary to show that the transaction was manifestly disadvantageous to the surety and in cases of unconscionable conduct a material benefit to the surety may show that the transaction was fair, just and reasonable in all the circumstances. See Sneddon 1990 *UNSWLJ* 302 at 304.
- 190 Various statutory provisions and the case law direct attention to whether independent legal or other advice was obtained. See, eg, s 9(2)(h) of the Contracts Review Act of 1980 (NSW); s 44 of the Consumer Transactions Act of 1972 (SA). See, also, *Powell v Powell* [1900] 1 Ch 243; *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127; *Yerkey v Jones* (1939) 63 CLR 649; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *McNamara v Commonwealth Trading Bank of Australia* (1984) 37 SASR 232; *Guthrie*

the type of that advice. Traditionally, the independent advice required has been legal advice and almost all the case law concerns independent legal advice. However, as commercial transactions become more sophisticated, a surety may equally need accounting or economic advice in order to understand the effect of a transaction and the risks involved in it.¹⁹¹ Although most cases have been and probably will continue to be concerned with legal advice, the expression "independent advice" will be used so as not to exclude other desirable forms of advice from contemplation.

3.5.2 Common-law defences

3.5.2.1 Introduction

At common law, sureties have available all the usual contractual defences, such as misrepresentation, duress, undue influence, and unconscionability. Although not strictly limited to issues of disclosure, the common-law aspects of undue influence and unconscionability will be addressed hereunder, as they particularly bear the seeds of disclosure. Thereafter the common-law principles of disclosure will be highlighted. A brief survey of duties of explanation will round off the common-law aspect of disclosure. A discussion of duress falls outside the scope of this thesis. As previously stated, the prohibition of misleading or deceptive conduct in terms of the Trade Practices Act 1974 (Cth) and in terms of the various states' Fair Trading Acts, has largely usurped the role of the general law relating to pre-contractual misrepresentation, whether innocent, negligent or fraudulent.¹⁹²

3.5.2.2 Relief in equity: undue influence

3.5.2.2.1 Background

In *Union Bank of Australia Ltd v Whitelaw*¹⁹³ Hodges J described undue influence in the

v Australia and New Zealand Banking Group Ltd [1989] NSW ConvR 55-463; *Vital Finance Corporation Pty Ltd v Taylor* [1991] ASC 58-167.

191 See Sneddon 1990 *UNSWLJ* 302; *Smith v Elders Rural Finance Ltd* (Unreported, Supreme Court NSW, 25 November 1994) — a case where the guarantor was incapable of assessing the financial risks of the transaction.

192 S 52 of the Trade Practices Act of 1974 (Cth); s 12 of the Fair Trading Act of 1992 (ACT); s 42 of the Fair Trading Act of 1987 (NSW); s 42 of the Consumer Affairs and Fair Trading Act of 1990 (NT); s 38 of the Fair Trading Act of 1989 (Qld); s 56 of the Fair Trading Act of 1987 (SA); s 14 of the Fair Trading Act of 1990 (Tas); s 11 of the Fair Trading Act of 1985 (Vic); s 10 of the Fair Trading Act of 1987 (WA).

193 [1906] VLR 711.

following terms:

"Influence is the ascendancy acquired by one person over another. 'Undue influence' is the improper use by the ascendant person of such ascendancy for the benefit of himself or someone else, so that the acts of the person influenced are not in the fullest sense of the word, his free, voluntary acts."¹⁹⁴

Since the judgment of the Court of Appeal in *Allcard v Skinner*¹⁹⁵ a distinction has been drawn between two categories of cases of undue influence:¹⁹⁶

- (1) those where influence is presumed from the nature of a pre-existing relationship between the parties to the transaction whereby one is in a position to exercise domination over the other (hereafter referred to as cases of presumed undue influence).¹⁹⁷

In cases where undue influence is presumed, the stronger party has the onus of proving that the weaker party did not enter into the transaction as a result of the influence, by showing that entering into the transaction was "the voluntary and well-understood act" of the weaker party's own mind.

- (2) those where the stronger party's dominance arises not from a pre-existing relationship but from particular circumstances.

In such cases there is no presumption of undue influence and the weaker party must prove that the transaction was the result of undue influence exercised by the stronger party (hereafter referred to as cases of actual undue influence).¹⁹⁸

194 *Ibid*, at 720.

195 (1887) 36 Ch D 145.

196 *Johnson v Buttress* (1936) 56 CLR 113 at 135-136 per Dixon J; *Bank of Credit and Commerce International S A v Aboody and Another* [1989] 2 WLR 759.

197 Relationships in which undue influence will be presumed can be divided into two types: relationships within certain established categories where the presumption automatically arises (eg doctor and patient, religious superior and inferior) and relationships not within those categories (eg husband and wife, bank and customer) where the evidence in the case shows that the particular relationship was one of influence, so as to justify the application of the presumption to the transaction in question.

198 In England, at least, the party complaining of undue influence must also show that the transaction was manifestly disadvantageous to him or her: *National Westminster Bank plc v Morgan* [1985] AC 686 and see *European Asian of Australia v Kurland and*

If it is proved that the transaction was entered into because of undue influence the normal remedy is for the transaction to be set aside and the parties restored to their original positions.¹⁹⁹ The order to set aside may be made subject to conditions so as to allow justice to be done between the parties.²⁰⁰ For the purposes of this thesis, the doctrine of undue influence in Anglo-American law is summarized sufficiently under the discussion of English law and needs no further discussion except for the issue of undue influence by third parties, particularly that of husbands over wives, where Australian law initially differed from English law.

3.5.2.2 Undue influence by husbands over wives

In most cases concerning undue influence in relation to guarantees, the lender will not have exercised undue influence over the surety directly.²⁰¹ Most often it is the debtor and not the lender who has exercised the undue influence and the question is whether the lender is in some way liable (or should at least have to bear the loss upon the setting aside of the suretyship) for the debtor's conduct. The general proposition is that the stronger party must have had actual knowledge of the special disability or of facts indicating a special disability, or that the debtor was acting as the agent of the lender in procuring the signature of the surety, before the rights of the stronger party under the suretyship can be subject to the surety's equity to have the transaction set aside.²⁰²

A debtor is not considered to be the agent of the lender merely because the lender allows the

Another (1985) 8 NSWLR 192 which applied the requirement in Australia. See, also, *Farmer's Co-operative Executors & Trustees Ltd v Perks* (1989) 52 SASR 399, and Cope 1986 ALJ 97.

- 199 *Thermo-Flo Corporation Ltd v Kuryluk* (1978) 84 DLR (3d) 529; *Mutual Finance Ltd v John Wetton and Sons Ltd* [1937] 2 KB 389; *Yerkey v Jones* (1939) 63 CLR 649.
- 200 *Sercombe v Sanders* (1865) 34 Beav 382; *Bank of New South Wales v Rogers* (1941) 65 CLR 42.
- 201 Such cases are rare because the lender usually is not in a relationship of influence over the surety. *Lloyds Bank v Bundy* [1975] 3 All ER 757 is an example of where a lender exercised direct undue influence over a surety. The relationship of influence arose because the surety was a long-standing customer of the lender. See, also, *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371.
- 202 On this subject, see *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *Akins v National Australia Bank* (1994) 34 NSWLR 155 (wife guaranteeing debts owed by husband); *Burke v State Bank of New South Wales Ltd* (1994) 37 NSWLR 53 (elderly parents guaranteed debt owed by son); *State Bank of New South Wales v Bosday Pty Ltd* (1995) 7 BPR 14-492 (SC NSW) (elderly migrants guaranteeing debt owed by son-in-law).

debtor to take the necessary steps to find a suitable guarantor and arrange for the guarantee to be executed.²⁰³

Previously, a special rule afforded relief in respect of a wife's guarantees of her husband's debts. In *Yerkey v Jones*²⁰⁴ it was noted that, although the "relation of a husband to his wife is not one of influence, and no presumption exists of undue influence, it has never been divested completely of what may be called equitable presumptions of an invalidating tendency".²⁰⁵

The special principle governing relief for guarantor wives was expressed by Dixon J in the following terms: if a married woman's consent to become surety for her husband's debt is procured by the husband and if, without understanding its effect in essential respects, she executes an instrument of suretyship which the creditor accepts without dealing directly with her personally, she has a *prima facie* right to have it set aside.²⁰⁶

Accordingly, as a general rule, a wife had a right, or "special equity" to have a guarantee set aside where she had guaranteed her husband's debt.²⁰⁷

The special rule attracted strong criticism for failing to recognize changes in the status and education of women, and the increasing role of women in business and financial affairs.²⁰⁸ The special rule has now been abandoned since the decision in *Barclays Bank plc v O'Brien and Another*.²⁰⁹ The Australian Courts have followed the *O'Brien*²¹⁰ decision in holding that the position of wives who guarantee the debts of their husbands is now governed by the ordinary

203 *Barclays Bank plc v O'Brien* [1994] 1 AC 180; [1993] 4 All ER 417; *HG & R Nominees Pty Ltd v Fava* [1995] V Conv R 66-155. Until recently, in Australia, the opposite was true. See *Avon Finance Co Ltd v Bridger* [1985] 2 All ER 281; *Kingsnorth Trust Ltd v Bell and Others* [1986] 1 WLR 119; [1986] 1 All ER 423; *Borg-Warner Acceptance Corporation (Australia) Ltd v Diprose* [1987] NSW Conv R 55-364.

204 (1939) 63 CLR 649.

205 *Ibid*, at 675.

206 *Ibid*, at 683.

207 See, also, *Bank of Victoria Ltd v Mueller* [1925] VLR 642.

208 See, eg, *European Asian of Australia Ltd v Kurland and Another* (1985) 8 NSWLR 192 at 200; *Warburton v Whiteley* [1989] NSW ConvR55-453; Aitken 1993 *ABLB* 46; Chen-Wishart 1993 *NZLJ* 224; Aitken 1992 *JBFLP* 261.

209 [1994] 1 AC 180; [1993] 4 All ER 417.

210 [1994] 1 AC 180; [1993] 4 All ER 417.

equitable principles, as set out in *Commercial Bank of Australia Ltd v Amadio*.²¹¹

It is unclear whether the approach that the transaction must hold a substantial risk (as required in the *O'Brien*²¹² case), as adopted by the House of Lords, applies in Australia. It has been applied in some cases,²¹³ but the weight of opinion appears to favour the view that the "substantial risk" approach is inconsistent with the principles of *Commercial Bank of Australia Ltd v Amadio*.²¹⁴

3.5.2.3 Relief in equity: unconscionable transactions

3.5.2.3.1 Common law

The equitable jurisdiction to set aside unconscionable transactions is long established.²¹⁵ It was described by Kitto J in *Blomley v Ryan*²¹⁶ as applying when two elements are present. First, one party to a transaction is at a special disadvantage in dealing with the other party (for example because of illness, ignorance, unfamiliarity with the language used or financial hardship) and secondly, the other party unconscientiously takes advantage of the opportunity thus placed in his hands. This formulation was approved by the High Court in *Commercial Bank of Australia Ltd v Amadio*²¹⁷ where the doctrine was applied to set aside a mortgage and guarantee given in favour of a bank by an elderly immigrant couple. Since the *Amadio*²¹⁸ case, there have been many claims

211 (1983) 151 CLR 447. See, eg, *Akins v National Australia Bank* (1994) 34 NSWLR 155; *National Australia Bank Ltd v Garcia* (1996) 39 NSWLR 577; *Gregg v Tasmanian Trustees Ltd* (1997) 143 ALR 328.

212 [1993] 4 All ER 417 at 429.

213 *Burke v State Bank of New South Wales Ltd* (1994) 37 NSWLR 53; *State Bank of New South Wales Ltd v Bosday Pty Ltd* (1995) 7BPR 14-492.

214 (1983) 151 CLR 447. See, eg, *Lisciandro v Official Trustee in Bankruptcy* [1995] ATPR 41-436; *National Australia Bank Ltd v Garcia* (1996) 39 NSWLR 577; *Teachers' Health Investments Pty Ltd v Wynne* [1996] ASC 56-972.

215 See *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 125; *Langdon v Rees* (1883) 4 LR (NSW) Eq 28; Cope 1983 ALJ 279 at 279-295.

216 (1956) 99 CLR 326 at 415.

217 (1983) 151 CLR 447. Mason, Wilson and Deane JJ set aside the transaction on the ground of unconscionable conduct. Gibbs CJ did not consider that ground to be made out, but held that the transaction should be set aside because the lender did not disclose certain unusual features of the transaction when it had a duty to do so. Dawson J dissenting, would have upheld the transaction.

218 *Ibid.*

for relief by guarantors on the basis of unconscionable conduct²¹⁹ by the lender, often allied with a claim of misleading conduct under s 52 of the Trade Practices Act of 1974 (Cth).²²⁰ Unconscionability has been described by learned commentators as a "pejorative adjective" and a "universal talisman in many fields of equity".²²¹ Some writers have eschewed any attempt at categorization or definition.²²² It is clear that the notion can decline all too readily into a generalized justification for the courts' doing whatever they deem to be fair, although the Australian Courts clearly reject such an approach.²²³

If the transaction is held to be unconscionable, the normal remedy is for the transaction to be set aside in whole or in part and on conditions, if necessary, in order to do justice between the parties.²²⁴

Undue influence and unconscionable transactions (or unconscionable conduct) are related, but distinct doctrines of equity. The doctrine of undue influence affords relief where the will of the innocent party is not independent and voluntary because it is dominated or suppressed. The doctrine of unconscionable conduct provides relief where the will of the innocent party, whether or not independent and voluntary, is the result of the disadvantageous position in which he or she is placed and the unconscientious advantage taken of that position by the stronger party.²²⁵

A distinction has been drawn between two types of unconscionability: procedural and

219 "Unconscionability" is a recurrent notion in many branches of the Australian law (as well as that of Canada, New Zealand and the United States) and has been the guiding principle of many developments in equity in recent years. See the article by Finn in Youdan (ed) *Equity* 6 on the subject.

220 See, eg, *National Australia Bank v Nobile and Martelli* [1988] ATPR 40-856 and *Money v Westpac Banking Corporation* [1988] ATPR 46-034.

221 Finn (ed) *Essays* 106 at 110; Mason in Finn (ed) *Essays* 242 at 244.

222 Sheridan *Equity* 2.

223 *Bridge v Campbell Discount Co Ltd* [1962] AC 600 at 626; *Muschinski v Dodds* (1985) 160 CLR 583 at 615; *Stern v McArthur* (1988) 165 CLR 489 at 514.

224 See *Blomley v Ryan* (1956) 99 CLR 362; *Commercial Bank Australia Ltd v Amadio* (1983) 151 CLR 447.

225 Per Mason J in *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 461, and per Deane J at 474. Deane J referred to the following cases: *Union Bank of Australia Ltd v Whitelaw* [1906] VLR 711; *Watkins and Another v Combes and Another* (1922) 30 CLR 180; *Morrison v Coast Finance Ltd* (1965) 55 DLR (2d) 710.

substantive.²²⁶ Procedural unconscionability refers to unfairness in the bargaining process and the method of making the contract. Substantive unconscionability refers to unfair terms in the contract or the unjust effects of the operation of the contract. The two types of unconscionability will often be present together²²⁷ because unfairness in the bargaining process often results in one-sided contract terms. This distinction originated in an analysis by Professor Leff of the unconscionability provision in s 2-302 of the United States' Uniform Commercial Code (UCC).²²⁸ The two are related. Much of the concern with unfairness in the process of contracting is the result of the unconscionable outcomes which arise from one-sided bargains. Grossly unfair outcomes lead to an inquiry about the negotiating process. Ideas about what is or what is not an unfair outcome may have a strong influence on decisions about whether aspects of the process should be deemed "unconscionable", such as the absence of independent advice.²²⁹

The classic equitable doctrines as described in *Blomley v Ryan*²³⁰ and *Commercial Bank of Australia Ltd v Amadio*²³¹ are concerned with procedural unconscionability: the methods used to make the contract. Relief from substantive unconscionability usually has to be sought under statute and not in equity. In the United States it appears that equity may grant relief for one type of substantive unconscionability — an overall gross imbalance in the rights and duties of the parties under the contract.²³² In Australia the view appears to be that inadequate consideration or other unfair terms do not of themselves make a transaction unconscionable, but will be evidence of the relationship of special disadvantage or the unfair taking of advantage which constitutes procedural unconscionability.²³³

The circumstances which may constitute a special disadvantage may take a wide variety of forms

226 *West v AGC (Advances) Ltd* (1986) 5 NSWLR 610; *Hart v O'Connor* [1985] AC 1000; Leff 1967 *University of Pennsylvania LR* 485.

227 Atiyah *Essays* 333-335; Chen-Wishart *Unconscionable Bargains* 104.

228 Leff 1967 *University of Pennsylvania LR* 485.

229 *Bester v Perpetual Trustee Co Ltd* [1970] 3 NSW 30; *Lloyds Bank Ltd v Bundy* [1975] QB 326; [1974] 3 All ER 757; *Backhouse v Backhouse* [1978] 1 All ER 1158; also reported as [1978] 1 WLR 243.

230 (1956) 99 CLR 362.

231 (1983) 151 CLR 447.

232 Leff 1967 *University of Pennsylvania LR* 485 at 538.

233 See *Blomley v Ryan* (1956) 99 CLR 362 at 405.

and cannot be listed exhaustively.²³⁴ In the *Amadio*²³⁵ case the justices had regard to the age of the sureties (76 and 71 years), their limited grasp of written English, their lack of relevant business experience, their misunderstanding of the extent of their liability under the guarantee and their mistaken belief that the debtor company's business (controlled by their son) was flourishing and their reliance on their son's financial advice and judgment. The unconscientious taking of advantage in the case consisted in the bank manager's proceeding with the transaction while knowing of the Amadios' situation of disadvantage and doing nothing to seek to correct it.²³⁶ Indeed, if the manager were aware of a reasonable possibility that the Amadios were unable to make a judgment about what was in their own best interests because of their position of special disadvantage, and still proceeded with the transaction without making enquiries or disclosing necessary facts or counseling them to take independent advice, the bank would be guilty of unconscionable conduct.²³⁷ It was held that the manager knew or ought to have known that the Amadios did not understand the extent of their liability under the guarantee and that they had a mistaken belief as to the financial soundness of the debtor company. In fact the bank and the son had been colluding to honour and dishonour cheques selectively in order to give the company the appearance of solvency, thereby giving credence to the mistaken belief.

Once the two elements of a special disadvantage and an unconscientious taking advantage are established, the transaction will be set aside unless the party seeking to uphold the transaction can prove that the transaction was, in all the circumstances, fair, just and reasonable.²³⁸

234 *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 462-463. Types of unconscionability can consist of exploitation of vulnerability, see *Stern v McArthur* (1988) 165 CLR 489; *Earl of Chesterfield v Janssen* (1751) 2 Ves Sen 125; *Blomley v Ryan* (1956) 99 CLR 362), or the abuse of trust or confidence, see *Chan v Zacharia* (1984) 154 CLR 178), or the insistence on rights which make that harsh or oppressive, see *Legione v Hately* (1983) 152 CLR 406; *Pierce Bell Sales Pty Ltd v Frazer* (1973) 130 CLR 575, or an unconscionable denial of obligations, see *Last v Rosenfeld* [1972] 2 NSWLR 923.

235 (1983) 151 CLR 447.

236 *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 479.

237 *Ibid.*, at 466-468.

238 *Fry v Lane* (1888) 40 Ch D 312 at 321; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 474 and 479; *European Asian of Australia Ltd v Kurland and Another* (1985) 8 NSWLR 192.

3.5.2.3.2 Overlap of statutory provisions and equitable doctrine

Unconscionable conduct is a ground for relief both in equity and under statute.²³⁹ The statutory provisions and the equitable doctrine overlap considerably, but there are also differences, the reasons for which are not always obvious. For example, the Contracts Review Act of 1980 (NSW), the various Credit Acts and the Consumer Credit Code²⁴⁰ generally deny relief to corporations that may take advantage of the provisions of Pt 1V A of the Trade Practices Act of 1974 (Cth) and the Fair Trading Acts.²⁴¹ The Trade Practices Act of 1974 (Cth) furnishes a broad array of remedies, many of which are not available under the equitable doctrine. The statutory definitions of the conduct in question, although generally aimed at "unconscionable" behaviour, differ in their formulations between "unfair", "harsh", "unjust" and "unconscionable". Despite the size of the body of legislation, its meaning and its impact upon many transactions remain indeterminate. It is not always clear whether a particular Act is directed at abuses by the stronger party or the lack of bargaining strength of the weaker. Of course, an Act may be directed at both. The established concepts of the equitable doctrine may have influenced the elements required by the Acts, but the various statutory expressions are not limited by the twin concepts of a special disability and the unconscientious taking of advantage which underpin the equitable doctrine.

The equitable doctrine of unconscionable dealing provides a basis for relief from transactions which have been procured by the unfair advantage taken by a stronger party of a special disability

239 In addition to the "unconscionable conduct" to which Pt IVA of the Trade Practices Act of 1974 (Cth) and Fair Trading Act equivalents are directed, two other Acts that provide relief against unconscionable or harsh contracts are the Petroleum Retail Marketing Act of 1980 (Cth) and the Petroleum Retail Marketing Sites Act of 1980 (Cth), which provide certain protection for franchisees and lessees in the petroleum industry. In relation to the operation of these acts, see *Caltex Oil (Australia) Pty Ltd v Best* (1990) 170 CLR 516; *Majik Markets Pty Ltd v Brake & Service Centre Drummoyne Pty Ltd* (1991) 28 NSWLR 443. See, also, Industrial Relations Act of 1991 (NSW), s 275 (1).

240 Credit Ordinance of 1985 (ACT); Consumer Credit Act of 1995 (ACT); Credit Act of 1984 (NSW); Consumer Credit Act of 1995 (NSW); Consumer Credit Act of 1995 (NT); Credit Act of 1987 (QLD); Consumer Credit Act of 1994 (QLD); Consumer Credit Act of 1995 (SA); Consumer Credit Act of 1996 (Tas); Credit Act of 1984 (Vic); Consumer Credit Act of 1995 (Vic); Credit Act of 1984 (WA); Consumer Credit Act of 1996 (WA). The Consumer Credit Act in each jurisdiction incorporates the Consumer Credit Code for that jurisdiction. The provisions of the Codes in all jurisdictions are identical and it is sufficient to refer to the Consumer Credit Code as one body of legislation.

241 S 13 of the Fair Trading Act of 1992 (ACT); s 43 of the Fair Trading Act of 1987 (NSW); s 43 of the Consumer Affairs and Fair Trading Act of 1990 (NT); s 39 of the Fair Trading Act of 1989 (QLD); s 57 of the Fair Trading Act of 1987 (SA); s 15 of the Fair Trading Act of 1990 (Tas); s 11A of the Fair Trading Act of 1985 (Vic); s 11 of the Fair Trading Act of 1987 (WA).

or disadvantageous position of a weaker party.²⁴² It must be shown that:

- (1) the weaker party suffered a special disability in dealing with the other, with the consequence that there was the absence of any reasonable degree of equality between them; and
- (2) the disability was sufficiently evident to the stronger party to make it unfair that the stronger party procure or accept the weaker party's assent to the impugned transaction.²⁴³

Where such circumstances are shown to have existed, the burden of proof is cast upon the stronger party to show that the transaction was fair, just and reasonable.²⁴⁴

The equitable doctrine is given statutory recognition by s 51AA of the Trade Practices Act of 1974 (Cth).

Section 51 AB of the Trade Practices Act of 1974 (Cth) relates to both procedural and substantive unconscionability, so that a contravention may occur in pre-contractual negotiations or by reason of the actual contents of the transaction. It is unclear whether a requirement exists that the supplier should either be aware of the consumer's disability or at least that the supplier should be in such a position that he should reasonably have known of it. The relative bargaining strengths of the parties are a factor in determining whether conduct is unconscionable. Clearly, the presence or absence of independent legal advice can be a critical factor in the assessment of the effect of an imbalance between the parties to a transaction. Factors prescribed for consideration, which are not exclusive, are referred to in s 51AB (2). Section 51AB, like s 51AA, is directed at "unconscionable conduct", and so is not limited in its application to contracts. Consequently, the enforcement of a contractual term may be unconscionable even though the initial inclusion of that term in the contract itself does not meet that description.

The notion of "unjustness in all the circumstances" which underlies the Contracts Review Act

242 *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 461 and at 474; *Louth v Diprose* (1992) 175 CLR 621 at 627; *Earl of Aylesford v Morris* (1873) LR 8 Ch App 484 at 491; *Morrison v Coast Finance Ltd* (1965) 55 DLR (2d) 710 at 713.

243 *Blomley v Ryan* (1956) 99 CLR 362 at 428-429; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 474; *Earl of Aylesford v Morris* (1873) LR 8 Ch App 484 at 491; *O'Rorke v Bolingbroke* (1877) 2 App Cas 814 at 823.

244 *Blomley v Ryan* (1956) 99 CLR 362 at 428-429; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 474; *Louth v Diprose* (1992) 175 CLR 621 at 632, and 636-637; *Earl of Aylesford v Morris* (1873) LR 8 Ch App 484 at 491; *O'Rorke v Bolingbroke* (1877) 2 App Cas 814 at 823; *Fry v Lane* (1888) 40 Ch D 312.

of 1980 (NSW), is wider than equity's notion of "unconscionable dealing". It allows greater emphasis to be given to contractual outcomes.

The Credit Acts and the Credit Consumer Code have a particular advantage in terms of ready access to informal tribunals. However, their scope is limited to consumer credit contracts.

3.5.3 The duty of disclosure

3.5.3.1 Introduction

While the courts will not hold a surety to a guarantee extracted from him as a result of unconscientious dealings or an abuse of the creditor's superior bargaining power, they have steadfastly refused to classify contracts of guarantee in the category of *uberrimae fidei*.²⁴⁵ Unlike contracts of insurance, suretyships are not contracts of the utmost good faith requiring full disclosure of all material facts by both parties.²⁴⁶

3.5.3.2 No general duty to disclose

At common law there is no universal obligation upon the creditor to disclose to the proposed surety all facts relative to his dealings with the principal debtor or affecting the debtor's credit.²⁴⁷ Nor is he expected to advise the proposed surety of every circumstance of which he has knowledge and which is material to the contract of guarantee and which it is essential for the surety to be acquainted with before he executes the guarantee.²⁴⁸ The creditor is not even obliged

245 *Seaton v Heath* [1899] 1 QB 782 at 792; *Yerkey v Jones* (1939) 63 CLR 649; *Goodwin v National Bank of Australasia Ltd* (1968) 42 ALJR 110 at 111; *Lindsay v L Stevenson and Sons Ltd* (1891) 17 VLR 112; *Fitzgerald v Jacomb* (1873) 4 AJR 189 *Davies v London and Provincial Marine Insurance Co* (1878) 8 Ch D 469 at 475; *Lee v Jones* (1864) 17 CB(NS) 482 at 495; *Behan v Obelon Pty Ltd* (1985) 157 CLR 326.

246 *Seaton v Heath* [1899] 1 QB 782 at 792; It is otherwise however, where the creditor's concealment of material facts amounts to fraud or misrepresentation; See, also, *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447. Moreover the creditor may be required by statute in certain contexts to give the guarantor a duplicate copy of his contract of suretyship. See s 13 of the Money Lenders Act of 1916 and the Consumer Credit legislation.

247 *Re Banister* (1879) 12 Ch D 131 at 136; *Re Marsh and Earl Granville* (1882) 24 Ch D 11 at 17; *Isman v Widen* [1926] 1 DLR 247; *National Mortgage & Agency Co of New Zealand Ltd v Stalker* [1993] NZLR 1182.

248 *Hamilton v Watson* (1845) 12 CI & Fin 109; *Davies v London and Provincial Marine Insurance Co* (1878) 8 Ch D 469. For this reason the creditor has no duty to disclose to one intending co-surety any adverse information about the credit of another intending

to divulge information unconnected with the transaction which may render the surety's undertaking more hazardous.²⁴⁹ The creditor has no general duty to the surety to advise him of any changes of circumstances or defaults by the principal debtor after the suretyship is created.²⁵⁰ A failure to disclose material facts at any stage will not vitiate the guarantee unless there is fraud or misrepresentation.²⁵¹ It is for the guarantor to ascertain and assess the risk which is being assumed.²⁵²

Several reasons have been advanced to justify this general rule. Sometimes there is an appeal to practicalities and business efficacy. Thus the rule is supported on the ground that otherwise no creditor could rely on a contract of guarantee unless he communicated to the proposed sureties everything relating to his dealings with the principal debtor.²⁵³ In *Hamilton v Watson*²⁵⁴ Lord Campbell went so far as to suggest that bankers would never get sureties, if full disclosure of all material facts were required. In some cases such a disclosure might constitute a breach of confidence by the creditor.²⁵⁵ In *London General Omnibus Co Ltd v Holloway*²⁵⁶ Farwell LJ also

surety *Behan v Obelon Pty Ltd* (1985) 157 CLR 326.

249 *Lindsay v L Stevenson and Sons Ltd* (1891) 17 VLR 112.

250 See *Britannia Steamship Insurance Association Ltd v Duff* (1909) 2 SLT 193 at 195; *Toronto-Dominion Bank v Rooke* (1983) 3 DLR (4th) 715; *Georgia Pacific Corporation (Williams Furniture Division) v Levitz* 149 Ariz 120 716 P 2 nd 1057 (1986). Certain statutes require the creditor to disclose specified information to the guarantor on request during the currency of a credit contract.

251 *Seaton v Heath* [1899] 1 QB 782 at 792. There are three classes of cases in which an obligation of disclosure does not ordinarily arise at all, or does not originally arise, but may be created by circumstances occurring before or during the negotiations. These are as follows;

- (1) where the party has a duty of disclosure owing to his previous fraud;
- (2) where a party has a duty to remove a delusion or make a correction in respect of a misunderstanding during the negotiations;
- (3) where a party is asked a direct question. When asked a direct question, the party is compelled to answer fully and truthfully.

252 *Seaton v Heath* [1899] 1 QB 782 792; *Goodwin v National Bank of Australasia Ltd* (1968) 42 ALJR 110; *Behan v Obelon Pty Ltd* (1985) 157 CLR 326; *Union Bank of Australia Ltd v Puddy* [1949] VLR 242; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.

253 *Lee v Jones* (1864) 17 CB (NS) 482 at 503.

254 (1845) 12 Cl & Fin 109.

255 *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461.

256 [1912] 2 KB 72.

stressed the difficulties which full disclosure would entail for bankers taking a guarantee: it would be indispensable for them to state how the principal debtor's account had been kept, whether he was in the habit of overdrawing, whether he was punctual in his dealings, and whether he performed his promises in an honourable manner.

The general rule obviates these difficulties by allowing the creditor to assume that the proposed surety has acquainted himself with the principal debtor's position. The surety is presumed to know that the guarantee is intended to secure repayment of the principal's debts and that dissatisfaction with the principal debtor's account is the probable reason for the creditor's insistence that a guarantee be given.²⁵⁷ It is left to the principal debtor to explain his financial position to the intending surety. At any rate, it is expected that the proposed surety will have ready access to the principal debtor and his financial statements so that he can assess the risk for himself.²⁵⁸

While there is no universal obligation to disclose all material facts to the intending surety, he is entitled to be informed of unusual matters in the principal transaction, which have the effect of making the position of the principal debtor different from that which the surety would naturally expect; this is especially so if those matters affect the nature and degree of the surety's responsibility.²⁵⁹ The emphasis is upon those matters which are different from those that the surety would naturally expect in the particular case. There is no duty to reveal to the surety all the facts which relate to the transactions of the customer simply because those transactions are out of the ordinary, and there is probably also no duty to disclose unusual transactions which have taken place between the principal debtor and third parties.²⁶⁰ In *Westpac Banking*

257 *Fitzgerald v Jacomb* (1873) 4 AJR 189 at 190.

258 *Seaton v Heath* [1899] 1 QB 782 at 792; *Behan v Obelon Pty Ltd* (1985) 157 CLR 326.

259 *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *Hamilton v Watson* (1845) 12 C1 & Fin 109; *Goodwin v National Bank of Australasia Ltd* (1968) 42 ALJR 110; *London General Omnibus Co Ltd v Holloway* [1912] 2 KB 72; *Lloyds Bank Ltd v Harrison* (1925) 4 LDAB 12 (CA); *Scott Pty Ltd v Dawson* [1962] NSWLR 1166. See, also, *Westminster Bank Ltd v Cond* (1940) 46 Com Cas 60; *Cooper v National Provincial Bank Ltd* [1946] 1 KB 1; *Goad v Canadian Imperial Bank of Commerce* (1968) 67 DLR (2d) 189.

260 See *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *London General Omnibus Co Ltd v Holloway* [1912] 2 KB 72 at 79J. The test laid down in *Goodwin v National Bank of Australasia Ltd* (1968) 42 ALJR 110 is that there is a duty to disclose "anything which has taken place between the bank and the principal debtor which was not naturally to be expected in the transaction".

*Corporation v Robinson*²⁶¹ Clarke JA expressed the duty of disclosure to be as follows:

"[T]he rule concerning contracts of guarantee stands apart from the rule applicable in cases such as contracts *uberrimae fidei* and the general rule relating to contracts and requires disclosure of facts only if concealment of those facts would otherwise misrepresent the transaction which the guarantor is undertaking to guarantee. In general, it would only be the non-disclosure of those circumstances which were not naturally to be expected which would misrepresent the material features of that transaction."

Most Australian Courts, however, do not require a misrepresentation and the definition in *Goodwin v National Bank of Australasia Ltd*²⁶² is normally followed,²⁶³ namely that the duty to disclose arises when there is something which has taken place between the bank and the principal debtor which was not naturally to be expected in the transaction — something unusual.

What it is that constitutes a matter that is different from that which the surety would normally expect in the principal transaction will depend upon the nature of the transaction in each case.²⁶⁴ Any private arrangements modifying the transaction between the principal debtor and the creditor as contained in the guarantee must be disclosed to the surety.²⁶⁵ Where a guarantee, which was obtained by merchants to secure payments to them of the receipts of their *del credere* agent, recited that the agent was employed on terms that he would settle with his principal's account promptly at intervals, the surety was entitled to be told that at the date of the guarantee, the agent was already behind in his accounts for coal sold.²⁶⁶

261 (1993) 30 NSWLR 668.

262 (1968) 42 ALJR 110.

263 See Murdoch 1995 *Journal of Contract Law* 288.

264 See *National Mortgage & Agency Co of New Zealand Ltd v Stalker* [1933] NZLR 1182; *Hamilton v Watson* (1845) 12 Cl & Fin 109; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 457; *Levett and Others v Barclays Bank plc* [1995] 2 All ER 615.

265 *Hamilton v Watson* (1845) 12 Cl & Fin 109; *Lee v Jones* (1864) 17 CB(NS) 482; *Walker v Hardman* (1837) 4 Cl & Fin 258; *Espey v Lake* (1852) 10 Hare 260; *Pendlebury v Walker* (1841) 4 Y & C Ex 424. Indeed a surety for a contractor was held to be entitled to be informed that the employer had entered into a separate arrangement with another party for the completion of the same project. See *Stiff v Eastbourne Local Board* (1868) 19 LT 408.

266 *Lee v Jones* (1864) 17 CB(NS) 482

3.5.3.3 A duty of explanation?

An interesting judgment was recently handed down in New Zealand in *Shotter v Westpac Banking Corporation and Villars*.²⁶⁷ In this case the Court created a new duty founded in tort:

"A duty of explanation, warning or recommendation of separate advice arises 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 expect might not be known to the prospective guarantor and which might be likely to affect that person's decision to enter to the guarantee".

In *Westpac Banking Corporation v McCreanor*,²⁶⁸ however, the Court reviewed all the authorities and particularly the *Shotter*²⁶⁹ case and came to the following conclusion:

"I have difficulty in accepting that by invoking a tortious duty of care the Court should negate the very clear line of authority 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 that have followed it... Thus with great respect I cannot agree with the conclusion reached by Wylie J in the *Shotter* case".²⁷⁰

3.5.4 Statutory relief and duties of disclosure

3.5.4.1 Background

Australians enjoy a vast array of statutory protection measures in regard to their contracts. Several enactments enforce disclosure of facts. I have decided to discuss also the activities of the ombudsman and the Code of Banking Practice under this head, notwithstanding the fact that it is not statute law.

267 [1987] BCL 352.

268 [1990] 1 NZLR 580.

269 [1987] BCL 352.

270 A conclusion accepted by O'Donovan 1992 *LIJ* 52; Walker 1988 *NZLJ* 319 at 324.

3.5.4.2 The banking industry ombudsman

The Australian Banking Industry Ombudsman Scheme (ABIO) commenced on 18 June 1990 and provides an independent mechanism for the resolution of banker-customer disputes. Offering a free service to customers, it was the first self-regulatory scheme operating on an industry-wide basis in Australia.²⁷¹

The scheme was created to provide individual customers of member banks with access to an independent avenue of redress when they had a complaint about one of those banks. The rationale behind the scheme was the high cost of litigation, the inability of the average customer to contest matters in courts against a bank and the inadequate in-house dispute resolution mechanisms of banks.²⁷²

The ABIO's mission is to facilitate the resolution of disputes between banks and consumers by;

- ensuring equitable access for all users of bank services;
- resolving banker-consumer disputes efficiently and fairly; and
- ensuring that the scheme maintains the highest level of public confidence.²⁷³

The ombudsman's powers and duties are set out in the Terms of Reference. The scheme provides as follows:

- The ombudsman has the final power to determine whether a matter falls within his or her Terms of Reference. A bank is entitled to challenge whether a complaint falls within the Terms of Reference. If such a challenge is made, the issue will be referred to a senior commercial lawyer drawn from a panel chosen by the council. The bank concerned will bear the costs and the ombudsman has the discretion to accept or reject such opinion.
- The ombudsman has power to make an award of up to \$100,000, which if accepted by the customer, becomes binding on the bank.
- The ombudsman can determine the procedures of his or her office in considering disputes and accepting referrals.

271 The scheme was modelled on a comparable scheme then introduced in the UK. Westpac Banking Corporation was the driving force behind the scheme. See Burton 1990 *JBFLP* 29.

272 Tyree *Banking* 292; Weerasooria *Banking Law* par 14.2.

273 The ombudsman scheme is comprehensively explained in Weerasooria & Wallace *Banker-Customer*; Weerasooria 1992 *AJCL* 225; Osborn 1992 *JBFLP* 268.

- The ombudsman can, with the consent of the customer, obtain the bank file of the customer or bank-held information relating to the dispute.
- The ombudsman can determine what is "fair in all the circumstances" with reference to the law, principles of good banking practice or codes of practice.
- Except for the power to make a recommendation or award, the ombudsman has a general power of delegation so that he/she could concentrate on substantive complaints.
- The council can appoint a deputy ombudsman to act in place of the ombudsman where the ombudsman is absent through leave of illness; or when a conflict of interest arises.

In addition to the specific exclusions contained in the Terms of Reference, the ombudsman can exercise his or her powers only after the senior management of the subject bank of the complaint has had the opportunity to consider and respond to the complaint. In other words, the ombudsman must be used as an alternative dispute resolution mechanism of last resort.²⁷⁴

The ombudsman's decisions are binding on banks, but not on applicants. When a matter is not resolved after reference to the bank the ombudsman calls a conciliation conference and acts as an independent third party. Applicants may come in person or be represented. In developing procedures to secure independence, the ombudsman's office relied on the experiences of judicial administration for both case management and alternative dispute resolution. The ombudsman couples investigative and determinative powers to award compensation. In resolving disputes he or she adopts the more innovative practices of alternative dispute resolution rather than the more formal evidentiary processes of the court system or the formal interview process of parliamentary ombudsmen.²⁷⁵ The processes of mediation, conciliation, negotiation and arbitration²⁷⁶ have been identified as working particularly well in situations where the disputing parties need to re-establish relationships.²⁷⁷

The ombudsman considers that banker-customer complaints were ideally suited to this type of

274 Tyree *Banking* 293; Weerasooria *Banking Law* par 14.6. Recent research shows that the existence of the ombudsman may have been responsible for a substantial improvement in the practice of banks' handling of customer complaints. See Osborn 1992 *JBFLP* 268.

275 In terms of par 15 of the Terms of Reference, the ombudsman is not bound by any legal rules of evidence.

276 When making any recommendation or award the ombudsman must have reference to what is, in his opinion fair, in all the circumstances. However, he is also required to observe any applicable rule of law or relevant judicial authority, and to have regard to general principles of good banking practice and any relevant code of practice applicable to the subject matter of the complaint. See par 15 of the Terms of Reference.

277 Weerasooria *Banking Law* par 14.9.

dispute resolution mechanism. Essentially, the banker-customer relationship is a relationship of trust. That trust is placed at risk when a complaint remains unresolved. The ombudsman's office empowers the customer by placing him or her on a more equal footing to negotiate with the banks.²⁷⁸

3.5.4.3 The Code of Banking Practice.²⁷⁹

The Code of Banking Practice (CBP) was released by the Australian Bankers Association on 3 November 1993.²⁸⁰ Its coverage is limited to individual (personal, domestic) customers as opposed to business customers (companies, partnerships, small business proprietors, and so forth) and the term "banking service" is restrictively defined. However, its impact on day-to-day banking is expected to be far greater and far more significant than the establishment of the voluntary banking ombudsman scheme,²⁸¹ and, furthermore, the code enjoys the endorsement of the federal Treasury.

The purpose of the Code, according to the preamble of the Code itself, is to describe standards of good practice and service, to promote disclosure of information which is relevant and useful to customers, to promote informed and effective relationships between banks and customers and to require banks to have procedures for the resolution of disputes between banks and customers.²⁸²

As far as the banker-surety relationship is concerned, it should be noted that the code was more conservative than the High Court's landmark decision in *Commercial Bank of Australia Ltd v Amadio*²⁸³ which concerned third-party guarantees. In that case, the High Court ruled that a bank should disclose unusual risks to guarantors.

278 See Banking Ombudsman *Annual Report* 1993-1994, quoted in Weerasooria *Banking Law* par 14.10.

279 Published as an appendix to Weerasooria *Banking Law* par 15.30.

280 Weerasooria *Banking Law* par 15.3.

281 Weerasooria *Banking Law* par 15.3.

282 For an overview of the Code, see Weaver 1994 *JBFLP* 60.

283 (1983) 151 CLR 447.

An important aspect of the code is the fact that disclosure duties in various respects²⁸⁴ are placed on bankers. As far as suretyship is concerned ss 17.1-17.6 relate to guarantees, and are of interest to this thesis:

- A bank can accept a guarantee only if the amount of the guarantor's liability is limited to a specific amount plus other liabilities (for example, interest, recovery costs) described in the guarantee.
- The bank must give written warning to the prospective guarantor that he may become personally liable for the borrower's indebtedness and must be shown a copy of the relevant documentation.
- The bank must recommend that the prospective guarantor obtain independent legal advice.
- With the borrower's approval the bank must, on request, inform the guarantor about the borrower's account.
- A guarantor may at any time extinguish his liability to the bank under the guarantee by paying the sum then due or by making other arrangements satisfactory to the bank.

In *Barclays Bank v O'Brien and Another*,²⁸⁵ a recent House of Lords decision, a wife's guarantee to a bank of her husband's indebtedness was set aside on the ground of undue influence. The House of Lords considered the provisions of the United Kingdom banking code on guarantees and felt that they adequately warned prospective guarantors of the legal effects and possible consequences of their guarantee and of the importance of receiving independent advice. It is noteworthy that the Australian provisions are far wider in the customer's favour.

The Code also imposes a duty on banks:

- to develop internal processes for handling customer disputes; and
- to develop an external and impartial process with jurisdiction similar to the banking ombudsman scheme to resolve a dispute that the bank's internal process has failed to resolve.²⁸⁶

As far as the interrelation of the Code, common law and statute law is concerned, the Code has

284 Disclosure, eg, in regard to terms and conditions, cost of credit, fees and charges, payments services, and operation of accounts are prescribed.

285 [1994] 1 AC 180; [1993] 4 All ER 417.

286 S 20 of the Code of Banking Practice.

to be read subject to any Commonwealth, State or Territory legislation, and, to the extent of any inconsistency, the Electronic Funds Transfer Code of Conduct.²⁸⁷ Tyree²⁸⁸ is of the opinion that the omission of any reference to non-statute law presumably means that the Code is to override non-statute law where this conflicts with the code. In some circumstances, it may not be possible for a non-statutory instrument such as the Code to override the general law,²⁸⁹ but where the non-statutory law merely defines implied contractual terms it seems as though the Code could prevail.²⁹⁰

Weerasooria²⁹¹ states that the terms of the Code become part of the bank's contract with its customer. Accordingly:

- a customer can insist that the Code's terms be observed; and
- the bank will be liable for breach.

A complaint about non-compliance, if not settled by the bank's internal dispute resolution mechanism, can be pursued by the customer with the banking Ombudsman or the Courts.²⁹²

3.5.4.4 Uniform consumer legislation and banking

A new regime of consumer credit regulation known as the Uniform Consumer Credit Code of 1996 (UCCC) is in force in Australia since 1996. This new legislation, which will replace the existing Credit Acts in each State, will affect most credit transactions with individual debtors. While there is no limiting monetary ceiling, the legislation covers all credit providers such as banks, finance companies, building societies and credit unions.²⁹³

287 See ss 1.2 and 1.4 of the Code of Banking Practice.

288 Tyree *Banking* 272.

289 No direct authority could be found, but by analogy there are several cases which have held that any conflict between the journalists' Code of Ethics and obedience to the law must be resolved in favour of the law. See *Independent Commission Against Corruption (ICAC) v Cornwall* (1993) 111 ALR 97; *McGuinness v Attorney General (Vic)* (1940) 63 CLR 73.

290 Tyree *Banking* 272.

291 Weerasooria *Banking Law* par 15.28.

292 Weerasooria *Banking Law* par 15.28.

293 Lanyon 1995 *LJ* 440; Kapman 1994 *Australian Banker* 45.

The new UCCC is the result of an inter-governmental agreement known as the Uniform Credit Laws Agreement of 1993. Under the agreement, uniform laws (codes) are to be established by what is termed "template" legislation. This expression means that a consumer credit law will be enacted principally in one State, Queensland (namely, Consumer Credit (Queensland) Act of 1994 (Qld)) and the other States and Territories will then either adopt that "template" legislation or pass alternative legislation which is consistent with the Queensland statute. All States and Territories (except Western Australia) will adopt the template legislation of Queensland. Western Australia is to pass its own consumer credit legislation which will not, however, conflict with the uniform legislation.²⁹⁴

The objectives of the new scheme are to provide laws which apply uniformly and equally to all forms of consumer lending and to all lenders throughout Australia.²⁹⁵ This is based on the principle of truth-in-lending which will enable borrowers through adequate disclosure to make informed choices when obtaining credit. It provides for all contracts, guarantees and notices governing the "credit" to be legible and clearly expressed and also seeks to ensure that the cost of credit is disclosed in order to prevent deception and to enable comparability and encourage competition. It also provides significant redress mechanisms for borrowers and civil and criminal penalties for non-complying lenders. There are also distinct advantages to credit providers like banks. For instance, they can use uniform documentation and procedures in all jurisdictions and while there are onerous sanctions for non-compliance, there are no automatic penalties as is currently the case.²⁹⁶

A detailed discussion of the UCCC falls outside the scope of this thesis and only aspects relevant to sureties and disclosure will be discussed.²⁹⁷ The UCCC applies to all credit provided for a personal, domestic or household purpose,²⁹⁸ regardless of the amount to be provided.²⁹⁹ The rate of interest charged is also irrelevant. Thus, there is no monetary or interest threshold. The term

294 The Courts view compliance by banks as of the utmost importance. See *AWA Ltd v Daniels* (1992) 10 ACLC 933; *GIO Finance Ltd v Various Debtors* [1994] ASC 56-292.

295 The previous consumer legislation was far from uniform and was both outdated and overly prescriptive. See Owens *et al Code* 11.

296 See Owens *et al Code* 11.

297 For comments on the code, see further Bingham 1996 *LIJ* 42; Lanyon 1995 *LIJ* 440; Pascoe 1996 *CLQ* 15; Boxall 1996 *LIJ* 35.

298 Lending to corporations (companies) is not covered by the UCCC other than lending to a "strata corporation" (a body corporate) defined in the UCCC.

299 S 6 of the UCCC.

"credit" is widely defined. Personal loans, bank term loans, overdraft facilities and other continuing credit contracts, credit-card facilities, housing loans, consumer leases and hire-purchase agreements, are all covered.

All credit contracts, guarantees or notices given under the UCCC must be easily legible and clearly expressed.³⁰⁰ The debtor must always be given a copy of the credit contract.³⁰¹ While the interest levied may vary through the life of the contract, it must be calculated on daily balances³⁰² and periodic statements of account must be given to the borrower.

In regard to guarantees the Code provides that:³⁰³

- they must be "easily legible and clearly expressed,³⁰⁴ lest they be open to complaint as being unjust and be prone to re-opening having regard to the 'form' and 'intelligibility' of the language in which they are expressed",³⁰⁵
- under s 55, each must contain a prominent statement to the effect that the guarantor may not be entitled to an indemnity against the debtor in circumstances where the debtor was under 18 when the liability occurred; and each will be void to the extent that it purports to limit the guarantor's right of indemnity from the debtor,³⁰⁶

This latter provision will outlaw those provisions usually included in guarantees to prevent the guarantor from competing with the credit provider in bankruptcy proceedings.

- whilst "all accounts" guarantees are permissible, they are unenforceable in relation to any further credit contract unless the credit provider gives the guarantor a copy of the further credit contract and obtains from the guarantor an acceptance of the extension of the

300 S 16(2) of the UCCC.

301 S 18 of the UCCC.

302 S 26 of the UCCC.

303 See in general Quirey 1995 *QLSJ* 165 at 170-171.

304 S 162 of the UCCC.

305 S 70(2)(g) of the UCCC.

306 S 55(5) of the UCCC.

guarantee.³⁰⁷

A credit contract or associated mortgage or guarantee may be re-opened if a court is satisfied that it was unjust.³⁰⁸ The definition of "unjust" includes "unconscionable, harsh or oppressive".³⁰⁹ A debtor or guarantor suffering loss due to a breach of the code may obtain compensation from the credit provider.³¹⁰ The UCCC does not prescribe an automatic forfeiture of interest for a breach (as is the current position). However, substantial penalties are imposed if the credit provider has breached a "key requirement". The following are some of the key requirements:

- credit provider's name;
- amount of credit;
- method of calculating interest charged;
- default interest rate;
- total interest (if ascertainable) and instalments payable; and
- fees, charges and commissions received.³¹¹

Any officer of a credit provider who knowingly authorises or permits a contravention of the UCCC will also be exposed to prosecution.³¹² Civil penalties imposed on a credit provider are capped at \$500,000 Australia-wide if the credit provider rather than an affected debtor, applies first to court.³¹³

It is obviously very desirable that credit providers like banks should promote a compliance-conscious culture throughout their organization. This requirement was highlighted in *AWA Ltd v Daniels*³¹⁴ from which case it is clear that companies must have in place, properly supervised

307 S 56 of the UCCC.

308 S 70(1) of the UCCC.

309 S 70(7) of the UCCC.

310 S 107(1) of the UCCC.

311 S 15 of the UCCC. For current case law on penalties imposed on credit providers for breaching the Credit acts, see *Westpac Banking Corporation v Donald Murrell* [1992] 2 VR 429; *Custom Credit Corporation v Grey* [1990] ASC 56-069; *Avco Financial Services Ltd v Abschinski* [1994] ASC 56-256.

312 S 183(1) of the UCCC.

313 S 105(1) of the UCCC.

314 (1992) 10 ACLC 933.

internal controls and reporting mechanisms to ensure that senior management and the boards of directors are properly informed and that risks are properly managed. The courts will impose lesser penalties where they are satisfied that the defaulting credit provider genuinely promoted a compliance program rather than merely paying lip service to it. In *GIO Finance Ltd v Various Debtors*³¹⁵ the Commercial Tribunal of New South Wales emphasized that compliance with the UCCC should be controlled at the level of the board of directors, that senior management should regularly monitor compliance and that lenders must not assume that staff — because of their experience — knew how to comply with UCCC.

The new UCCC is expected to radically change the way in which personal lending is undertaken in the future.³¹⁶ Accordingly, a legal-compliance program should not be looked upon as a luxury, but as a necessity.³¹⁷

3.5.4.5 The Trade Practices Act of 1974 (Cth) and consumer legislation on banking

3.5.4.5.1 Introduction

The Trade Practices Act of 1974 (Cth)³¹⁸ is Commonwealth legislation which came into operation on 1 October 1974. It is modeled on US anti-trust law. It provides a new code of conduct for the business community and encourages fair trading at all levels — from manufacturer to retailer to shopkeeper — right down to the ultimate customer or consumer. The TPA has broad scope and reach. It promotes competition, controls mergers and acquisitions,³¹⁹ misuse of market power, anti-competitive agreements, exclusive dealings, price maintenance and discrimination, misleading, deceptive and unconscionable conduct, sharp practices, and ensures that goods are of merchantable quality and covers product and manufacturers' liability. Thus the

315 [1994] ASC 56-292.

316 Despite its shortcomings, even the previous credit legislation was successfully used to curb unconscionable conduct by bankers. See *Custom Credit Corp v Lupi* [1991] ASC 56-024; *Morelend Finance Corporation (Vic) Pty Ltd v Westendorp* [1993] ASC 56-200; *Custom Credit Corp v Lynch* [1993] ASC 56-201.

317 Weerasooria *Banking Law* par 16.10.

318 Abbreviated as TPA.

319 Eg, in March 1995, the Trade Practices Commission, after protracted negotiations and extracting conditions, approved the \$3 billion merger of petrol giants Caltex and Ampol, which merger it had earlier rejected. According to the TPC the merger would result in greater efficiency in the industry while protecting consumers from higher petrol prices. The merged entity will control 28 per cent of the retail market. See Weerasooria *Banking Law* par 18.2.

TPA protects not only consumers, but also their sources of supply.³²⁰ The prohibition on misleading or deceptive conduct found in s 52 of the Trade Practices Act of 1974 (Cth), and the Fair Trading Acts of the various States and territories,³²¹ must rate as one of the most widely litigated statutory provisions in recent Australian history.³²²

Lawyers appearing for banks' customers are now resorting to the TPA — as a substitute for or in addition to the common law³²³ — in litigation against banks. Its application to banks and banking business is now well established and beyond any doubt.³²⁴ Banks are specifically included in the definition of corporations. Also the term "services" is defined to include:

- a contract between a banker and a customer of the banker entered into in the course of the carrying on by the banker of the business of banking; or
- any contract for or in relation to the lending of moneys.³²⁵

3.5.4.5.2 Misleading or deceptive conduct by banks

Section 52 of the TPA on "misleading and deceptive" conduct is one of the shortest statutory sections enacted and it simply states:

"A corporation shall not in trade or commerce engage in conduct that is misleading or deceptive or is likely to mislead or deceive."

320 See Steinwall & Layton *Annotated Trade Practices Act 1974* 1.

321 Fair Trading Act of 1992 (ACT); Fair Trading Act of 1987 (NSW); Consumer Affairs and Fair Trading Act of 1990 (NT); Fair Trading Act of 1989 (QLD); Fair Trading Act of 1987 (SA); Fair Trading Act of 1990 (Tas); Fair Trading Act of 1985 (Vic); Fair Trading Act of 1987 (WA).

322 Lockhart, in Lockhart (ed) *Misleading Conduct* iii, states that at last count in 1996 there were over 1 500 reported decisions concerning the prohibition and associated remedial provisions.

323 In *Brown v Jam Factory Pty Ltd* (1981) 53 FLR 340 at 348 Fox J described s 52 of the Trade Practices Act of 1974 (Cth) as "a comprehensive provision of wide impact, which does not adopt the language of any common law cause of action".

324 *Re Ku-ring-gai Co-operative Building Society (No 12) Ltd* (1978) 36 FLR 134; *Barton v Westpac Banking Corporation* [1983] ATPR 40-388; *Westpac Banking Corporation v Eltran Pty Ltd* (1987) 74 ALR 45.

325 See, also, *Barton v Westpac Banking Corporation* [1983] ATPR 40-388; *Westpac Banking Corporation v Eltran (Pty) Ltd* (1987) 74 ALR 45.

The simplicity and breadth of its language, coupled with its lack of any express limitations or qualifications has led to s 52's being the most litigated section in any Australian statute.³²⁶ It has been used as a substitute for or as an alternative to actions in tort such as passing-off, misrepresentation and defamation, and in contract.³²⁷ Its general nature is such that it may be the basis of a remedy in circumstances where tort, contract, or other areas of the common law would not provide a remedy.³²⁸

This is also the section which customers commonly use against banks.³²⁹ As an experienced lawyer and former TPA Commissioner has stated, "banks and financial institutions are currently in fashionable target of customers riding to battle mounted on their s 52 white chargers".³³⁰ This section has been resorted to by customers in order to sue banks in almost every sphere of banking business, for example, in the spheres of financial and investment advice, bankers' credit references and opinions, the granting of loans and overdrafts, taking of guarantees and mortgages and the advertising of banks' services and more recently, foreign-currency transactions.³³¹

Under s 52 of the TPA, a customer may claim not only damages, but also ancillary and interlocutory relief as set out in ss 82 and 87 of the TPA. The type of ancillary relief available under s 87 includes: declaring contracts and collateral agreements void in whole or in part; varying such contracts or agreement; refusing the enforcement of all or any of the provisions of

326 See French 1989 *ALJ* 250-268, who states that in the 14 years (at that stage) of its existence, the TPA has generated a considerable body of case law. In the first five years to 1979 there were 19 cases reported in the Australian Trade Practice Reports. From 1979-84 there were a further 236 cases reported or digested in that service, and as seen cases abound in other jurisdictions. The simplicity and strength of the language of s 52 has been reflected in its wide application as a norm for commercial conduct. Whatever course it takes in the future, it is clear that the story of s 52 is a long way from its conclusion. See Weerasooria *Banking Law* 18.15.

327 See French 1989 *ALJ* 250; Clarke 1989 *ABR* 109.

328 In *Brown v Jam Factory Pty Ltd* (1981) 53 *FLR* 340 at 348, Fox J held that the section does not purport to create liability at all; rather it establishes a norm of conduct, failure to observe which has consequences provided for elsewhere in the same statute or under the general law. See, also, the remarks of Malcolm J in Lockhart (ed) *Misleading Conduct* 5-6; Duns & Davison *Cases* 581.

329 Weerasooria *Banking Law* par 18.5.

330 See Pengilley 1989 *Bond LR* 157.

331 See, eg, *Kullack v Australia and New Zealand Banking Group Ltd* [1988] *ATPR* 40-861; *Rhone Poulenc Agrochimie SA and Another v UIM Chemical Services Pty Ltd and Another* (1986) 68 *ALR* 77; *Herjo Investments Pty Ltd v Collins Marrickville Pty Ltd* (1988) 79 *ALR* 83; *Commonwealth Bank of Australia v Mehta* (1991) 23 *NSWLR* 84.

a contract; ordering the refund of money or property; ordering payment of the amount of any loss or damage suffered; directing the execution of an instrument to vary or terminate the effect of an instrument transferring an interest in land.

Banks, being corporations, are clearly covered by TPA s 52. Additionally, by the combined operation of ss 82 and 75B of the TPA, even an individual bank staff member may be liable if he or she has aided, abetted, procured, induced or conspired to contravene the provisions of Pt IV or Pt V of the TPA. However, for individual liability, fault must be proved.

The section also includes advice given in negotiations between the claimant and the bank prior to a particular transaction.³³² The Federal Court recognizes that there now exists the trade or business of advising on investments.³³³

Several judicial decisions have interpreted s 52 of the TPA. The following aspects of this section are relevant to banking, guarantees and disclosure.

Section 52 of the TPA aims at having a broad reach in order to prevent consumers (for example, customers of banks) from being misled or deceived.³³⁴ While the words "misleading" and "deceptive" may overlap, they are not necessarily synonymous.³³⁵ As Mason J said in *Parkdale Custom Built Furniture Pty Ltd v Puxu Pty Ltd*:³³⁶

"s 52 should be generously construed and should not be read down to conform with former common law or equitable requirements."

In contrast to the common law, the application of s 52 of the TPA is not restricted to cases where it is necessary to show fault or intent. Intention is not a necessary element or ingredient under s 52.³³⁷ The section includes fraudulent and negligent misrepresentations, but is not restricted to

332 *Chiarabaglio v Westpac Banking Corporation* [1989] ATPR 40-971.

333 See *Thannhauser v Westpac Banking Corporation* (1991) 104 ALR 485.

334 French 1989 ALJ 250 at 268.

335 *Brown v Jam Factory Pty Ltd* (1981) 53 FLR 340.

336 (1982) 149 CLR 191 at 204.

337 *Yorke v Ross Lucas* (1985) 158 CLR 661 at 666; *Parkdale Custom Built Furniture Pty Ltd v Puxu Pty Ltd* (1982) 149 CLR 191; *Greco v Bendigo Machinery Pty Ltd* [1985] ATPR 40-521.

them. Even a bank that has behaved honestly, carefully and reasonably may contravene the section.

Liability under s 52 of the TPA is quite unrelated to fault. For instance the lack of awareness of a banker who breaches s 52, of the consequences of his or her conduct, is not an answer to the allegations that the conduct was misleading or deceptive. Nor is there any requirement to establish a duty of care dependent on the existence of a special relationship between the parties. This section could also catch misleading and deceptive statements made in brochures and other forms of advertisements in respect of which no relationship is likely to exist because the maker of the statement may not know that he or she was being relied on.³³⁸

Misleading or deceptive conduct³³⁹ generally consists of misrepresentations, whether express or by silence, but it does not have to be so. Whether any particular conduct is misleading or deceptive is a question of fact to be decided in each case in the context of the surrounding facts and circumstances. The question is an objective one.³⁴⁰

Silence alone may constitute a breach of s 52 of the TPA when there is an obligation to reveal facts.³⁴¹ "Half truths" would infringe the section because there is a duty to speak and complete

338 Conduct will not be misleading if it merely confuses those to whom it is directed, although an intent to cause confusion may give rise to liability. See *Hornsby Building Information Centre Pty Ltd v Sydney Building Information Centre Ltd* (1978) 140 CLR 216; *Parkdale Custom Built Furniture Pty Ltd v Puxu Pty Ltd* (1982) 149 CLR 191; *McWilliam's Wines Pty Ltd v McDonald's System of Australia Pty Ltd* (1980) 49 FLR 455; *Taco Company of Australia Inc v Taco Bell Pty Ltd* (1982) 42 ALR 177.

339 The TPA and Fair Trading Acts define the concept of engaging in conduct as meaning broadly "doing or refusing to do any act", and refusing to do an act is in turn defined to include refraining from doing an act, or making it known that an act will not be done.

340 *Parkdale Custom Built Furniture Pty Ltd v Puxu Pty Ltd* (1982) 149 CLR 191; *Taco Company of Australia Inc v Taco Bell Pty Ltd* (1982) 42 ALR 177; *Rhone-Poulenc Agrochimie SA and Another v UIM Chemical Services Pty Ltd and Another* (1986) 68 ALR 77.

341 Where a duty to disclose information exists, the conscious (although perhaps not the unconscious) failure to fulfil that duty will amount to engaging in misleading conduct. See *Rhone-Poulenc Agrochimie SA and Another v UIM Chemical Services Pty Ltd and Another* (1986) 68 ALR 77; *Henjo Investments Pty Ltd v Collins Marrickville Pty Ltd* (1988) 79 ALR 83; *Kimberley NZI Finance Ltd v Torero Pty Ltd* [1989] ATPR Digest 46-054.

the full story.³⁴² In the *Rhone-Poulenc*³⁴³ case, Bowen CJ observed:

"Where silence is relied on in order to show a breach of s 52 it will depend upon the circumstances whether the silence constitutes conduct which is misleading or deceptive. As in the case of other sections of the Trade Practices Act 1974 the court may gain assistance from consideration of cases at common law and in equity dealing with related types of situations. However, the court is not confined by such cases because it is concerned with the interpretation and application of the words of the particular statute."

In several banking cases it was alleged that the bank's silence when it had a duty to inform the customer of certain facts amounted to misleading or deceptive conduct.³⁴⁴ In *Demagogue Pty Ltd v Ramensky*³⁴⁵ a vendor company had remained silent when the buyer thought that the access to the property was a private driveway when in fact it was a public road. The purchaser succeeded in a claim under s 52 of the TPA for breach of duty of disclosure. A full Federal Court held:

"The question is whether in the light of all of the relevant factual circumstances, constituted by acts, omissions, statements or silence, there has been conduct that is or is likely to be misleading or deceptive."³⁴⁶

The circumstances of the particular case are therefore of determining importance.³⁴⁷

342 *Henjo Investments Pty Ltd v Collins Marrickville Pty Ltd* (1988) 79 ALR 83; *Rhone-Poulenc Agrochimie SA and Another v UIM Chemical Services Pty Ltd and Another* (1986) 68 ALR 77.

343 (1986) 68 ALR 77.

344 See Robertson 1991 *QLJ* 29 at 29-37.

345 (1992) 110 ALR 608.

346 For further cases on the duty of disclosure of bankers see *Nobile v National Australia Bank Ltd* [1987] ASC 55-580; *Nolan v Westpac Banking Corporation* (1989) 51 SASR 496; *Stanton v Australia and New Zealand Banking Group Ltd* [1987] ATPR 40-755; *Crisp v Australia and New Zealand Banking Group Ltd* [1994] ATPR 41-294.

347 Duncan 1988 *QUTLJ* 31; Robertson 1991 *QLJ* 29; *Hoover (Australia) Pty Ltd v Email Ltd* (1991) 104 ALR 369; *Rhone-Poulenc Agrochimie SA and Another v UIM Chemical Services Pty Ltd and Another* (1986) 68 ALJ 77; *Henjo Investments Pty Ltd v Collins Marrickville Pty Ltd* (1988) 79 ALR 83; *Kimberley NZI Finance Ltd v Torero Pty Ltd* [1989] ATPR Digest 46-054; *Warner v Elders Rural Finance Ltd* (1993) 113 ALR 517.

3.5.4.5.3 Opinions, advice and gratuitous comments

Several cases relating to bankers and financial advisers have considered the circumstances in which opinions, advice and gratuitous statements could constitute misleading or deceptive conduct under s 52 of the TPA.³⁴⁸ Where a banker embarks on advice or opinion to an intending surety, the transaction will be subject to s 52 of the TPA.

3.5.4.5.4 Some notable disclosure decisions

In *Nobile v National Australia Bank Ltd*³⁴⁹ the parents and parents-in-law of the main director of the company had given a guarantee and mortgage security for an overdraft of \$250,000 by the bank to the company. It was held that the bank manager's conduct in obtaining the documents was both misleading, deceptive and unconscionable because some of his representations about the company's financial position were untrue. The facts in the *Nobile*³⁵⁰ case were very similar to those in the *Amadio*³⁵¹ case.

*Money v Westpac Banking Corporation*³⁵² was an uncommon case where a husband alleged that he had been misled when he had signed as a guarantor for a bank loan to his wife's travel business. Normally, it is the converse situation that comes before the courts, namely, where wives complain that they had been misled into signing as guarantors for their husbands' business debts. When the bank claimed about \$96,000 plus interest, the husband argued that the bank manager had assured him that the advances to his ex-wife would not exceed \$35,000 and that his liability should be so limited. The court held in his favour observing that the bank manager's omitting to inform the husband of the unlimited nature of the mortgage security, amounted to misleading and deceptive conduct.

*Nolan v Westpac Banking Corporation*³⁵³ where the bank was held liable, illustrates the

348 In regard to advice and future predictions, see Pengilley 1992 *QUTLJ* 35; *James v Australia and New Zealand Banking Group Ltd* (1986) 64 ALR 347; *Hamer v Westpac Banking Corporation* [1987] ATPR 40-811; *Lake Koala Pty Ltd v Walker* [1990] ATPR 41-041; *Wheeler Grace & Pierucci Pty Ltd v Wright* [1989] ATPR 40-940.

349 [1987] ASC 55-580.

350 *Ibid.*

351 (1983) 151 CLR 447. For the facts of that case, see par 3.5.2.3.1.

352 [1988] ATPR 46-034.

353 (1989) 51 SASR 496.

disgraceful conduct of a bank manager. Mrs Nolan was a pensioner, a divorcee in her late thirties bringing up an 18-year-old daughter. She mortgaged her home unit, already the subject of a mortgage to the State Bank of South Australia, to support a loan to her ex-husband in connection with his heavily indebted carpet cleaning business. The court found that Westpac's branch manager who got the mortgage executed by Mrs Nolan did not caution her against the transaction or advise her to get independent advice. The manager's manipulation of Mrs Nolan in the matter of her dealings with the bank, amounted to fraudulent conduct on his part, conduct based on his concern about his own position in relation to the husband's account. The totality of the manager's conduct showed that he took unconscionable advantage of Mrs Nolan in getting her to sign the guarantee. Further, it was found that he had misrepresented the position about the ex-husband's overdraft. Mrs Nolan's guarantee was set aside.

In *Crisp v Australia and New Zealand Banking Group Ltd*⁵⁴ Crisp had mortgaged his house to the bank as security for moneys loaned by the bank to a company operating a take-away food business in Hobart, of which his wife and daughter were directors. The company defaulted and the bank sought to sell C's house to recover \$162,300, plus interest, owing to it. Crisp asked that the mortgage be set aside on the ground that the bank had engaged in misleading or deceptive conduct under s 52 of the TPA by not disclosing to C that on the very morning of the day the mortgage was executed, the bank had dishonoured the company's cheques and the branch manager had told the company that its overdraft facility would be withdrawn unless the mortgage was given. The evidence also showed that C had not been told that the mortgage was to cover "all moneys owed or becoming owing" by the company to the bank. The court held in C's favour and declared the mortgage void.

3.5.4.5.5 Other consumer protection and unfair contracts legislation

Apart from the TPA there are several other State statutes whose objective is the protection of consumers and the striking down of unfair and unjust contracts. The most important of them in relation to banks are:

- the Contracts Review Act of 1980 (NSW);
- the Fair Trading Acts in each State which mirror the TPA provisions and apply them to non-corporate bodies and individuals; and
- the Consumer Transactions Act of 1972 (SA).

3.6 CONCLUSION

The banker-customer relationship is a relationship peculiar to banking. The general relationship that exists between the parties is a complex contractual relationship consisting of reciprocal rights and duties founded on the practices and usages prevailing among bankers. The contract is basically of an implied nature. In Australia (as in England) there is rarely, if ever, a written or even an oral contract setting out the terms and conditions of the relationship. Apart from contract, the legal relationship of banker and customer is that of debtor and creditor (the banker being the debtor and the customer the creditor) with the super-added obligation of the banker's having to honour the customer's cheques when there is sufficient credit in his or her account at the bank. There are a number of implied super-added obligations in the relationship between banker and customer that distinguish it from the ordinary case of a loan of money and the normal debtor and creditor relationship.³⁵⁵

Banks are today moving away from traditional deposit taking and lending activities into roles more akin to those of financial supermarkets or conglomerates. Modern Australian banking, like that of most Western countries, is multi-functional and multi-divisional.³⁵⁶

New trends in bank liability are emerging. Apart from contract law — the foundation of the banker-customer relationship — banks are being sued in tort law for negligence where the pitfalls are greater and the scope of liability is wider. Many equitable doctrines are now often relied on to sue banks. Duress, economic duress, undue influence, unconscionable conduct are favourites especially after the High Court judgment in *Commercial Bank of Australia Ltd v Amadio*.³⁵⁷

Other risk issues confronting banks are the consumer protection legislation in each Australian jurisdiction.³⁵⁸

In most situations the relationship between the bank and its customers will be governed by the express or implied terms of a contract. Circumstances can arise where a bank may owe fiduciary

355 See par 3.1.

356 See par 3.2.

357 (1983) 151 CLR 447. See par 3.5.2.3.1.

358 See par 3.2 and particularly the statutes referred to in n 37 and n 38.

duties to a customer,³⁵⁹ or equitable duties of confidence.³⁶⁰

The banker's duty of confidentiality is contractual — being an implied term of the contract between the parties.³⁶¹ As is the case in English law, the duty is not absolute, but qualified.

Investment advice is subject to the prohibition of misleading or deceptive conduct.³⁶² Where a misrepresentation of fact, past or future, is otherwise absent, relief may still be available where the advice given is not underscored by a genuine belief and where there are no reasonable grounds for such advice. The authority of branch managers to advise, and whether such advice will bind the bank, will naturally depend on the particular transaction and the facts of each case. General principles governing the express, implied and ostensible authority of employees, will also apply. In the context of current judicial decisions, a banker can incur liability towards a customer for negligent financial or investment advice if:

- the customer relied on that advice and suffered loss;
- the banker was aware or ought to have been aware that the customer was going to rely on such advice;
- the advice was given in serious circumstances and not in an informal way or on an informal occasion (for example, in a casual telephone conversation) which would make it unreasonable for the customer to have relied on such advice.³⁶³

As in most Western countries, Australian banks and other lenders are increasingly being faced with claims by borrowers, guarantors and mortgagors that their contracts with the lender ought to be set aside on the grounds that their contract or the lender's or borrower's conduct in relation to the contract is unfair.³⁶⁴ Australian bankers and the various Law Societies are also striving to find a set of procedural steps which, if followed, will make the transaction immune from later challenge. One of the principal elements included in such procedures is that the surety receives independent advice, or at least is urged to take such advice and is given a real opportunity to do

359 See par 3.2 and the authorities quoted in n 40.

360 See par 3.3.

361 *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461.

362 S 52 of the Trade Practices Act of 1974 (Cth).

363 See par 3.4.

364 See pars 3.5.1; 3.5.2.2; 3.5.2.3.1.

so.³⁶⁵ Sureties can obtain relief from unfair contracts from several sources. Traditionally, relief from unfair bargains has been obtainable in equity, notably through the doctrines of undue influence and unconscionable conduct. Today relief can also be obtained under statutes such as the Contracts Review Act of 1980 (NSW), certain sections of the TPA which proscribes engaging in unconscionable conduct, and the Uniform Consumer Credit Code which is based upon the principle of truth-in-lending which will enable borrowers through adequate disclosure to make informed choices when obtaining credit. Sections of the TPA are often used as an alternative source of relief where the unfair conduct is misleading or deceptive. In those States with Fair Trading Acts certain sections of the TPA are replicated as State law. In addition, the circumstances of a case may permit relief to be obtained on common-law grounds such as misrepresentation,³⁶⁶ mistake, undue influence³⁶⁷ or failing in a duty of disclosure.³⁶⁸

While the courts will not hold a surety to a guarantee extracted from him as a result of unconscientious dealings or an abuse of the creditor's superior bargaining power, they have steadfastly refused to classify contracts of guarantee in the category of *uberrimae fidei*.³⁶⁹ Unlike contracts of insurance, suretyships are not contracts of the utmost good faith requiring full disclosure of all material facts by both parties. At common law there is no universal obligation upon the creditor to disclose to the proposed surety all facts relative to his dealings with the principal debtor or affecting the debtor's credit. However, the intending surety is entitled to be informed of unusual matters in the principal transaction, which have the effect of making the position of the principal debtor different from that which the surety would naturally expect; this is especially so if those matters affect the nature and degree of the surety's responsibility.³⁷⁰

Australian bankers have also taken steps from their side to improve banker-customer relationships. The Australian Banking Industry Ombudsman Scheme provides an independent mechanism for the resolution of banker-customer disputes. Offering a free service to customers, it was the first self-regulatory scheme operating on an industry-wide basis in Australia.³⁷¹

365 See chapter 5 for a detailed analysis of the concept of independent advice.

366 See par 3.5.1.

367 See par 3.5.2.2.

368 See par 3.5.3.

369 See par 3.5.3.1 and the authorities quoted in n 248.

370 See par 3.5.3.2.

371 See par 3.5.4.2 for a discussion of the ombudsman's powers and duties.

The Code of Banking Practice released by the Australian Bankers Association, *inter alia*, describes standards of good practice and service, and endeavors to promote disclosure of information which is relevant and useful to customers.³⁷²

It is clear that the Australian consumer is well protected against unconscionable conduct, flowing from an array of common-law and statutory protection mechanisms. Confronted with the formidable TPA and bound by the provisions of their own Code, Australian bankers are effectively forced to combine full disclosure to an intending surety with a duty to refer the surety to an attorney for independent advice.

From a banker's perspective, it is unlikely that suretyship will remain an acceptable form of security in such an environment.

372 See par 3.5.4.3.

CHAPTER 4: THE BANKER'S DUTIES OF DISCLOSURE AND ADVICE TO CUSTOMERS AND SURETIES: USA

4.1 A COMPARATIVE NOTE

The USA has been said to possess "perhaps the most complicated legal structure that has ever been devised and made effective in man's effort to govern himself".¹ Many problems have arisen in the USA from the complexities of the concurrence of federal and State law, and from the fact that both the USA and the several States possess fully equipped Court systems.²

Be that as it may, I believe that a study of the Restatements of the American Law Institute, articles produced by the American law schools and the Uniform Commercial Code, can give valuable insight into the determination of disclosure to and advisory duties towards an intending surety. Furthermore, the concept of good faith, which is growing in importance in many jurisdictions, has been addressed thoroughly in the case law of the USA.

4.2 BANKING LAW: BACKGROUND

4.2.1 The banker-customer relationship

The banker-customer relationship in the USA is largely a matter of contract law (as embodied in the judicial law of the various States³) and of commercial law (as embodied in State Uniform Commercial Code (UCC) statutes and as such statutes are interpreted in State judicial decisions).⁴ This statement becomes even more meaningful when the multi-dimensions (including the regulatory, institutional, and operational environments) of the banker-customer relationship are

1 Griswold *Law* 3.

2 Zweigert & Kötz *Introduction* 250.

3 Symons 1983 *Banking LJ* 220 at 221; Symons 1983 *Banking LJ* 325.

4 Zweigert & Kötz *Introduction* 249-252.

better understood. For example, it is important to understand what in fact a "banking institution"⁵ is and is not, as this may well make a difference to how the legal relationship is viewed. In addition, the legal relationship may be affected by what type of consumer is involved: is it an individual or a wholesale depositor, a sophisticated commercial or a consumer borrower, or a user of other services? Further, the contractual and commercial underpinnings of the banker-customer relationship may be overlaid with, influenced by, and reshaped by special common-law doctrines such as those of "special relationship",⁶ "good faith and fair dealings",⁷ and even possibly fiduciary duty (or quasi-fiduciary duty).⁸

Moreover, particularly in the USA, the banker-customer relationship can be affected by the regulatory environment applicable either to a particular banking institution (for example, deposit and lending regulations for federal commercial banks are not necessarily coextensive with the regulations for thrift institutions and credit unions) or to a particular type of customer (for example, a consumer requiring consumer protection).⁹ Further, the nature of the US judicial process, with its widespread use of jury trials and availability of punitive damages under various

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- 5 The generic term to cover institutions exercising a "depository" function, and would generally cover commercial banks, thrift institutions and credit unions. See Jones 1983 *Banking LJ* 247.
- 6 See, eg, *Standard Wire and Cable Co v Ameritrust Corporation* 697 F Supp 368 (CD Cal 1988); *Arnold v National County Mutual Fire Insurance* (1987) 725 SW 2d 165 (Tex).
- 7 Imposed by s 1-203; s 1-208 of the UCC; 2 205 of the Restatement (Second) of Contracts. The overwhelming majority of jurisdictions apply it as a matter of common law. See *KMC Com v Irving Trust Company* 757 F 2d 752 (6th Circuit 1985); *Keffer v Keffer* 852 P 2d 394 at 398 (Alaska 1993); *Ervin v Amoco Oil Co* 885 P 2d 246 at 250 (Colo Ct App 1994); *Habetz v Condon* 618 A 2d 501 at 505 (Conn 1992); *Abbott v Amoco Oil Co* 619 NE 2d 789 at 795 (Ill App Ct 1993); *Weldon v Montana Bank* 885 P 2d 511 at 515 (Mont 1994); *Pacific First Bank v New Morgan Park Corporation* 876 P 2d 761 at 762 (Or 1994). The State of Texas limits its application to cases in which a special relationship between the parties is found, such as insurance contracts. See, eg, *Natividad v Alexis Inc* 875 SW 2d 695 at 697 (Tex 1994).
- 8 In regard to quasi-fiduciary relationships, see *Young v United States Department of Justice*; *Young v Chemical Bank* 882 F 2d 633 (2d Circuit 1989); *Barnett Bank of W Florida v Hooper* 498 So 2d 923 (Fla. 1986); *Crystal Springs Trout Co v First State Bank of Froid* No 85-342 (Sup Ct Mont 15 Jan. 1987). In regard to fiduciary relationships, see *Federal Land Bank of Spokane v Stiles* 700 F Supp 1060 (D Mont 1988); *Barrett v Bank of America* 178 Cal App 3d 960 224 Cal Rptr 76 (1986); *American Spacers Ltd v Ross* 269 SE 2d 176 (Ga 1982); *Deist v Wachholz* 678 P 2d 188 (Mont 1984).
- 9 See, eg, Cranston (ed) *European Banking Law* 165-166; *Habetz v Condon* 618 A 2d 501 (Conn 1992); *High v Mc Lean Financial Corporation* 659 F Supp 1561 (DDC 1987); Equal Credit Opportunity Act (s 1691 of 15 USC).

"contort"¹⁰ and bank liability theories¹¹ can exacerbate the practical liability aspects of the banker-customer relationship in the United States.¹²

4.2.2 Defining a "bank"

4.2.2.1 A legal perspective.

Whilst banking institutions operate in significant numbers in the United States and play a substantial role in the US economy and financial markets, there does not appear to be any clear or precise definition of a "bank".

Though the US Supreme Court has stated its views on the nature of the commercial bank on several occasions,¹³ the legal reality is that defining a bank is essentially the function of the legislature.¹⁴ However, in the United States, there are 50 state legislatures and the US Congress, all of which (from time to time) have employed differing definitions of "bank" in various of their State and federal statutes for differing purposes.¹⁵ Today, however, the operative term is not solely "bank" but also "the business of banking". Recent judicial decisions have given broad deference to the bank regulators, such as the Comptroller of the Currency, in determining the

10 Some US Courts have tended to confuse the contract causes of actions with tort causes of actions, eg in lender liability suits. The effect of this "contort" confusion has been to provide plaintiffs in contract causes of actions, with the means to seek tort damages, which is much broader than contract damages. See Restatement (Second) of Torts, which generally provides for all reasonably foreseeable damages, whilst s 347 of the Restatement (Second) of Contracts generally provides for the recovery of damages which include those that return the benefit of the bargain to the complaining party; or places the claimant in the position it would have occupied had the contract been performed. See Cranston (ed) *Risk* 398.

11 See Cranston (ed) *Risk* 337-364.

12 See Cranston (ed) *European Banking Law* 166; Many authors foresee a trend toward increased findings of lender liability. See, generally, Blanchard *Lender Liability*; Budnitz *Lender Liability*; Cappello *Lender Liability*; Mannino *Lender Liability*.

13 See, eg, *Oulton v German Savings & Loan Society* 84 US (17 Wall) 109 at 118 (1873); *United States v Philadelphia National Bank* 374 US 321 at 326.

14 See National Bank Act (12 USC s 24).

15 Eg, separate definitions of "bank" exist under National Bank Act (s 24 of 12 USC), State banking codes, the UCC, the federal security laws, The Federal Internal Revenue Code (26 US Code), the Bank Holding Company Act of 1956 (as amended) (s 1841 of 12 USC), and the Federal Deposit Insurance Corporation Improvement Act of 1991 (105 Stat 2236 (1991)). See Hackley 1969 *Virginia LR* 1421 at 1423n13.

definitional embrace of this word and phrase.¹⁶

4.2.2.2 Forms of banks

In the USA, the main forms of banking institution comprise commercial banks, thrift institutions,¹⁷ and credit unions.¹⁸ There are also bank-type institutions which are not formally banks, such as money market funds, life assurance companies, investment banking firms, pension funds, mortgage banking firms and finance companies, all regulated by some or other State authorities.¹⁹

In this thesis I shall concentrate solely on commercial banks, in particular national banks.²⁰

4.2.2.3 Banking operations

Banking institutions in the USA operate either as unit banks, branches, or as part of bank holding company systems. Many banks also have significant correspondent relationships with other banks. The manner in which the organisational and operational structure of the bank is configured may often affect the regulatory structure and legal environment within which a particular banking institution and its customers co-exist.²¹

Unit banking involves the conduct of a bank's business operations through a centralised facility (with auxiliary facilities to the extent permitted by law). Unit banking results not so much from economic preference, but from federal and State restrictions on branch banking and geographic activities. There still are several States that have geographic restrictions on banking.²² However,

16 See, eg, *NationsBank of North Carolina NA v Variable Annuity Life Insurance Co* 513 US 251 (1995); *Clarke v Securities Industry Association* 479 US 388 93 L Ed 2d 757 108 Sct 750 (1987); *Investment Company Institute v Camp* 401 US 617 28 L Ed 367 91 S G 1091 (1971). The operative term is not solely "bank" but also "the business of banking".

17 See *Friend Industry*; Jones 1983 *Banking LJ* 247.

18 On Credit Unions, see *Moody & Fite Movement*; Jones 1983 *Banking LJ* 247.

19 See, for background, Norton & Whitley *Manual* s 1.04.

20 That is, banks chartered under National Banking Act (s 24 of 12 USC).

21 Cranston (ed) *European Banking Law* 168.

22 See Norton & Whitley *Manual* Ch 17.

the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994²³ has significantly expanded geographic banking opportunities.²⁴

Branch banking entails multiple office banking. Under federal law, the ability to branch is left essentially for federal purposes as a matter of State law and preference under the 1927 McFadden Act.²⁵ The liability of the branch is essentially imputed to that of the main banking facility, as there is no corporate distinction between the head office and the branch. Even though branch banks or offices may, in an economic sense, constitute distinct business entities or even lines of business, they are not separate legal entities. The parent (ie head office) bank owns the property of the branch, is liable for the debts of the branch, and is responsible for its operations.²⁶

The primary example of group banking in the USA today is the use of bank holding companies, by which a parent entity may have one or more wholly-owned banking subsidiaries and one or more wholly-owned non-banking subsidiaries. Bank holding companies are primarily regulated by the Federal Reserve Board (FRB) under the Bank Holding Company Act of 1956, as amended.²⁷ Except in emergency takeover situations, this Act prohibits multi-bank holding companies from acquiring a bank in another State, unless the law of the State in which the bank is to be acquired and is domiciled expressly so provides.²⁸ The non-banking subsidiaries of bank holding companies, however, operate across State lines to perform many functions closely related to banking.²⁹ The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, referred to above, significantly expands interstate banking opportunities.

From the above it is clear that the term "bank" is subject to legislative vagaries, and that the regulation of these institutions is also subject to a highly fragmented regulatory system in the

23 Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (108 Stat 2338 (1994)).

24 Cranston (ed) *European Banking Law* 169.

25 S 36 of 12 USC.

26 See Norton & Whitley *Manual* Ch 17.

27 S 1841 of 12 USC; Beckford *Compliance*.

28 The Douglas Amendment of 1970 (s 1842(d) of 12 USC).

29 The Bank Holding Company Act of 1956 (s 1843(c)(8) of 12 USC) limits the activities and powers of the non-bank subsidiaries to those activities closely related to banking. The FRB was given a broad regulatory power to define the term "banking" and it does so through its Regulation Y (s 225 of 12 CFR).

USA.³⁰ The overall regulatory environment within which a US bank operates is extremely important in the shaping of the character and practices of the bank itself.³¹

4.3 THE BANKER-CUSTOMER RELATIONSHIP:³² CUSTOMER DEPOSITOR

4.3.1 A relationship founded in contract³³

A general account creates a debtor-creditor relationship,³⁴ and a special account and a night deposit create a bailor-bailee relationship. The duties and liabilities of the bank and the customer are determined by the legal nature of the relationship.³⁵

The law does not require a particular procedure for the establishment of an account. However, the institution and the customer must mutually assent to the deposit, either expressly or impliedly. If the parties do not expressly agree to the terms of an account, the law will imply terms based on the usual banking relationship.³⁶ The terms that govern checking and savings accounts are generally embodied in a signature card or passbook that a customer signs when the account is opened.³⁷ A signature card incorporates by reference the rules of the institution. Passbooks include printed rules³⁸ relating to imposters, presentation of the book, cheque and deposit requirements.

Contractual terms may also be included in deposit slips. If the institution and the customer have

30 Hackley 1969 *Virginia LR* 1421; Golembe 1967 *Virginia LR* 1091; Randall 1966 *Law and Contemporary Problems* 696.

31 See, eg, Norton 1986 *Oklahoma City University LR* 547; Hackley 1969 *Virginia LR* 1421; Scott 1977 *Stanford LR* 30.

32 The UCC and most cases use the term "relationship". The Restatement (Second) of Contract uses the term "relation". It has been suggested that "relation" is the better term. See Symons 1983 *Banking LJ* 220n1.

33 Symons 1983 *Banking LJ* 220 at 221.

34 It does not create a trust. See s 12 of the Restatement (Second) of Trusts Comment e; *Suburban Trust Company v Waller* 44 Md App 335 408 A 2d 758 (Md 1979); *Umbaugh Pole Building Co Inc v Scott* 58 Ohio S Ct 2d 282 390 NE 2d 320 at 323 (1979).

35 Norton & Whitley *Manual* s 11.03.

36 *Taylor v Equitable Trust Co* 304 A 2d 833 (Md 1973).

37 The relationship will generally be covered by s 4 of the UCC.

38 See ss 3-404; 3-405; 3-406; 4-401 and 4-406 of the UCC.

embodied the terms of their deposit agreement in a written contract (ie a signature card or passbook), the contract generally is conclusive as between the customer and the institution. In the absence of fraud, duress or mistake, a court will be bound by the terms of the agreement, and may not consider extrinsic evidence.³⁹ The contract is formed when the institution accepts and acknowledges the deposit. Accordingly, the legal relationship is determined at the time the account is established. The money deposited is consideration for the obligation of the institution to repay the deposit. The contract will be interpreted so as to give effect to the intent of the parties.⁴⁰ The courts will generally enforce terms that impose limitations upon the institution and the customer. Some courts, however, will not enforce clauses exculpating the institution from liability for failure to exercise reasonable care.⁴¹

4.3.2 Creation and nature of the relationship

The legal relationship between a banking institution and its customer is created by an express or implied contract.⁴² If the deposit is a general deposit, title to the money passes to the institution, and a debtor-creditor relationship is created. Thus, the institution assumes an obligation to the depositor to repay the funds, and the funds become the property of the institution.⁴³ Some courts consider depositors to be beneficiaries of a fiduciary relationship with the bank or (at least) of a quasi-fiduciary duty resulting from a special relationship of trust and confidence.⁴⁴ Whether this is generally accepted is questionable.⁴⁵

4.3.3 Duties and liabilities of the bank

4.3.3.1 General deposits.

When title to a general deposit passes to the banking institution, it assumes the risk of loss if the

39 See, eg, *Bennett v First National Bank* 443 F 2d 518 (8th Circuit 1971).

40 *Western Nat Bank v Hawkeye-Security Insurance Co* 380 F Supp 508 (D Wyo 1974).

41 *Hy-Grade Oil Co v New Jersey Bank* 350 A 2d 279 (NJ 1975).

42 *Johnson v Stamets* 148 NW 2d 468 (Iowa 1967).

43 *Meyer v Idaho First National Bank* 525 P 2d 990 (Idaho 1974).

44 See discussion by Miller & Harrell *Payment Systems* s 9.03; *Mills County State Bank v Fisher* 282 NW 2d 712 (Iowa 1979); *Pigg v Robertson* 549 SW 2d 597 (Mo 1977).

45 See *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 147; Symons 1983 *Banking LJ* 220 at 221.

deposit is lost, destroyed or stolen. Thus, if an institution pays out funds upon presentment of a lost or stolen passbook, it may be liable to the account owner for the fraudulently withdrawn funds. In the absence of an agreement limiting the bank's liability, the courts are divided as to the extent of an institution's liability in these cases. Some courts hold that an institution is absolutely liable for payment made upon presentment of a lost or stolen passbook. Other courts impose liability only if the fraudulent withdrawal of funds resulted from the institution's failure to take reasonable care. Generally, a banking institution breaches its duty of reasonable care if it fails to compare the signature on the signature card with the signature on the withdrawal order. In some cases, where an institution's employee doubts the identity of the person making a withdrawal, the employee may have a duty to require identification.⁴⁶

The duties and liabilities of a banking institution with regard to checking account transactions are governed by Article 4 of the UCC. Article 4 provides that an institution is liable for:

- wrongful dishonour;⁴⁷
- failure to act promptly on a cheque or other item;⁴⁸
- ignoring a stop payment order;⁴⁹ or
- paying a forged cheque.⁵⁰

4.3.3.2 Special deposits

A banking institution must exercise reasonable care as bailee of a special deposit. If the institution exercises reasonable care, it will not be held liable for loss, destruction or theft of the deposit. The loss or theft of a special deposit, however, raises a presumption that the institution has acted negligently. Thus, the bank has the burden of proving that it exercised reasonable care. If the institution is acting as a gratuitous bailee, receiving no compensation for holding a special deposit, some courts limit liability to actions that are grossly negligent.⁵¹

46 S 3-501(b)(2) of the UCC.

47 S 4-402 of the UCC.

48 S 4-301 of the UCC.

49 S 4-403 of the UCC.

50 S 4-406 of the UCC.

51 See *Owosso Masonic Temple Association v State Savings Bank* 263 NW 771 (Mich 1936); *Miller v Viola State Bank* 246 P 517 (Kan 1926).

4.3.3.3 Night deposits

If a customer leaves a deposit in a banking institution's night depository, the legal relationship created is that of bailor-bailee. Therefore, the institution must exercise ordinary care to protect the deposit.⁵² If the deposit is a general deposit, risk of loss is not assumed by the institution until it takes some unequivocal act with respect to the deposit, such that a debtor-creditor relationship is created. An "unequivocal act" is an act or series of acts by a bank that objectively evidence that a deposit has been made, and that the depositor is not required to take further action (for example, entering the deposit in a passbook, or crediting the account of the depositor).⁵³

4.3.4 Termination of the relationship

The relationship between a bank and a customer, in the absence of a contractual provision to the contrary, is terminable at the will of either party. The bank may terminate the relationship by tendering the full amount of the deposit, and some courts require the bank to give reasonable notice prior to closing the account. A customer generally may terminate the relationship by withdrawing the funds from the account.⁵⁴

4.4 THE BANKER-CUSTOMER RELATIONSHIP: CUSTOMER A BORROWER

4.4.1 Legal bases of lending powers

The lending powers of banking institutions are derived from statute, and may be expanded upon or defined by statutory and judicial notions of "incidental" or implied powers, or (for non-bank lending subsidiaries of bank holding companies) by the statutory concept of "closely related to banking" powers.⁵⁵

Specifically with respect to national banks, these institutions derive their lending powers primarily from the National Bank Act.⁵⁶ They are empowered to discount and to negotiate promissory notes, drafts, bills and exchanges, and other evidence of indebtedness, and to lend

52 *Phillips Home Furnishing Inc v Continental Bank* 331 A 2d 840 (Pa 1974).

53 *Bowling Corporation v Long Island National Bank* 292 NYS 2d 562 (1968).

54 *Elliott v Capital City State Bank* 103 NW 777 (Iowa 1905).

55 Bank Holding Company Act of 1956 (s 1843(c)(8) of 12 USC).

56 National Bank Act (s 24 of 12 USC).

money on personal security.⁵⁷ Under the Federal Deposit Insurance Corporation Improvement Act of 1991,⁵⁸ the federal bank regulators are required to promulgate comprehensive real-estate regulations concerning such matters as loan-to-value appraisal standards, and aggregate lending limitations as to real estate related loans.⁵⁹

The investment powers of banking institutions are also statutorily based, and their investment powers are curtailed.⁶⁰

4.4.2 Limitations on available funds

Banking institutions primarily derive their funds for loans and investments by accepting deposits and by borrowing from non-depository creditors such as central banks, other banking institutions and the general public. Borrowing limitations on banking institutions may be statutory, regulatory or supervisory. Limitations on funds available for loans and investments include reserve requirements,⁶¹ liquidity requirements⁶² and practices,⁶³ permitted investment requirements,⁶⁴ usury violations⁶⁵ and legal considerations as far as commercial loans are concerned.⁶⁶

57 12 USC 24 (Seventh).

58 105 Stat 2236 (1991).

59 57 Fed Reg 62, 890 (1992); 58 Fed Reg 4460 (1993).

60 See s1 of 12 CFR; Norton 1987 *BL* 327 *et seq*; Perkins 1971 *Banking LJ* 483; Willis 1935 *Columbia LR* 696.

61 Such as FRB reserve requirements, such as Regulation D. See s 204 of 12 CFR.

62 *Via* the bank examination and supervisory processes and the formal bank "CAMEL" rating system. See Cranston (ed) *European Banking Law* 187.

63 Such as the limitation on loans to single borrowers, see National Banking Act (12 USC s 84); 12 CFR s 32; Norton 1984 *Banking LJ* 122. Liability is imposed on directors of banks in respect of violations, see *Larimore v Conover* 1775 F 2d 890 (1985); reviewed 789 F 2d 1244 (7th Circuit 1986); *Tirso del Junco v Conover* 682 F 2d 1338 (9th Circuit 1982); s 410 of the Garn-St Germain Depository Institutions Act of 1982 (96 Stat 1469 (1982)).

64 See, eg, Community Reinvestment Act (s 2901 *et seq* of 12 USC); Equal Credit Opportunity Act (s 1691 *et seq* of 15 USC); the Fair Lending Initiative (59 Fed Reg 18266)(1994).

65 National Banking Act (s 95 of 12 USC); National Banking Act (s 96 of 12 USC); Norton (ed) *Guide* Ch 20; s 501 *et seq* of the Monetary Control Act of 1980 (94 Stat 132 (1980)).

66 In regard to loans involving securities, see s 221 of 12 CFR; on anti-trust, see the Bank Tying Act (s 1972 of 12 USC); on interlocking directorate restrictions, see FRB

4.5 MULTI-FUNCTIONAL BANKING

The general state of the law is that a lender, solely by virtue of the lending relationship, is not in a fiduciary position with the borrower, but is in a contractual, creditor-debtor relationship.⁶⁷ There are developments in case law⁶⁸ and commentary⁶⁹ in the bank-depositor area aimed at creating a fiduciary relationship between a bank and its customers. Other cases limit such duties to depositors' situations (if then, and only in special circumstances) and do not extend them to commercial, arm's length, lending situations.⁷⁰ This being said, however, additional facts and circumstances (including the nature of a pre-existing lending relationship, prior course of conduct, reasonable expectations of the borrowers, inordinate lender control, and ongoing rendering of advice to a borrower who relies on such advice) may give rise to a "quasi-fiducial" or "special relationship" between lender and borrower, which at minimum would create an implied lender duty of good faith and fair dealing⁷¹ and possibly a fiduciary duty.⁷²

Where a fiduciary relationship exists, the lender will be deemed to have far greater duties than those arising under a loan contract (for example, due care, undivided loyalty, confidentiality, fair dealing, material disclosure) and may be charged with the burden of showing the fairness of the

Regulation L (s 212 of 12 CFR); on truth-in-lending, see FRB Regulation 2 (s 226 of 12 CFR).

- 67 See *Okura & Co (America) Inc v Careau Group* 783 F Supp 482 at 494 (CD Cal 1991); *Peters v Sjolholm* 25 Wash App 39 604 P 2d 527 (1979). It is not a trust, see Comment e to s 12 of the Restatement (Second) of Trusts.
- 68 See, eg, *Mills County State Bank v Fisher* 282 NW 2d 712 (Iowa 1979); *Pigg v Robertson* 549 SW 2d 597 (Mo 1977); *Young v United States Department of Justice*; *Young v Chemical Bank* 882 F 2d 633 (2d Circuit 1989); *Barnett Bank of W Florida v Hooper* 498 So 2d 923 (Fla 1986); *Crystal Springs Trout Co v First State Bank of Froid* No 85-342 (Sup Ct Mont 15 Jan 1987).
- 69 See Chao 1980 *California LR* 153; Millhiser 1980 *Wash & Lee LR* 953; Tettenborn 1980 *J of Business Law* 10; Hagedorn 1980 *Willamette LR* 803; Hagedorn 1978 *Mo BJ* 406.
- 70 *Lanz v Resolution Trust Corporation* 764 F Supp 176 at 179 (SD Fla. 1991); *Bankest Imports Inc v ISCA Corporation* 717 F Supp 1537 at 1541 (SD Fla 1989).
- 71 *Commercial Cotton Co v United California Bank* 163 Cal App 3d 551 209 Cal Rptr (1985); *Copesky v Superior Court of San Diego County* 229 Cal App 3d 678 (Cal 1991); *Federal Land Bank of Spokane v Stiles* 700 F Supp 1060 (D Mont 1988); *Deist v Wachholz* 678 P 2d 188 (Mont 1984); *Hutson v Wenatchee Federal Savings & Loan Association* 22 Wash App 91 588 P 2d 1192 (1978).
- 72 When a bank has accepted the customer's trust and confidence, it may be held to a fiduciary standard of conduct. See *Brasher v First National Bank of Birmingham* 168 So 42 (Ala 1936); *Stewart v Phoenix National Bank* 49 Ariz 34 64 P 2d 101 (1937); *Pigg v Robertson* 549 SW 2d 597 (Mo 1977).

lender's conduct.⁷³ A legal issue of concern to a bank is whether a fiduciary duty exists with respect to the use of information submitted to it by a borrower in connection with a loan. Prudent counseling may require the bank to assume that a fiduciary duty does exist concerning the dissemination of non-public information to a third party or to another department of the bank. In addition, dissemination of "inside" information could have federal security-law implications. The fiduciary standards on "insider" loans set forth in the Financial Institutions Regulatory and Interest Rate Contract Act of 1978 (FIRA),⁷⁴ and implementing federal regulation, are applicable to commercial loan transactions.

A bank may be given the power to act as agent or trustee for its customers and others in areas incidental to the ordinary business of banking.⁷⁵ Apart from statutes governing the relationship, banks, when operating as a trustee, are generally subject to the common-law "prudent person" rule in the administration of the trust.⁷⁶ Self-dealing in such a relationship is taboo. Unless authorised by the instrument creating the fiduciary relationship, by State law or by court order, funds held in a fiduciary capacity by a national bank cannot be invested in stock or obligations of, or property acquired from the bank or its directors, officers, employees, or from individuals or organisations with which there exists a connection or interest that might affect the exercise of the best judgment of the bank in making the investment or acquiring the property.⁷⁷

73 A fiduciary relationship obliges the parties, essentially, to act with the utmost good faith, honesty and loyalty on behalf of the other. See Tepper *Contracts* 51; Hagedorn 1980 *Willamette LR* 803 at 807; Hagedorn 1978 M0 BJ 406.

74 Financial Institutions Regulatory and Interest Rate Contract Act of 1978 (FIRA) (92 Stat 3641 (1978)).

75 These trust relationships will be governed by a complex of State and federal banking laws. See Norton & Whitley *Manual* s 4.03[1][d].

76 See, eg, *First Alabama Bank of Montgomery NA v Martin* 425 So 2d 415 (Ala 1982).

77 S 9.12 of 12 CFR.

4.6 THE BANKER'S DUTY OF CONFIDENTIALITY

At common law, the existence of a general duty of confidentiality is by no means wholeheartedly accepted. Perhaps the earliest recognition of the bank-customer duty of confidentiality is *Brex v Smith*⁷⁸ where a government prosecutor sought the bank records of all members of the Newark police department. In refusing the demand, the Court stated that there is an implied obligation on the bank to keep the records from scrutiny.

In general, the US Courts have easily found a duty of confidentiality where the customer deposits money with the bank.⁷⁹ Neither the line of reasoning nor the results, however, are as consistent where the bank-customer relationship is one of loan. In *Granery Development Corporation v Taksen*⁸⁰ the customer brought an action against his bank claiming that the implied contract of confidentiality had been breached as the bank had informed both another lender as well as a prospective credit seller of his default on a loan. The court held that because there was a loan relationship, not deposit, plaintiff could not expect that the information would be kept confidential. In *Washington Steel Corporation v TW Corporation*⁸¹ the circuit court refused an injunction for an alleged infringement of the duty of confidentiality, as there was no fiduciary relationship between the parties. In *Humana Inc v American Medicorp Inc*⁸² the Court indicated that it would support a duty not to disclose externally or to use internally the information for anything other than analysis of the customer's loan. Virtually all courts, other than the court in the *Washington Steel*⁸³ case,⁸⁴ have concluded that the loan can be made only if the confidential information supplied by the target customer is not used.⁸⁵

78 146 A 34 (NJ Ch 1929).

79 See, eg, *Suburban Trust Company v Waller* 44 Md App 335 408 A 2d 758 (Md 1979) in which case the passage regarding the implied duty of confidentiality as stated in *Tournier v National Provincial and Union Bank of England* (1924) 1 KB 461 at 480 was quoted with approval. See, also, *Peterson v Idaho First National Bank* 367 P 2d 284 (1961).

80 92 Misc 2d 764 400 NYS 2d 717 (1978).

81 602 F 2d 594 (3d Circuit 1979).

82 [1978 Transfer Binder] CCH Fed Sec L Rep 96 286 at 92 829 (SDNY 1978).

83 602 F 2d 594 (3d Circuit 1979)

84 For a critical discussion of this case, see Chao 1980 *California LR* 153; Milhiser 1980 *Wash & Lee LR* 953.

85 *American Medicorp Inc v Continental Illinois National Bank & Trust Co* 77 C 3865 (ND Ill Dec 30 1977); *Humana Inc v American Medicorp Inc* [1978 Transfer Binder] CCH Fed Sec L Rep 96 286 (SDNY 1978); *Harnischfeger Corporation v Paccar Inc* 474 F

Because of the courts' general failure to recognize the confidentiality of financial information⁸⁶ held by the bank, Congress stepped in with legislation. The Foreign Transactions Reporting Act of 1970⁸⁷ provides that any "consumer reporting agency" must adhere to certain safeguards before disseminating virtually any information about individuals, and is designed, in part, to ensure that such agencies exercise their responsibilities with fairness, impartiality, and respect for the consumer's right to privacy.⁸⁸

The Right to Financial Privacy Act of 1978⁸⁹ was passed in direct response to a Supreme Court case, *United States v Miller*,⁹⁰ a criminal case where the court held that where a prosecutor had seized the financial records of an accused, no Fourth Amendment right had been violated, as a bank customer has no individual rights to privacy in financial records held by the bank. In 1978, Congress expressed its determination that a bank customer has a reasonable expectation of privacy in its financial dealings with a bank.⁹¹

Supp 1157 (ED Wis 1979).

86 In 1991, eg, in *Boccardo v Citibank NA* 152 Misc 2d 1012 (1991). One New York Supreme Court Judge refused to find that Citibank had any duty of confidentiality to the non-defaulting holder of a line of credit. In *Young v United States Department of Justice; Young v Chemical Bank* 882 F 2d 633 (2d Circuit 1989) the US Court of Appeals for the Second Circuit surveyed many of the relevant judicial decisions both in New York and elsewhere. The Court concluded that the State of New York had not articulated a duty of confidentiality with respect to the relationship between a bank and its customers, who were depositors in this case, and abstained from deciding the case.

87 S 1681 of 12 USC; 84 Stat 1118 (1970).

88 S 1681(a)(4) of 12 USC.

89 S 3401 of 12 USC.

90 425 US 435 (1976).

91 Neate *Bank Confidentiality* 518-520.

4.7 LIABILITY FOR ADVICE AND OTHER BANKER/LENDER LIABILITY THEORIES

4.7.1 Theories of lender liability

Litigation against lenders by disgruntled borrowers or affected third parties is increasing. More and more actions instituted by lending banks are defended. These suits or defences may be based on one more of numerous innovative legal theories, the most commonly used theories being those discussed below.⁹²

4.7.1.1 Control theories

If a bank becomes so entwined in control over the conduct of a borrower and in a manner that goes beyond the bounds of prudent lending practices, a bank may find itself judicially characterised as the principal, partner or joint venturer, *alter ego*, or fiduciary of the borrower. This, in turn, could expose the bank to liability for third-party claims against the borrower.⁹³ In addition, such degrees of inordinate control could, given the proper circumstances, create lender liability for the bank under federal securities,⁹⁴ tax,⁹⁵ and bankruptcy laws.⁹⁶

4.7.1.2. Common-law tort and fraud

The Restatement (Second) of Torts asserts that one who aids another may be liable to the other for physical harm resulting from his failure to exercise care to perform his undertaking if:

- his failure to exercise such care increases the risk of harm; or,
- the harm is suffered because of the other's reliance upon the undertaking.

92 On US lender liability generally, see Cranston (ed) *Risk* 331-412; Blanchard *Lender Liability*; Budnitz *Lender Liability*; Cappello *Lender Liability*; Mannino *Lender Liability*.

93 See *AG Jensen Farms Co v Cargill Inc* 309 NW 2d 285 (Minn1981); *Krivo Industrial Supply v National Distillers and Chemical Company* 483 F 2d 1098 (5th Circuit1973); *James E McFadden Inc v Baltimore Contractors Inc* 609 F Supp 1102 (ED Penn1985); Hynes1991 *Tennessee LR* 635 at 635-668.

94 S 15 of the Securities Act of 1933 (s 77 of 15 USC).

95 Ss 3402, 3505 and 6672 of the Internal Revenue Code (26 US Code).

96 Bankruptcy Code (s 510 of 11 USC).

Building upon this theory of legal duties, borrowers have argued that where a lender provides specific assistance to a debtor or assumes control (directly or indirectly) over a borrower's business, and the debtor relies on the creditor, the lender is liable to the borrower for any failure to perform such assumed duties with reasonable care.⁹⁷

In addition, in instances where a lender can be shown to have misrepresented a material fact to the borrower in order to coerce the borrower into some action, or can be shown to be otherwise in bad faith in the lending relationship, common-law actions for misrepresentational fraud,⁹⁸ constructive fraud,⁹⁹ duress¹⁰⁰ tortious interference,¹⁰¹ or negligence,¹⁰² may lie.

97 *AG Jensen Farms Co v Cargill Inc* 309 NW 2d 285 (Minn1981); *Krivo Industrial Supply v National Distillers and Chemical Company* 483 F 2d 1098 (5th Circuit 1973); *James E McFadden Inc v Baltimore Contractors Inc* 609 F Supp 1102 (ED Pa 1985).

98 In regard to fraud, its requirements and evidence, see *Bank of El Paso v (TO) Stanley Boot Co* 847 SW 2d 218 at 222 (Tex1992); *State National Bank of El Paso v Farah Manufacturing Co* 678 SW 2d 661 at 681 (Tex App 1984); *Banco do Brasil SA v Latian Inc* 234 Cal App 3d 973 285 Cal Rptr 870 at 896 (Cal Ct App 1991); *Commonwealth Mortgage Corporation v First Nationwide Bank* 873 F 2d 859 (5th Circuit 1989).

Fraud is frequently alleged in connection with a bank's promises of benefits in exchange for security, (see *Dean W Knight & Sons Inc v First W Bank & Trust Co* Cal App 2d 148 Cal Rptr 767 (Cal Ct App 1978)), groundless threats, (see *State National Bank of El Paso v Farah Manufacturing Co* 678 SW 2d 661 at 681 (Tex App1984); *Loyola Fed Sav & Loan Association v Galanes* 365 A 2d 580 (Md Ct Spec App 1976)), misrepresentation concerning the effect of the loan documents, (see *Holm v Sun Bank/Broward* NA 423 So 2d 1007 (Fla Dist Ct App1982); *Lee v The Heights Bank* 446 NE 2d 248 (Ill App Ct 1983)), failure to disclose information in order to protect its own interests, (see *Merrill Lynch Pierce Fenner & Smith Inc v First National Bank Of Little Rock Arkansas* 774 F 2d 909 (8th Circuit1985); *General Motors Acceptance Corporation v Central National Bank Mattoon* 773 F 2d 771 (7th Circuit1985); *Central States Stamping Co v Terminal Equipment Co Inc* 727 F 2d 1405 (6th Circuit 1984)), giving improper advice to a borrower, (see *Banco Totta e Acores v Fleet National Bank* 768 F Supp 943 (DRI 1991); *United Companies Financial Corporation v Brown* 584 So 2d 470 (Ala 1991); *Rainsville Bank v Willingham* 485 So 2d 319 (Ala. 1986); *Nie v Galena State Bank & Trust Co* 387 NW 2d 373 (Iowa Ct App 1986); *Shogyo International Corporation v First National Bank of Clarksdale* 475 So 2d 425 (Miss1985)), and falsely representing that it has done or will do something for the borrower, (see *Richter v Bank of America National Trust and Savings Association* 939 F 2d 1176 (5th Circuit 1991); *General Motors Acceptance Corporation v Covington* 586 So 2d 178 (Ala 1991); *First Federal Saving & Loan Association v Caudle* 425 So 2d 1050 (Ala 1982); *Frame v Boatmen's Bank* 782 SW2d 117 (Mo Ct App 1989); *Commerce Savings Scottsbluff Inc v FH Schafer Elevator Inc* 436 NW2d 151 (Neb1989).

99 Constructive fraud most commonly arises in lender liability where a confidential or fiduciary duty has arisen between the parties and the bank either fails to disclose material facts to the borrower or engages in some self-dealing or overreaching. See *Greater Southwest Office Park Ltd v Texas Commerce Bank National Association* 786 SW 2d 386 (Tex App Houston 1st Dist 1990). Ordinarily such a special relationship does not exist between borrower and lender and where one has been found, it rested on extraneous facts and conduct. See *Cara Corporation v Continental Bank (In re Cara Corporation)* 148

4.7.1.3 Good-faith covenant

Section 1-203 of the UCC states:

"Every contract or duty within this Act imposes an obligation of good faith in its performance or engagement."

"Good faith" under s 1-201(19) of the UCC is, in turn, defined as "honesty in fact in the conduct or transaction". This contract-based duty has been held in certain cases to apply to the conduct of lenders in enforcing security arrangements coming within the scope of the UCC.¹⁰³ If a "special relationship" is deemed to exist, a tort-based duty of good faith outside the UCC may be implied.¹⁰⁴ In principle, UCC bad-faith claims are contractual (and not tort) claims.¹⁰⁵

BB 760 (Bankr ED Pa 1992).

- 100 *Mirax Chemical Producers v First Interstate Commercial Corporation* 950 F2d 566 at 570 (8th Circuit 1991); *Bank of El Paso v TO Stanley Boot Co* 847 SW 2d 218 at 222 (Tex 1992); *Federal Deposit Insurance Corporation v Linn* 671 F Supp 547 at 556 (ND Ill 1987); *Spillers v Five Points Guaranty Bank* 335 So 2d 851 (Fla Dist Ct App 1976)
- 101 Tortious interference typically encompasses two torts, interference with contract and interference with prospective business relations. See *State National Bank v Academia* 802 SW 2d 282 at 295 (Tex App 1990); *Victoria Bank & Trust Co v Brady* 811 SW2d 931 at 939 (Tex 1991); *Flintridge Station Associates v American Fletcher Mortgage Co* 761 F 2d 434 at 440 (7th Circuit 1985); *Lachenmaier v First Bank Systems Inc* 803 P2d 614 at 619 (Mont 1990).
- 102 The existence of a duty of care is a prerequisite to establishing a claim of negligence against a lender. See *Nymark v Heart Federal Savings & Loan Association* 231 Cal App 3d 1089 283 Cal Rptr 53 (1991); *Larsen v United Federal Savings and Loan Association of Des Moines* 300 NW 2d 281 (Iowa 1981). Lenders have incurred liability based on negligence in many instances, including negligent processing of a loan application, (see *Hig v McLean Financial Corporation* 659 F Supp 1561 (DDC 1987)); negligent appraisal, (see *Hughes v Holt* 435 A 2d 687 (Vt 1981); negligent inspection, (see *Williamson v Reality Champion and First Union Mortgage Corporation* 551 So 2d 1000 (Ala 1989)) negligent response to credit enquiries, (see *MSA Tubular Products Inc v First Bank and Trust Co Yale Oklahoma* 869 F 2d 1422 (10th Circuit 1989); *Berklene Corporation v Bank of Mississippi* 453 So 2d 699 (Miss 1984).
- 103 Eg, *KMC Co Inc v Irving Trust Company* 757 F 2d 752 (6th Circuit 1985).
- 104 Compare, eg, *Kraus/Jewell v Bank of America* 248 Cal Rptr 217 (1988) with *Copesky v Superior Court of San Diego County* 229 Cal App 3d 678 (Cal 1991).
- 105 The concept of good faith shall be discussed in more detail in Chapter 4.8 below.

4.7.1.4 Environmental claims

A lender may incur significant risk of liability under federal and State environmental laws with respect to its control over a borrower's property which impacts adversely on the environment.¹⁰⁶ Lenders who secure their loans through security interests in real property are becoming increasingly concerned with the impact on their interests of hazardous-waste clean-up sites under federal and State laws, especially under the federal Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA).¹⁰⁷ CERCLA imposes liability for the cost of hazardous-waste clean-up on a broad range of people, including former and current owners or operators of a site. Responsible parties are strictly liable, and liability is joint and several. Lenders, however, can take advantage of certain narrowly drawn defences to liability.¹⁰⁸

4.7.2 More instances of banking regulation

US banking law consists of a maze of regulations. In addition to the few statutes already discussed, mention should be made here of a few other regulations which play a vital role in the lender's ability to lend. In this regard regulation is provided for asset classification,¹⁰⁹ allowances for losses, and capital and CRA ratings.¹¹⁰

4.8 DUTIES OF DISCLOSURE AND OTHER RELEVANT PRINCIPLES

4.8.1 Introduction: good faith.

In the sub-chapter on disclosure in England, chapter 2 pars 2.2.1 to 2.2.5, I have looked fairly extensively at the legal principles of English law. US law is, of course, part of the Anglo-American legal family and has its roots in English law. There are important differences however, between US contract law and English contract law, notably in regard to the requirement of good

106 See, eg, *United States v Maryland Bank and Trust Co* 632 F Supp 573 Md 1986).

107 Comprehensive Environmental Response Compensation and Liability Act of 1980 (s 9601 *et seq* of 42 USC) (CERCLA).

108 Ss 300 and 1100 *et seq* of 40 CFR.

109 See Federal Reserve Board Regulation Service Locator No 3-1501 of 1979; 38(b)(1) of the Federal Deposit Insurance Act of 1950 (s 1811 of 12 USC).

110 S 3 of 12 CFR.

faith. There is no general principle of good faith in English law.¹¹¹ As far as good faith and US law are concerned, it can be stated briefly that during the nineteenth century, the US common law was reluctant to recognize explicitly any "generalized duty to act in good faith".¹¹² US law now imposes a duty of good faith across a broad spectrum of commercial transactions.¹¹³ For example, as far as bankers are concerned, it applies to commercial paper and other negotiable instruments, bank deposits and collections, electronic funds transfers, letters of credit, bulk transfer, documents of title, investment securities, secured transactions, and contracts including sales.¹¹⁴

The UCC,¹¹⁵ the Restatement (Second) of Contracts,¹¹⁶ and a majority of the States¹¹⁷ recognize the duty to perform a contract in good faith.

Despite a promising beginning in the eighteenth century, the common law has traditionally been reluctant to recognize, at least as overt doctrine, any generalized duty to act in good faith toward others in social intercourse.¹¹⁸ This approach was solidified with the development, "during the nineteenth century, of the pure theory of contract characterized by notions of volition, *laissez-faire*, freedom of contract, judicial non-intervention and bargained-for-exchange".¹¹⁹ In recent years doctrines of promissory estoppel, unconscionability and modern theories of quasi-contracts have changed these rigid notions.¹²⁰ As part of the same development, modern contract law appears to support and promote good-faith conduct based on reasonable standards in the formation, performance and discharge of contracts.¹²¹ The Uniform Commercial Code and

111 See Atiyah *Contract* 266; Zimmermann & Whittaker (eds) *Good Faith* 39 and the discussion on non-disclosure in English law in Chapter 2.

112 Holmes 1978 *University of Pittsburgh LR* 381 at 384.

113 Farnsworth 1963 *University of Chicago LR* 666 at 667; Eisenberg 1971 *Marquette LR* 1; Zimmermann & Whittaker (eds) *Good Faith* 119-120.

114 Eg, ss 3-302, 4-406, 5-114 of the UCC.

115 S 1-203 of the UCC.

116 S 205 of the Restatement (Second) of Contracts.

117 Burton 1980 *Harvard LR* 369.

118 Holmes 1978 *University of Pittsburgh LR* 381 at 384.

119 *Ibid*, at 384-5.

120 *Ibid*, at 389-90.

121 *Ibid*, at 381.

Restatement (Second) of Contracts have been influential in bringing about this result.¹²²

The concept of good faith has been applied in many areas of the law.¹²³ In the area of indefiniteness, it will be noted that where "a contract confers on one party a discretionary power affecting the rights of the other, a duty is imposed to exercise the discretion in good faith and in accordance with fair dealing".¹²⁴ The concept of good faith is furthermore referred to with respect to the termination of an agreement, illusory promises, the surrender of an invalid claim and output and requirements contracts. The concept is also used in the area of duress.¹²⁵ In the area of promissory estoppel the notion of *culpa in contrahendo* is based upon a duty to bargain in good faith.¹²⁶

Perhaps the largest number of cases involving the topic of good faith arise in the context of an implied-in-fact promise or a constructive promise to act in good faith.¹²⁷ A much quoted phrase

122 *Ibid*, at 384. On the UCC and Good Faith, see, also, Hillman 1981 *Cornell LR* 1; Adler & Mann 1994 *Akron LR* 31; Summers 1982 *Cornell LR* 810; Farnsworth 1963 *University of Chicago LR* 666.

123 The overwhelming majority of jurisdictions apply it as a matter of common law. See, eg, *Keffer v Keffer* 852 P 2d 394 at 398 (Alaska 1993); *Carma Developers (California) Inc v Marathon Development California Inc* 826 P 2d 710 at 726 (Cal 1992); *Ervin v Amoco Oil Co* 885 P 2d 246 at 250 (Colo Ct App 1994); *Habetz v Condon* 618 A 2d 501 at 505 (Conn 1992); *Southern Business Machines of Savannah Inc v Norwest Financial Leasing Inc* 390 SE 2d 402 at 405 (Ga Ct App 1990); *Abbott v Amoco Oil Co* 619 NE 2d 789 at 795 (III App Ct 1993); *Kansas Baptist Convention v Mesa Operating Ltd Partnership* 864 P 2d 204 210-11 (Kan 1993); *Blank v Chelmsford OB/GYN* 649 NE 2d 1102 at 1105 (Mass 1995); *Ferrel v Vic Tanny International Inc* 357 NW 2d 669 at 672 (Mich Ct App 1984); *Weldon v Montana Bank* 885 P 2d 511 at 515 (Mont 1994); *Perry v Jordaan* 900 P 2d 335 at 338 (Nev 1995); *Planning & Design Solutions v City of Santa Fe* 885 P 2d 885 P 2d 628 at 635 (NM 1994); *Dalton v Educational Testing Serv* 614 NYS 2d 742 at 743 (App Div 1994); *Bicycle Transit Authority Inc v Bell* 333 SE 2d 299 at 305 (NC1985); *Pacific First Bank v New Morgan Park Corporation* 876 P 2d 761 at 762 (Or 1994); *Carmichael v Adirondack Bottled Gas Corporation* 635 A 2d 1211 at 1216 (Vt 1993); *Miller v United States Bank* 865 P 2d 536 at 542 (Wash Ct App 1994). Only Texas has expressly refused to recognize the covenant's relevance to arms' length contracts and limited its application to cases in which a special relationship between the parties is found, such as in insurance contracts. See, eg, *Natividad v Alexis Inc* 875 SW 2d 695 at 697 (Tex 1994).

124 *Perdue v Crocker National Bank* 38 Cal 3d 913 216 Cal Rptr 345 702 P 2d 503 (Cal 1985).

125 See, in general, Calamari & Perillo *Contracts* 508-509; Farnsworth *On Contracts* 328 *et seq*.

126 Kessler & Fine 1964 *Harvard LR* 401; Calamari & Perillo *Contracts* 509; Farnsworth 1984 *Canadian Bus LJ* 426 at 427-428.

127 Calamari & Perillio *Contracts* 509.

is "that in every contract there exists an implied covenant of good faith and fair dealing."¹²⁸ Normally, the violation of such a duty is treated as a breach of contract. There is a tendency, however, in violations of the insurance contracts of insurers¹²⁹ and in abusive discharges of at-will employees¹³⁰ to treat violations of the duty of good faith and fair dealing as torts. The distinction is not purely of academic interest. Characterization of the violation as a tort opens the doors to punitive damages and difficulties in choosing the applicable statute of limitations.¹³¹

Section 1-203 of the UCC states that every contract or duty within the Act imposes an obligation of good faith in its performance or enforcement.¹³² The comment to the UCC adds:

"This section sets forth a basic principle running throughout this Act. The principle involved is that in commercial transactions good faith is required in the performance and enforcement of all agreements or duties."

Section 1-203 of the UCC does not define "good faith". However, there are two sections that do. Section 1-201(19) defines "good faith" as "honesty in fact in the conduct or transaction concerned."¹³³ Since the section is in Article 1 it applies to the entire Code. It has been said that this definition makes negligence irrelevant to good faith, its being a subjective test also known as "the pure heart and the empty head test".¹³⁴ The subjective nature of this test has been severely

128 *Kirke La Shelle Co v Paul Armstrong Co* 263 NY 79 87 188 NE 163 at 167 (1933); s 205 of the Restatement (Second) of Contracts. The concept of good faith is embodied in both s 1-203 of the the UCC and s 205 of the Restatement (Second) of Contracts. It has been pointed out that "there is an express mention of 'good faith' in some fifty of the four hundred sections of the Code." See Farnsworth 1963 *University of Chicago LR* 666 at 667.

129 See Louderback & Jurika 1982 *USFLR* 187; Speidel 1983 *N Kentucky LR* 163.

130 See *Murphy v American Home Products Corporation* 58 N 2d 293 461 NYS 2d 232 448 NE 2d 86 (1983).

131 Calamari & Perillo *Contracts* 509.

132 Note that this does not apply to contract formation, but it applies to a modification because a modification relates to the performance of a contract. Calamari & Perillo *Contracts* 509.

133 See, also, *Wendling v Cundall* 568 P 2d 888 (Wyo1977). Speidel 1996 *J of Legal Education* 537 at 540 points out that a proposed revision of s 1-201(19) of the UCC states that good faith means "honesty in fact and the observance of reasonable standards of fair dealing in the conduct of the transaction concerned".

134 See Braucher 1958 *Columbia LR* 798:

"Some term it the 'white heart, empty head' test. It is not sufficient that there be

criticized. There is a strong feeling that the test should have an objective component.¹³⁵

However, for sales of goods, the Code has a different definition in the case of a merchant. Section 2-103 states: "Good faith" in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade. This definition includes the subjective test supplied by s 1-203, but adds an objective standard.¹³⁶

The Restatement (Second) of Contract provides: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."¹³⁷ In the Official Comment a to the section, the UCC definitions of good faith are repeated. The Comment goes on to say that the meaning of the phrase varies somewhat with the context. According to the Comment, "[G]ood faith performance or enforcement of the contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness, or reasonableness".

Comment d of the Restatement (Second) of Contract elaborates on what is good faith and what is bad faith. It states: "Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions; evasion of the spirit of the bargain, lack of diligence and slacking off, wilful rendering of imperfect performance, abuse of

circumstances or suspicions such as would put a careful purchaser on inquiry. We have traditionally held that subjective good faith is simply 'the honest belief that [your] conduct is rightful'".

As held in *Schluter v United Farmers Elevator* 479 NW 2d 82 at 85 (Minn Ct App 1992) quoting *Wohlrabe v Pownell* 307 NW 2d 478 at 483 (Minn 1981)); cf *Utility Contractors Financial Services Inc V Amsouth Bank NA (In re Joe Morgan Inc)* 985 F 2d 1554 at 1506-61 (11th Circuit 1993) where it was recognised that Alabama applies both subjective and objective analyses of good faith under the UCC); *Shearson Lehman Brothers v Wasatch Bank* 788 F Supp 1184 at 1194 (D Utah 1992); *Bill v Catfish Shaks of America Inc* 727 F Supp 1035 at 1040-41 (ED La 1989); *Kline v Central Motors Dodge Inc* 614 A 2d 1313 at 1316 (Md Ct Spec App 1992).

135 For a critical discussion, see, eg, Farnsworth 1963 *University of Chicago LR* 666; Summers 1968 *Virginia LR* 195; Heatherman 1993 *Willamette LR* 567 at 590.

136 Calamari & Perillo *Contracts* 510; Heatherman 1993 *Willamette LR* 567 at 590; Adler & Mann 1994 *Akron LR* 31 at 43.

137 S 205 of the Restatement (Second) of Contracts.

a power to specify terms, and interference with or failure to cooperate in the other party's performance." This catalogue contains both subjective and objective criteria.¹³⁸

It should be noted that Comment b states that this section does not relate to the formation of a contract. *A fortiori* it does not relate to preliminary negotiations.¹³⁹ Pre-contractual bad faith may, however, be redressed under rules regulating fraud, duress and promissory estoppel.¹⁴⁰

The Restatement section has been quoted in detail to show that the concept of good faith is amorphous.¹⁴¹ A wide variety of attempts to give it flesh and substance can be found in the literature.¹⁴² What is or is not good faith is ordinarily a question of fact.¹⁴³

Closely related to the topic of good faith is the doctrine of tortious bad faith breach of contract.¹⁴⁴ In the case of *Silberg v California Life Insurance Co*¹⁴⁵ it was stated that the insurer's duty is to give the interest of the insured at least as much consideration as it gives to its own interest.¹⁴⁶ However, another case has stated that a duty of good faith does not mean that a party vested with a clear right is obligated to exercise the right to his own detriment for the purpose of benefitting

138 Calamari & Perillo *Contracts* 510.

139 Zimmermann & Whittaker (eds) *Good Faith* 125. There are specific instances where it might be said that the general requirement applies even at the negotiating stage. Farnsworth gives the example of the "closed-mouth negotiator". Non-disclosure may amount to a misrepresentation unless remaining silent is consistent with good faith and reasonable standards of fair dealing. See Farnsworth 1984 *Canadian Bus LJ* 426 at 427-428; s 161 of the Restatement (Second) of Contracts.

140 Calamari & Perillo *Contracts* 510.

141 Burton 1981 *Iowa LR* 1; Eisenberg 1971 *Marquette LR* 1.

142 Calamari & Perillo *Contracts* 511; Burton 1980 *Harvard LR* 369; Burton 1981 *Iowa LR* 1; Summers 1982 *Cornell LR* 810; Lillard 1992 *Mo LR* 1233 at 1237; Summers 1968 *Virginia LR* 195; Cook 1986 *Iowa LR* 893.

143 Eisenberg 1971 *Marquette LR* 1 at 15.

144 See *Louderback and Jurika* 1982 *USFLR* 187; Speidel 1983 *N Kentucky LR* 163; *Murphy v American Home Products Corporation* 448 NE 2d 86 (1983); and *Silberg v California Life Insurance Co* 11 Cal 3d 452 113 Cal Rptr 711 521 P 2d 1103 (1974).

145 11 Cal 3d 452 113 Cal Rptr 711 521 P 2d 1103 (1974).

146 460 521 P 2d at 1109 113 Cal Rptr at 716-717. See, also, Holmes 1980 *Cornell LR* 330 at 360-7.

another party to the contract.¹⁴⁷

It is apparent that the concept of "good faith" can be used in any situation to right a wrong that would be created if the traditional rule were applied.¹⁴⁸

4.8.2 Disclosure principles

Information is valuable.¹⁴⁹ Possession of it frequently permits an individual to enter into a transaction that is profitable precisely because he is acting on the information possessed by him but not by the other party. To what extent must a contracting party share information with the other party when that information bears on the relative exchange of values? Poker players do not share information concerning the content of their hands. Calamari and Perillo pose the question whether this is analogous to a bargaining transaction. They find the answer to be complex. The kinds of information that affect values are many. Means of gathering information are multiple. The circumstances surrounding the negotiating parties are diverse.¹⁵⁰

As a general rule, in a bargaining transaction there is generally no duty to disclose information to the other party.¹⁵¹ This rule contains numerous exceptions. The first exception or group of exceptions is where a statute or regulation requires disclosure. The number of such statutes perhaps attests to the inadequacy of common-law disclosure rules. The Securities Act of 1933,¹⁵² Truth-in-Lending legislation,¹⁵³ the Interstate Land Sales Full Disclosure Act,¹⁵⁴ and the Truth-in-

147 *Rio Algom Corporation v Jimco Ltd* 618 P2d 497 (Utah 1980). It has been held that the concept of good faith may not be used to override explicit contractual terms. See *Grand Light & Supply Co Inc v Honeywell Inc* 771 F 2d 672 at 679 (2d Circuit 1985), but see *Wakefield v Northern Telecom Inc* 769 F 2d 109 (2d Circuit 1985) for a contrary view.

148 S 205 of the Restatement (Second) Contracts; *Fortune v National Cash Register Co* 373 Mass 96 364 NE 2d 1251 (Mass 1977); Calamari & Perillo *Contracts* 512.

149 Calamari & Perillo *Contracts* 366.

150 Calamari & Perillo *Contracts* 366.

151 *Laidlaw v Organ* 15 US (2 Wheat) 178 4 L Ed 214 (1817). See generally, Keeton 1936 *Texas LR* 1; Williston 12 1497-99; Prosser & Keeton *Torts* 737-40; Berger & Hirsch 1948 *Temple LQ* 368; Goldfarb 1956 *Western Reserve LR* 5.

152 S 77 of 15 USC. See, generally, *Loss Regulation*.

153 See, generally, *Clontz Manual*.

154 Interstate Land Sales Full Disclosure Act (s 1701 of 15 USC).

Negotiations Act,¹⁵⁵ are some of the more prominent legislative steps in this field displacing the common law. These all involve transactions where one party is in possession of information which can be obtained by the other, if at all, only by extremely expensive means and where abuses of the information monopoly frequently take the form of false or misleading statements.¹⁵⁶

A second exception to or qualification of the general rule is the distinction made between non-disclosure and concealment. Positive action designed to hide the truth or to stymie the other party's investigation is deemed to constitute misfeasance that can result in liability for misrepresentation.¹⁵⁷

A third exception is that where partial disclosure is made, lack of full disclosure (a half truth) may constitute misrepresentation.¹⁵⁸ Thus where one party reads a suggested contract to another, leaving out portions, he has run afoul of this exception.¹⁵⁹ Where a resident of the Philippines was offered a job in Oregon, without disclosure that the existence of the job slot was under review, non-disclosure was deemed fraudulent and damages were awarded when the slot was cancelled as of the date of the promised employment.¹⁶⁰

A fourth exception is where a party has made a statement in good faith, but supervening events make it no longer true, or he discovers new information demonstrating to him that the statement was not true when made. If he knows that the other is relying upon it, he has a duty to disclose the truth.¹⁶¹ Similarly, if one party becomes aware that the other is operating under a mistake as

155 S 2304 of 10 USC. Applicable to US government contracts.

156 Calamari & Perillo *Contracts* 367.

157 See Keeton 1936 *Texas LR* 1 at 2-6; *Kuelling v Roderick Lean Manufacturing Co* 183 NY 78 75 NE 1098 2 LRA (NS) 303 (1905). See, also, s 160 of the Restatement (Second) of Contracts.

158 *Norton v Poplos* 443 A 2d 1 (Delaware 1982); *Russ v Brown* 96 Idaho 369 529 P 2d 765 (1974); *Kannavos v Annino* 356 Mass 42 247 NE 2d 708 (1969); *Krause v Eugene Dodge Inc* 265 Or 486 509 P 2d 1199 (Or 1973) ("new car" had 5 000 miles of use); *Williston* 12 1497 n 4.

159 *Ten-Cate v First National Bank of Decatur* 52 SW 2d 323 (Tex CivApp 1932). *Prosser & Keeton Torts* 736-40; *Coral Gables v Mayer* 241 App Div 340 271 NYS 662 (1st Dep't 1934), second appeal 246 App Div 518 282 NYS 596 (1st Dep't 1935) affirmed 270 NY 670 1 NE 2d 991 (1936).

160 *Elizaga v Kaiser Foundation Hospitals Inc* 259 Or 542 487 P 2d 870 (Or 1971). See Comment b to s 159 of the Restatement (Second) Contracts.

161 S 472 of the Restatement (Second) of Contracts (similarly where he knowingly tells an untruth not expecting the other to rely and discover that he is relying); Keeton 1936 *Texas*

to a basic assumption upon which he is contracting,¹⁶² he has a duty to correct the mistake even if he did not cause it.¹⁶³ Under this heading come the numerous cases holding that the seller of goods, lands or securities is under an obligation to disclose latent defects. This is a very old doctrine, certainly prevalent in the early nineteenth century. "A sound price warrants a sound commodity" was the maxim.¹⁶⁴ But later in that century the phrase *caveat emptor* had thoroughly eradicated the earlier maxim.¹⁶⁵ Although the dust has not yet settled, it may safely be said that the older law once again prevails as to latent defects¹⁶⁶ although some citadels of *caveat emptor* remain.¹⁶⁷ Thus, in Massachusetts a seller of a house need not disclose that the house is infested with termites,¹⁶⁸ although he must disclose conditions dangerous to health and safety.¹⁶⁹

In most cases where the transaction involves the sale of goods, the question of non-disclosure is of no relevance inasmuch as the Uniform Commercial Code supplies an array of implied warranties granting the purchaser relief for defects in the goods, whether or not these are known

LR 1 at 6; Williston 12 1497 and 1499; s 161(a) of the Restatement (Second) of Contracts.

162 S 161(b) of the Restatement (Second) of Contracts.

163 *Davis v Reisinger* 120 App Div 766 105 NYS 603 (1st Dep't 1907); Williston 12 s 1497 and 1499.

164 Horwitz 1974 *Harvard LR* 917 at 926; Calamari & Perillo *Contracts* 367.

165 By 1873 a leading text could state that the maxim "a sound price implies a sound article" is peculiar to South Carolina. Calamari & Perillo *Contracts* 368.

166 *Neuman v Corn Exchange National Bank & Trust Co* 356 Pa 442 51 A2d 759 (1947), reargument refused 356 Pa 442 52 A 2d 177 (1947); Williston 12 s 1498; Prosser & Keeton *Torts* 736-40; Goldfarb 1956 *Western Reserve LR* 5 at 19.

167 Calamari & Perillo *Contracts* 368.

168 *Swinton v Whitinsville Savings Bank* 311 Mass 677 42 NE 2d 808 (1942); *contra*, *Obde v Schlemeyer* 56 Wn 2d 449 353 P 2d 672 (1960); *Williams v Benson* 3 Mich App 9 141 NW 2d 650 (1966), reversed 378 Mich 721 (1966); see, also, *Weintraub v Krobatsch* 64 NJ 445 317 A 2d 68 (1974) (roaches); *Greenberg v Glickman* 50 NYS 2d 489 (1944), modified 268 App Div 882 51 NYS 2d 96 (2d Dep't 1944), second appeal denied 268 App Div 987 51 NYS 2d 861 (2d Dep't 1944) (duty to disclose sub-surface water conditions); *De Meo v Horn* 70 Misc 2d 339 334 NYS 2d 22 (1972); *Lawson v Citizens & Southern National Bank of South Carolina* 259 SC 477 193 SE 2d 124 (1972) (filled earth); *Ollerman v O'Rourke Co Inc* 94 Wis 2d 17 288 NW 2d 95 (1980).

169 *Cutter v Hamlen* 147 Mass 471 18 NE 397 (1888) (child of prior tenant died of diphtheria because of defective drains); accord, *Cesar v Karutz* 60 NY 229 (1875) (prior tenant died of smallpox).

to the seller.¹⁷⁰ Thus the question whether non-disclosure constitutes a misrepresentation becomes significant primarily in those cases where warranties have been effectively disclaimed,¹⁷¹ or where the non-disclosure is by a buyer rather than by a seller.¹⁷² Although at common law there were no warranties attaching to a sale of real property other than those recited in the deed, there is a modern trend recognizing an implied warranty of habitability in the sale of new housing.¹⁷³

A fifth exception centres on the nature of the transaction. Contracts of insurance¹⁷⁴ are transactions in which, by long established precedent, broad duties of disclosure are required.

A sixth exception focuses upon the relationship of the parties. If there is a fiduciary or confidential relation between the parties, there is a duty of disclosure of material facts.¹⁷⁵ Indeed, the duty extends somewhat beyond such relationships. Whenever one party to a transaction justifiably believes the other is looking out for his interests, a duty of disclosure arises.¹⁷⁶

A broad duty of disclosure appears to be desirable.¹⁷⁷ The US Court of Claims appears to have gone far toward the adoption of such a principle. A government agency is required to disclose information in its possession which it knew that bidders did not have and would need in order

170 Ss 2-312 to 2-318 of the UCC.

171 S 2-316 of the UCC.

172 It is only rarely that a buyer is held to have a duty to disclose. See generally, Goldfarb, 1956 *Western Reserve LR* 5 at 26-31; Keeton 1936 *Texas LR* 1 at 22-27. If he fails to disclose material facts known to him, however, specific performance will be denied him. See Calamari & Perillo *Contracts* 369.

173 *Tassan v United Development Co* 88 Ill App 3d 581 43 Ill Dec 769 410 NE 2d 902 (1980); *Yepsen v Burgess* 269 Or 635 525 P 2d 1019 (Or 1974); see Williston 12 s 1506A; Demko 1983 *Illinois BJ* 724; Moskowitz 1974 *California LR* 1444; Wells 1971 *University of Florida LR* 626.

174 Keeton *Text* 326-28; Patterson *Insurance* ch 10.

175 S 161(d) of the Restatement (Second) of Contracts; Keeton 1936 *Texas LR* 1 at 11-14; Williston 12 s 1499. This rule is closely tied to and overlaps the doctrine of undue influence. Calamari & Perillo *Contracts* 369; *Village of Burnsville v Westwood Co* 290 Minn 159 189 NW 2d 392 (1971); *Jackson v Seymour* 193 Va 735 71 SE 2d 181 (Va 1952) (constructive fraud; could have been based on innocent misrepresentation).

176 S 472(c) of the Restatement (Second) of Contracts; Goldfarb 1956 *Western Reserve LR* 5 at 32-34; but see, the following case where a confidential relationship was required, *Grow v Indiana Retired Teachers Community* 149 Ind App 109 271 NE 2d 140 (Indiana 1971).

177 Calamari & Perillo *Contracts* 370.

to make an intelligent appraisal of the problems and costs that would be involved in the performance of the proposed contract.¹⁷⁸ Despite the desirability of a broad rule of disclosure an exception must, however, be made for collateral information deliberately acquired at some cost in time or money such as by scientific market research or careful investment analysis. The non-disclosure of such information is no breach of the obligation of good faith and fair dealing.¹⁷⁹

4.8.3 Disclosure principles relating to suretyship

4.8.3.1 Suretyship: introduction

In this sub-chapter I shall analyze disclosure principles relating to the contract of suretyship.¹⁸⁰ Defences based on fraud and misrepresentation are closely allied to the defence of non-disclosure; therefore some attention will be given to these defences as well. It is not only positive false statements made by the creditor to the surety which will give the latter grounds for avoiding his contract on the basis of fraud, but any concealment or misrepresentation of material facts, at the time the suretyship is executed, which affects the risk of the surety and which the creditor has the opportunity and the duty to disclose, will also be a defence to the surety.¹⁸¹

In the best of all possible worlds, a surety fully investigates the financial condition and technical ability of the principal debtor and takes all steps possible to assure itself prior to issuing the suretyship that the principal debtor will be able to comply with all his obligations. We do not live in the best of all possible worlds, however, and when a principal is at times unable to perform, his surety must step in and arrange for completion or pay the bills.

178 *TF Scholes Inc v United States* 357 F 2d 963 at 970 (1966), followed in *JA Jones Construction Co v United States* 390 F 2d 886 (1968).

179 See *Kronman & Posner Economics* 116-121; *L & N Grove Inc v Chapman* 291 So 2d 217 (Fla Dist Ct App 1974), dismissed 298 So 2d 412 (1974).

180 The terms "surety" and "guarantee" are often used as being synonymous, consistent with their treatment in the cases on this subject and the usage established in the comment to s 82 of the Restatement of Security. See, also, 68 Am Jur 2d *Guaranty* par 14; 74 Am Jur 2d *Suretyship* par 2.

181 *Griswold v Hazard* 141 US 260 35 L Ed 675 (1890); *Copper Process Co v Chicago Bonding & Insurance Co* 262 F 66 (1920); *Northwestern Jobbers Credit Bureau v National Surety Corp* 54 F Supp 716 (1944); *Guardian Fire & Life Assurance Co v Thompson* 68 Cal 208, 9 P 1 (1885); *Hier v Harpster* 76 Kan 1 90 P 817 (1907); *First Citizens Bank & Trust Co v Sherman's Estate* 294 NYS 131 (1937); *Herbert v Lee* 118 Tenn 133 101 SW175 (1906).

Suretyship has been defined as follows:¹⁸²

"a contractual relation resulting from an agreement whereby one person, the surety, engages to be answerable for the debt, default, or miscarriage of another, the principal. The surety's obligation is not an original and direct one for the performance of his own act, but is accessory or collateral to the obligation contracted by the principal."

Although not quite as clear, the Restatement of Security's¹⁸³ definition is similar:

"Suretyship is the relation which exists where one person has undertaken an obligation and another person is also under an obligation or other duty to the obligee, who is entitled to but one performance, and as between the two who are bound, one rather than the other should perform."

This chapter is devoted to a discussion of those situations in which a surety or the surety's principal attempts to rescind its suretyship or relieve himself/herself/itself of his/her/its obligations thereunder by asserting fraud, misrepresentation or, particularly, non-disclosure¹⁸⁴ on the part of the principal debtor of the creditor, and whether and in what circumstances this remedy or defence is allowed.¹⁸⁵

4.8.3.2 The conduct of the principal debtor

The surety's assertion of a defence to a claim under a suretyship or performance bond on the ground that the principal debtor has perpetrated a fraud on the principle debtor's surety is an extremely difficult defence to sustain. Fraud by the principal debtor alone is not a defence to a claim by a creditor.¹⁸⁶ As a general rule, the principal's fraud on the surety has no effect on the surety's obligation to the creditor unless the creditor has participated in the fraud or concealed

182 *Meek v Gratzfeld* 233 Neb 306 at 313 389 NW 2d 300 at 305 (1986), citing *Nicklaus v Phoenix Indemnity Co* 166 Neb 438 at 445 NW 2d 258 at 262 (1958).

183 S 82 of the Restatement of Security. The comment to this section goes on to state that the suretyship situation always involves three parties.

184 74 Am Jur 2d *Suretyship* par 128.

185 *Ibid*, par 127.

186 *Ibid*, par 133.

material facts from the surety when it was his duty to disclose them.¹⁸⁷

It should be noted that fraud practiced on the principal by the obligee can be a defence for the surety. If the principal's obligation is void, the surety should be relieved of performing because otherwise either the principal would be made to satisfy indirectly an obligation which is void or the surety's right of reimbursement is destroyed.¹⁸⁸ Either result is contrary to the principles of suretyship.

4.8.3.3 Fraud, misrepresentation and non-disclosure by creditor

4.8.3.3.1 The Restatement of Security

A surety has virtually no defence based on a fraud perpetrated upon the surety by the principal debtor, but if the creditor has perpetrated a fraud or assisted in the perpetration of the fraud by the principal debtor upon the surety, a defence becomes more viable.

Most cases which address the defence of fraud by a creditor adopt the Restatement rule. Section 124 of the Restatement of Security sets forth the basic principle applicable to situations in which a creditor defrauds a surety.¹⁸⁹

"(1) Where before the surety has undertaken his obligation the creditor knows facts unknown to the surety that materially increase the risk beyond that which the creditor has reason to believe the surety intends to assume, and the creditor has also reason to believe that these facts are unknown to the surety and has a reasonable opportunity to communicate them to the surety, failure of the creditor to notify the surety of such facts is a defense to the surety.

187 74 Am Jur 2d *Suretyship* par 133; s 119 of the Restatement of Security. See, also, *St Charles National Bank v Ford* 39 Ill App 3d 291 349 NE 2d 430 (1976); *Re Estate of Polevski* 452 A 2d 469 (1982).

188 S 118 of the Restatement of Security.

189 S 124 of the Restatement of Security. See, eg, *Sumitomo Bank of California v Iwasaki* 70 Cal 2d 81 73 Cal Rptr 564 447 P 2d 956 (1968); *First National Bank and Trust Company of Racine v Notte* 97 Wis 2d 207 293 NW 2d 530 (1980); *Peoples National Bank of Washington v Taylor* 42 Wash App 518 711 P 2d 1021 (1985); *St Charles National Bank v Ford* 39 Ill App 3d 291 349 NE 2d 430 (1976); *St Paul Fire & Marine Insurance Co v Commodity Credit Corporation* 646 F 2d 1064 (5th Circuit 1981); *Georgia-Pacific Corporation (Williams Furniture Division) v Levitz* 149 Ariz 120 716 P 2d 1057 (1986); *Security Bank NA v Mudd* 215 Mt 242 696 P 2d 458 (1985); Annotation 1986 ALR 678.

(2) Where, during the existence of the suretyship relation, the creditor discovers facts unknown to the surety which would give the surety the privilege of terminating his obligation to the creditor as to liability for subsequent defaults, and the creditor has reason to believe these facts are unknown to the surety and has a reasonable opportunity to communicate them to the surety without a violation of a confidential duty, the creditor has a duty to notify the surety, and breach of this duty is a defense to the surety except in respect of his liability for defaults which have occurred before such disclosure should have been made."

The comments to the Restatement emphasize that the rule is merely a special application in suretyship of the rule that fraud creates a defence.¹⁹⁰ The comments also recognize that difficulty is encountered in determining the materiality of the allegedly concealed facts.¹⁹¹ The creditor is not required to investigate for the surety's benefit or take any unusual steps to make sure that the surety is acquainted with facts which the creditor assumes are known to both the surety and the creditor.¹⁹²

"[Even though] ... there is often considerable difficulty in ascertaining the precise degree of knowledge of surety and creditor and even in determining the materiality of the facts alleged to be concealed, the rule itself is simple. It does not place any burden on the creditor to investigate for the surety's benefit."¹⁹³

The surety himself must exercise reasonable diligence in an effort to ascertain the circumstances of the transaction and the principal debtor's condition, and, if there are suspicious circumstances, he should make inquiry about these.¹⁹⁴

The comments then go on to set forth examples of material facts.

190 Comment to s 124 of the Restatement of Security, at 328.

191 74 Am Jur 2d *Suretyship* par 131.

192 74 Am Jur 2d *Suretyship* par 129.

193 Comment to s 124 of the Restatement of Security, at 328.

194 A few cases have held that where a bond is involved, the creditor has no duty to make disclosure to a prospective surety unless the latter makes inquiry of him. See *Couch v Stout* 194 Ark 385 107 SW(2d) 351 (1937); *Larmore v Peoples State Bank* 206 Ind 66 188 NE 317 (1934); *Re Tabasinski's Estate* 228 Iowa 1102 293 NW 578 (1940); *Wait v Homestead Bldg Assn* 76 W Va 431 85 SE 637 (1915); 74 Am Jur 2d *Suretyship* par 130.

"Among facts that are material are the financial condition of the principal, secret agreements between the parties, or the relations of third parties to the principal. If the surety requests information, the creditor must disclose it. Where he realizes that the surety is acting or is about to act in reliance upon a mistaken belief about the principal in respect of a matter material to the surety's risk, he should afford the surety the benefit of his information if he has an opportunity to do so."¹⁹⁵

The comments state that there may be a lesser burden on an obligee to notify a compensated surety because compensated sureties are supposed to undertake an investigation prior to taking on an obligation.¹⁹⁶

For the most part, the decisions which adopt the Restatement rule turn upon the information which the creditor failed to disclose to the principal. All discuss at some length the creditor's duty to a surety.

From a banking perspective, it should be remembered that a bank may incur liability based on various tort theories, such as fraud.¹⁹⁷ If the lender's representation involves a promise to perform an act in the future, the borrower must prove that, at the time the bank's representative made the promise, the bank had no intention of performing the act.¹⁹⁸ The intent not to perform an act in the future as promised may be proven by circumstantial evidence.¹⁹⁹

Finally, a representation that is literally true is actionable as fraud if it is used to create an impression that is substantially false.²⁰⁰

195 Comment to s 124 of the Restatement of Security, at 328-329.

196 *Ibid*, at 329.

197 See *Bank of El Paso v (TO) Stanley Boot Co* 847 SW 2d 218 at 222 (Tex1992); *State National Bank of El Paso v Farah Manufacturing Co* 678 SW 2d 661 at 681 (Tex App 1984). See, also, *Banco do Brasil SA v Latian Inc* 234 Cal App 3d 973 285 Cal Rptr 870 at 896 (Cal Ct App 1991), where it was held that, in order to recover for fraud against a lender under California Law, the borrower must prove (1) that the lender made a representation including a promise made without the intent to perform; (2) knowledge of the representation's falsity; (3) an intent to defraud; that is, to induce reliance; (4) justifiable reliance on borrower's part; and (5) resulting damage.

198 *Bank of El Paso v (TO) Stanley Boot Co* 847 SW 2d 218 at 222 (Tex 1992).

199 *State National Bank of El Paso v Farah Manufacturing Co* 678 SW 2d 661 (Tex 1984)

200 *Commonwealth Mortgage Corporation v First Nationwide Bank* 873 F 2d 859 (5th Circuit1989); *State National Bank of El Paso v Farah Manufacturing Co* 678 SW 2d 661 at 681 (Tex App1984).

Fraudulent practice typically is asserted in connection with a lender's promises of benefits in exchange for security,²⁰¹ groundless threats,²⁰² misrepresentation concerning the effect of loan documents,²⁰³ failure to disclose information in order to protect its own interests,²⁰⁴ giving improper advice to a borrower²⁰⁵ and falsely representing that it has done or will do something for the borrower.²⁰⁶

For example, in *State National Bank Bank of El Paso v Farah Manufacturing Co*²⁰⁷ allegations of fraud focused on the lender's representation that a default would be declared and the borrower bankrupted and locked up if William Farah, rather than the lender's preferred candidate, was elected CEO of the borrower. The failure of the lenders to explain their intention when they knew it was capable of two interpretations, one false (the declaration of default upon William Farah's election), was actionable fraudulent conduct: "[W]here a promise regarding future action is made with the intent that it will not be performed and is made to deceive a person, then it is actionable as a fraudulent representation."²⁰⁸

201 See, eg, *Dean W Knight & Sons Inc v First W Bank & Trust Co* Cal App 2d 148 Cal Rptr 767 (Cal Ct App 1978). But see *Centerre Bank of Kansas City NA v Distributors Inc* 705 SW 2d 42 (Mo Ct App 1985).

202 See, eg, *Loyola Federal Savings & Loan Association v Galanes* 365 A 2d 580 (Md Ct Spec App 1976); *State National Bank of El Paso v Farah Manufacturing Co* 678 SW 2d 661 at 681 (Tex App 1984).

203 See, eg, *Holm v Sun Bank/Broward NA* 423 So 2d 1007 (Fla Dist Ct App 1982); *Lee v The Heights Bank* 446 NE 2d 248 (Ill App Ct 1985).

204 See, eg, *Merrill Lynch Pierce Fenner & Smith Inc v First National Bank of Little Rock Arkansas* 774 F 2d 909 (8th Circuit 1985); *General Motors Acceptance Corporation v Central National Bank Mattoon* 773 F 2d 771 (7th Circuit 1985); *Central States Stamping Co v Terminal Equip Co Inc* 727 F 2d 1405 (6th Circuit 1984).

205 *Banco Totta e Acores v Fleet National Bank* 768 F Supp 943 (DRI 1991); *United Companies Financial Corporation v Brown* 584 So 2d 470 (Ala 1991); *Rainsville Bank v Willingham* 485 So 2d 319 (Ala 1986); *Nie v Galena State Bank & Trust Co* 387 NW 2d 373 (Iowa Ct App 1986); *Shogyo International Corporation v First National Bank of Clarksdale* 475 So 2d 425 (Miss 1985).

206 See eg, *Richter v Bank of America National Trust and Savings Association* 939 F 2d 1176 (5th Circuit 1991); *General Motors Acceptance Corporation v Covington* 586 So 2d 178 (Ala 1991); *First Federal Savings & Loan Association v Caudle* 425 So 2d 1050 (Ala 1982); *Frame v Boatmen's Bank* 782 SW 2d 117 (Mo Ct App 1989); *Commerce Savings Scottsbluff Inc v FH Schafer Elevator Inc* 436 NWd 151 (Neb 1989).

207 678 SW 2d 661 at 681 (Tex App 1984).

208 *Ibid*, at 682.

The *Farah*²⁰⁹ case involved a form of promissory misrepresentation by the lender. A lender's conduct may also give rise to a form of fraud known as constructive fraud. Constructive fraud is the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests.²¹⁰ Constructive fraud most commonly arises in lender liability where a confidential or fiduciary duty has arisen between the lender and borrower or where the lender engages in overreaching. Ordinarily, however, such a special relationship does not exist between a borrower and a lender, and where one has been found it has rested on extraneous facts and conduct, such as excessive lender control over or influence in the borrower's activities.²¹¹

4.8.3.3.2 Material facts — relating to risk assumed

The leading case in the USA in which a surety alleged the fraud of the principal debtor, is *Sumitomo Bank of California v Iwasaki*.²¹² The court in this case followed the Restatement²¹³ rule cited above. Here, the defendants executed a continuing guarantee agreement guaranteeing all future and present indebtedness of Miku and Yo Nagayama. The plaintiff brought this action to recover the amounts which the Nagayamas owed on three loans, one of which was made several months after the defendants executed the continuing guaranty. The trial court held that the defendant was discharged from liability on the third loan by plaintiff's failure to disclose to the defendant surety that the Nagayamas needed the loan to pay their federal taxes.²¹⁴

The appeals court reversed the trial court's decision, finding that the plaintiff's failure to inform the defendant surety that the Nagayamas required a loan to pay their federal taxes did not constitute a breach of the plaintiff's duty to disclose material information so as to discharge the defendant surety from liability on the third loan. The court starts off by saying that:

"In all suretyship relations, the creditor owes to the surety a duty of continuous good faith

209 *Ibid.*

210 *Greater Southwest Office Park Ltd v Texas Commerce Bank National Association* 786 SW 2d 386 at 391 (Tex App 1990).

211 *Cara Corporation v Continental Bank (In re Cara Corporation)* 148 BB 760 (Bankr ED Pa 1992); *Greater Southwest Office Park Ltd v Texas Commerce Bank National Association* 786 SW 2d 386 at 391 (Tex App Houston 1st Dist 1990) writ denied.

212 70 Cal 2d 81 73 Cal Rptr 564 447 P 2d 956 (1968).

213 S 124 of the Restatement of Security.

214 *Ibid.*, at 958.

and fair dealing... Thus, the creditor must not misrepresent or conceal facts so as to induce or permit the surety to enter or continue in the relationship in reliance on a false impression as to the nature of the risk."²¹⁵

But it then goes on to discuss the history of this defence, and its development in the fidelity suretyship context and then distinguishes the suretyship relation in the case before it from the fidelity suretyship situation. The court stated that in fidelity suretyship situations, American courts appear to have adopted the rule which imposes an absolute duty upon the creditor voluntarily to disclose all facts materially affecting the surety's risk on a fidelity bond.²¹⁶ The creditor in the *Sumitomo Bank*²¹⁷ case, however, did not owe "an absolute duty to the surety to disclose, without request by the surety, all facts within its knowledge which may affect the surety's risk".²¹⁸

A creditor such as a bank is often in no better position than the surety to acquire information about the financial condition of the debtor. Particularly in those cases in which the surety assumes the risk at the debtor's request, rather than at the creditor's, the creditor may reasonably assume that the surety will acquire from the debtor himself all information which he reasonably believes to be relevant to the risk.²¹⁹

The court discusses s 124 of the Restatement of Security and applied this section to the evidence in the case and concluded that the surety had no defence against the plaintiff's claim.

Although the evidence established that the plaintiff knew about the Nagayamas' inability to pay their federal taxes without a loan, the evidence could not establish that the plaintiff had reason to believe that this fact materially increased the risk beyond that which defendant intended to assume. The evidence could not establish this condition because the evidence did not disclose the financial condition of the Nagayamas in July 1961, when defendant executed the guaranty. As a result no evidence described the risk defendant intended to assume, or indicated whether plaintiff had reason to know what risk defendant intended to assume. Thus the evidence could not support a finding that the Nagayamas' inability to pay the taxes without a loan materially

215 *Ibid*, at 959.

216 See, eg, *Larmore v Peoples State Bank* 206 Ind 66 188 NE 317 (1934).

217 70 Cal 2d 81 73 Cal Rptr 564 447 P 2d 956 (1968).

218 *Ibid*, at 960.

219 *Ibid*, at 961.

increased defendant's risk. *A fortiori*, it could not support a finding that plaintiff had reason to believe this fact materially increased defendant's risk.²²⁰

The creditor's duty to the surety is certainly not a fiduciary duty. In fact, it appears that the creditor has no duty to advise a surety of facts which the creditor assumes the surety knows. Failure to disclose pertinent information would not seem to be the strongest basis upon which a surety can assert a defence.²²¹

*First National Bank and Trust Company of Racine v Notte*²²² is another decision which specifically adopted the Restatement rule²²³ and discusses at some length the creditor's duty to the surety. In this case, Notte, the surety, guaranteed a loan made to the principal, after the creditor bank had advised Notte that the principal's credit record was good and that she had always paid her loans. Unknown to Notte, part of the proceeds of the loan which Notte guaranteed was used to pay off the principal's indebtedness on a prior loan. The court in this case discussed the duty which a creditor owes to a surety.

"Although the creditor owes a surety a duty of continuous good faith and fair dealing, there is no general obligation imposed upon the creditor to disclose to the surety all matters which the creditor knows might affect the surety's risk. There are, however, circumstances under which the creditor may be required to make disclosure and the failure to do so will discharge the surety. In such circumstances it is not necessary that the concealment or the failure to disclose facts material to the surety be willfully done by the creditor, or that the creditor have the intent to deceive. The motive behind the concealment or misrepresentation is immaterial...Although the surety is considered 'a favorite of the law,' the relationship between the creditor and the surety does not in itself give rise to strict fiduciary obligations."²²⁴

The court differentiates the defence based on whether the creditor simply failed to disclose facts from that where the creditor actively concealed information and notes that if a surety specifically requests information from the creditor, the creditor should respond by answering fully and

220 *Ibid*, at 966.

221 *Ibid*, at 966.

222 97 Wis.2d 207 293 NW 2d 530 (1980).

223 S 124 of the Restatement of Security.

224 *Ibid*, at 534.

truthfully. The creditor's failure to disclose to the promisor everything within his knowledge that is material to the matter, will be equivalent to an affirmative misrepresentation and will give the surety the right to avoid his agreement.²²⁵

In *Peoples National Bank of Washington v Taylor*²²⁶ the surety's defence was based on the fact that the creditor bank had failed to disclose to him and his agent facts which were material to his decision to undertake the guaranty. The surety in this case guaranteed \$17,000 of a \$58,888 loan which the creditor made to the purchaser of the surety's boat. Prior to making the loan, the creditor bank obtained a credit report on the purchaser. The purchaser's rating was the highest obtainable, although two creditors indicated that for the previous five months, the purchaser was 30 to 60 days behind schedule. The down payment for the purchase of the boat was to come from the proceeds of the sale of the purchaser's house. Because the sale of the house was taking longer than anticipated, the creditor loaned the purchaser the down payment. This loan for the down payment was ultimately paid off when the house was sold.

When the surety and creditor met to discuss the possibility of a suretyship, the creditor told the surety that the purchaser's down payment was to come from the proceeds of the sale of his home, that the percentage of the purchaser's income to be used for loan payments exceeded the creditor's normal credit standards, and that the creditor did not feel secure about the purchaser as a credit risk because the purchaser had only been living and working in the area a short while. The surety also badly needed to sell his boat and, if it had to be sold quickly to some other purchaser, it would sell for about \$50,000 as opposed to the current \$75,888 sale price.²²⁷ The purchaser eventually defaulted on the loan which the creditor had made to him; the creditor attempted to collect on the surety's suretyship and thus litigation ensued. The surety claimed that the creditor had failed to disclose the details of the transactions surrounding this guaranty, namely

225 See, also, *Cook v Heinbough* 202 Iowa 1002 210 NW 129 (1926); *Peoples State Bank v Hill* 210 Ky 222 275 SW 694 (1925); *Harrison v Lumbermen Insurance Co* 8 Mo App 37 (1879); *Putney v Schmidt* 16 NM 400 120 P 720 (1911); *Damon v Empire State Surety Co* 161 App Div 875 (1914); *Lauer Brewing Co v Riley* 195 Pa 449 46 A 71 (1900); *Goodwin v Abilene State Bank* 294 SW 883 (Tex Civ App 1927); *Brillion Lumber Co v Barnard* 131 Wis 284 111 NW 483 (1907).

Where, however, the surety's inquiry is made of an official who has no authority or duty to give the information requested, and who answers falsely, the surety will not be relieved of liability. See *American Surety Co of New York v Pauly* NO 170 US 133 42 L Ed 977 (1897); *Independent School District of Sioux City v Hubbard* 110 Iowa 58 81 NW 241 (1899); *United States Fid & Guar Co v Commonwealth* 31 Ky L Rep 1179 104 SW 1029 (1907); *Commonwealth v Ramsey* 314 Pa 508 171 A 575 (1934).

226 42 Wash App 518 711 P 2d 1021 (1985).

227 *Ibid*, at 1023.

the loan for the down payment.

Both parties in this case cited s 124(1) of the Restatement of Security in support of their respective positions. The court quoted the comment to s 124 of the Restatement of Security concerning the creditor's duty to the surety, that is, that the creditor does not have to take any unusual steps to assure himself that the surety is acquainted with facts which he may assume are known to both surety and creditor but that if the surety requests information, the creditor must disclose it.²²⁸ Here, the court said that the evidence did not establish that the creditor had reason to believe that loaning the principal the down payment materially increased the risk which the surety intended to assume. The court stated that neither the surety nor his attorney inquired as to the source of the down payment or the principal's financial stability. The court emphasized that sureties, in particular compensated sureties, have a responsibility to inquire about the risk they are to undertake. There was no evidence that the creditor misrepresented or concealed facts so as to induce or permit the surety "to guarantee the loan in reliance on a false impression as to the nature of the risk".²²⁹

In *St Charles National Bank v Ford*²³⁰ the defendant surety claimed that when he guaranteed five loans which the creditor bank had made to the principal debtor, he was not aware or advised by the Bank that the principal debtor had other outstanding loans. The court found that this argument was without merit.

"There is nothing in the mere nature of the contract of suretyship itself which requires the obligee to disclose to the proposed surety all the material facts affecting the risk. There must be a duty on the part of the obligee to make the disclosure; in the absence of such a duty in the circumstances of the particular case, the surety will not be released merely because he did not have the information which the obligee possessed....

If the creditor knows that the surety is acting on a belief that there are no unusual circumstances by which his risk is materially increased, whereas, to the knowledge of the creditor, there are such circumstances, and he has opportunity to make them known, good faith and fair dealing demand that there should be a full disclosure if the surety is to be held liable. But while the obligee must act in entire good faith, the surety has no right ordinarily to rely for information upon the obligee's duty to make disclosure of all the

228 *Ibid*, at 1026.

229 *Ibid*, at 1028.

230 39 Ill App 3d 291 349 NE 2d 430 (1976).

facts affecting the risk, but must himself make inquiry. Particularly in cases, as here, in which the surety assumes the risk at the debtor's request, rather than at the creditor's, the creditor may reasonably assume that the surety will acquire from the debtor himself all information which he reasonably believes to be relevant to the risk."²³¹

Most of the decisions in which this defence is discussed contain similar terminology.²³² Not all cases, however, have rejected this defence by the surety. In *St Paul Fire & Marine Insurance Co v Commodity Credit Corporation*²³³ the creditor failed to advise the compensated sureties on a bond assuring performance by the principal debtor under a cooperative loan agreement, that the creditor had released collateral or that the principal was experiencing serious financial problems. The lower court had found that the sureties relied on the creditor to provide them with information concerning the principal's financial condition and the sureties, in fact, had no knowledge of the problems. The fifth Circuit stated that although the creditor has no duty to disclose information to the surety which the surety has not requested, the creditor cannot withhold information which the surety has requested.²³⁴ It then went on to say that:

"In some respects, however, the suretyship bond is fragile, easily broken by the conduct of the creditor. The validity of the contract may be vitiated *ab initio* by the creditor's actions during its creation. A creditor who, during negotiations, actively and fraudulently conceals pertinent facts cannot then turn to the surety for reimbursement."²³⁵

The court found that the sureties had no knowledge of the principal debtor's condition and that the creditor should have known that the sureties would not have issued their bonds had they known of the problems. The sureties, therefore, had a complete defence to liability.²³⁶

Two fairly recent decisions which touch peripherally on this defence and which involve

231 *Ibid*, at 434.

232 See, also, *Meek v Gratzfeld* 233 Neb 306 389 NW 2d 300 (1986); *Maine National Bank v Fontaine* 456 A 2d 1273 (1983 Me).

233 646 F 2d 1064 (5th Circuit 1981).

234 *Ibid*, at 1072-1073.

235 *Ibid*, at 1073.

236 *Ibid*, at 1074. For other discussions relieving the surety from liability, see *Security Bank NA v Mudd* 215 Mt 242 696 P 2d 458 (1985); *Georgia-Pacific Corporation (Williams Furniture Division) v Levitz* 149 Ariz 120 716 P 2d 1057 (1986).

performance bond sureties should be noted. Even though *Ransom v United States*²³⁷ does not involve the defence of fraud by a creditor, it does discuss the creditor's duty to a surety in a contract bond situation. In this case, Ransom contracted to serve as surety on a bid bond and payment and performance bond submitted to the government by A Marvin Company Diversified, Inc, who was the lowest bidder on a contract to rehabilitate housing units located at Edwards Air Force Base in California. Marvin's bid was approximately \$1,7 million lower than the government's estimate of the cost. The government, therefore, asked Marvin to confirm the bid price, which Marvin did in writing. The contract officer made a written request that Marvin confirm the bid or notify the government of a mistake. Marvin then reported an error of \$496,234 but two weeks later advised the government that the error was actually only \$386,440 and requested that the bid be increased by that amount. The Judge Advocate concluded that there was a *bona fide* error but that there was no clear and convincing evidence as to the intended amount of the bid. He gave Marvin the opportunity to withdraw its bid but not to reform it. Marvin indicated that it would perform the contract for the originally submitted bid price and was awarded the contract on September 25, 1980. Ransom, apparently, was unaware of the mistake in the bid. Marvin received progress payments through June 8, 1981. On July 24, 1981, Ransom was notified that the government was concerned about default by Marvin. The government terminated Marvin's contract for default on October 26, 1981. Ransom took over the project and ultimately submitted a claim for money damages for its costs in completing the contract. Ransom asserted that the surety relationship between him and the government, "inherently included covenants of good faith and fair dealing" which the government allegedly breached when it failed to notify Ransom of Marvin's option to withdraw its bid.²³⁸

The court held that Ransom had no claim against the government.

"Ransom asserts that an express contract existed among the government, Marvin and Ransom, because of the written contract the government and Marvin executed creating implied obligations to Ransom that the government deal fairly and in good faith with Ransom... We conclude that on these facts no express contract was intended by the parties to this suit and none existed..."²³⁹

Arguably, therefore, even though a suretyship agreement involves a three-party relationship, the creditor has very few obligations to the surety.

237 900 F 2d 242 (Fed Circuit 1990).

238 *Ibid*, at 243.

239 *Ibid*, at 244.

In *Brinderson-Newberg Joint Venture v Pacific Erectors Inc*²⁴⁰ one of the many claims and cross-claims among the various parties in a dispute between a general contractor and one of its subcontractors was the defence asserted by the subcontractor's surety that the general contractor had made false representations concerning the subcontractor's scope of work which induced the surety to bind himself. The court ruled in favour of the general contractor, holding that the evidence upon which the surety relied to support this defence was inadmissible under the parol evidence rule.²⁴¹

Both the *Ransom*²⁴² and the *Brinderson-Newberg*²⁴³ decisions highlight the difficulties a surety has in successfully asserting the defence of fraud, misrepresentation or non-disclosure on the part of the creditor. In terms of the *Ransom* case which does seem to be an aberration, a creditor does not even have a duty to deal fairly and in good faith with the surety. Presumably, this defence would not be asserted often because the creditor usually does not provide information to the surety concerning the principal. Of course, this defence could be asserted in a situation where a creditor is aware that a principal debtor has had problems in completing other contracts with the creditor. In this situation, the creditor probably would have the obligation to disclose to the surety its problems with the principal if the surety had never written bonds for this principal and if the surety had inquired of the creditor as to the principal debtor's performance record as far as other contracts were concerned which the creditor had entered into with the principal. The creditor, however, would not necessarily have the obligation to advise the surety voluntarily of the problems. The presumption is that the surety (which in all likelihood would be a compensated surety) should have learned of his principal's performance record during his investigations.²⁴⁴

4.8.3.3.3 Knowledge of creditor

Where the surety makes no inquiry and the creditor makes no voluntary disclosure of facts which would materially increase the risk, the surety cannot escape liability unless the creditor knew that the surety was acting in the belief that there were no unusual circumstances and the creditor had

240 971 F 2d 272 (9th Cir 1992).

241 *Ibid*, at 282.

242 900 F 2d 242 (Fed Circuit) 1990).

243 971 F 2d 272 (9th Circuit 1992).

244 See Gallagher (ed) *Suretyship* 5-16.

an opportunity to disclose the true facts.²⁴⁵

The surety will not be discharged if the undisclosed facts were not known to the creditor. Fraud will not be imputed to the creditor because of his negligence or inattention to his own affairs resulting in a lack of knowledge of facts which may materially affect the suretyship risk.²⁴⁶

Of interest to the suretyship relationship where banks are involved, is the general approach of American Courts in terms of which they hold that the creditor is not required voluntarily to communicate to the prospective surety matters concerning the financial responsibility of the principal, unless the surety makes specific inquiries regarding the point.²⁴⁷

Where, however, a banker has a duty to disclose but fails to do so in order to protect his own interests, he may incur liability in tort.²⁴⁸

245 *Griswold v Hazard* 141 US 260 35 L Ed 675 (1890); *Magee v Manhattan Life Insurance Co* 92 US 93 23 L Ed 699 (1876); *San Francisco v Staude* 92 Cal 560 28 P 778 (1892); *Benton County Savings Bank v Boddicker* 105 Iowa 548 75 NW 632 (1898); *Gano v Farmers Bank* 103 Ky 508 45 SW 519 (1898); *Lachman v Block* 47 La Ann 505 17 So 153 (1895); *Bryant v Crosby* 36 Me 562 (1853); *Powers Dry-Goods Co v Harlin* 68 Minn 193 71 NW 16 (1897); *Bridges v Miller Rubber Co* 150 Md 1 132 A 271 (1926); *State Savings and Trust Co v Grady* 20 O App 385 153 NE 238 (1923); *Johnson v Ivey* 4 Coldw (Tenn) 608 (1867); *Goodwin v Abilene State Bank* 294 SW 883 (Tex Civ App 1927); *Jungk v Holbrook* 15 Utah 198 49 P 305 (1897); *Connecticut General Life Insurance Co v Chase* 72 Vt 176 47 A 825 (1900); *Associated Indemnity Corporation v Del Guzzo* 195 Wash 487 81 P 2d 516 (1938).

246 *Anaheim Co v Parker* 101 Cal 483 35 P 1048 (1894); *Hudson v Miles* 185 Mass 582 71 NE 63 (1904); *Bowne v Mt Holly Bank* 45 NJ Law 360 (1883); *Wayne v Bank* 52 Pa 343 (1866); *Brillion Lumber Co v Barnard* 131 Wis 284 111 NW 483 (1907); but see *Graves v Lebanon National Bank* 10 Bush (Ky) 23 (1873).

247 *Magee v Manhattan Life Insurance Co* 92 US 93 23 L Ed 699 (1876); *Hardeman v Harris* 7 How (US) 726 12 L Ed 889 (1849); *Ham v Greve* 34 Ind 18 (1870); *Bank of Monroe v Gifford* 72 Iowa 750 32 NW 669 (1887); *Sebald v Citizens Deposit Bank* 31 Ky L Rep 1244, 105 SW 130 (1907); *First National Bank v Johnson* 133 Mich 700 95 NW 975 (1903); *Molin v New Amsterdam Casualty Co* 118 Wash 208 203 P 8 (1922).

Therefore the creditor need not state that the surety is replacing another surety, or that the principal's property is about to be sold. See *North British Insurance Co v Lloyd* 10 Tex 523 (1854); *Smith v First National Bank* 107 Ky 257 53 SW 648 (1899). But if the surety requests information of the creditor regarding the solvency or credit of the principal, the creditor must disclose all the facts affecting the risk, within his knowledge. See *Benton County Savings Bank v Boddicker* 105 Iowa 548 75 NW 632 (1898).

248 See *Merrill Lynch Pierce Fenner & Smith Inc v First National Bank Of Little Rock Arkansas* 774 F 2d 909 (8th Circuit 1985); *General Motors Acceptance Corporation v Central National Bank Mattoon* 773 F 2d 771 (7th Circuit 1985); *Central States Stamping Co v Terminal Equipment Co Inc* 727 F 2d 1405 (6th Circuit 1984).

4.8.3.4 The creditor's duty of disclosure to the surety after inception of suretyship

Because a suretyship relationship is often continuous, I consider it relevant to investigate, briefly, what the effect is on the duty of disclosure, of events occurring after the signing of the suretyship. It is interesting to look at the situation in the USA in this regard as the USA has a specific statute dealing with this problem. In this sub-chapter I shall analyze the State and federal cases in which the courts have expressly discussed a creditor's duty of disclosure to a surety after the inception of the suretyship, in accordance with the terms of s 124 of the Restatement of Security.²⁴⁹ Section 124(1) of the Restatement of Security speaks in terms of facts unknown to the surety that materially increase the risk beyond that which the creditor has reason to believe the surety intended to assume while s 124 (2) speaks in terms of facts unknown to the surety that would entitle the surety to terminate his or her obligation as to subsequent defaults. I do not include cases involving fidelity bonds or other bonds not specifically issued to guarantee credit, the sub-chapter being restricted to the continuing obligations of a creditor to one who agrees to be responsible for the repayment of the debts of another.

As a general rule there is no duty of disclosure owed by a creditor to a surety, in the absence of unusual circumstances.²⁵⁰ However, if the creditor knows that the surety is unaware of facts materially increasing the risk contemplated by the surety, then the creditor's duty of good faith and fair dealing requires full disclosure of such facts within his knowledge if the surety is to be held liable.²⁵¹ The cases in this sub-chapter involve the creditor's duty of disclosure after the inception of the suretyship according to the terms of s 124 of the Restatement of Security.

Although, by its terms, s 124(1) of the Restatement of Security applies before the suretyship has been undertaken, it was intended to be used also after the inception of the suretyship in cases where the surety has agreed to guarantee successive extensions of credit,²⁵² and courts have applied it in this way, based on the theory that a continuing guaranty of credit is actually a continuing offer accepted by the creditor after each new extension of credit, resulting in a series of suretyship contracts.²⁵³ In other cases involving continuing guaranties of credit, courts have

249 Cases following the terminology of s 124 of the Restatement of Security are included, even if they do not expressly refer to that provision.

250 See cases cited above; 74 Am Jur 2d *Suretyship* par 128.

251 *Ibid*, at 129.

252 Comment c to s 124(1) of the Restatement of Security.

253 See, eg, *Sumitomo Bank of California v Iwasaki* 70 Cal 2d 81 73 Cal Rptr 564 447 P 2d 956 (1968).

followed the language of s 124 (1) on the reasoning that the surety's consent to a renewal of the note,²⁵⁴ or to a release of collateral,²⁵⁵ is invalid if the creditor has breached its duty of disclosure.

Section 124 (2) is expressly applicable during the existence of the suretyship, and imposes a continuous duty on the creditor to inform the surety of facts that would give the surety the privilege of terminating any obligation to the creditor as to subsequent defaults by the debtor, if the creditor had reason to believe that these facts were unknown to the surety and had reasonable opportunity to communicate them to the surety without violating a confidential duty. However, this subsection was not intended to apply to successive extensions of credit on a continuing guaranty, but only to suretyships containing express reservations of the surety's power to terminate the contract on the happening of certain events, as is generally true in fidelity bonds, or as may be implied from other types of surety contract.²⁵⁶ Although guaranties of credit do not generally contain such terms, sureties have nevertheless attempted, without success, to use s 124(2) of the Restatement of Security as a basis for a defence to liability on credit guaranties.²⁵⁷

Most courts that have considered the applicability of the terms of s 124 of the Restatement of Security to situations arising after the suretyship has been initiated, have recognized the creditor's duty of disclosure. In some circumstances, including the creditor's awareness of the surety's mistake, the surety's justifiable expectation regarding the use of collateral to satisfy the debtor's obligation,²⁵⁸ and the surety's reliance on the creditor's promise to help the debtor obtain other financial assistance,²⁵⁹ the courts have found that the duty was breached, or that a sufficient foundation was laid to require consideration of the issue.²⁶⁰

254 *Maine National Bank v Fontaine* 456 A 2d 1273 (1983 Me).

255 *McHenry State Bank v Y & A Trucking Inc* 454 NE 2d 345 (1983 Ill App 2d Dist).

256 Comment e to s 124 of the Restatement of Security.

257 *Warren v Washington Trust Bank* 19 Wash App 348 575 P 2d 1077 (Wash 1978); *State of New York v Peerless Insurance Co* 67 NY 2d 845 501 NYS 2d 651 492 NE 2d 779 (NY 1986).

258 *Security Bank NA v Mudd* 215 Mt 242 696 P 2d (1985).

259 *Maine National Bank v Fontaine* 456 A 2d 1273 (1983 Me).

260 See, also, *Georgia-Pacific Corporation (Williams Furniture Division) v Levitz* 149 Ariz 120 716 P 2d 1057 (1986); *McHenry State Bank v Y & A Trucking Inc* 454 NE 2d 345 (1983 Ill App 2d Dist); *Morris v Columbia National Bank of Chicago* 79 Banker 777; *Maine National Bank v Fontaine* 456 A 2d 1273 (1983 Me); *Security Bank NA v Mudd* 215 Mt 242 696 P 2d 458 (1985).

In other circumstances,²⁶¹ including inadequate showing of the risks contemplated by the surety at the outset,²⁶² and non-disclosure of immaterial facts,²⁶³ the court held that the duty was not shown to have been breached. In *State of New York v Peerless Insurance Co*²⁶⁴ the court refused to recognize s 124 of the Restatement of Security as authority for imposing any duty of disclosure on the part of the creditor; however, the surety in that case, unlike those in the other cases referred to in this sub-chapter, was a surety company that was compensated for its bond,²⁶⁵ and thus did not enjoy the favored status that the courts have often attributed to gratuitous sureties.²⁶⁶

Briefly, although a creditor's duty of disclosure subsequent to the formation of a suretyship contract has been recognized by most courts, the question whether the duty has been breached depends on the particular circumstances of each case. It is clear that the duty does not include a responsibility by the creditor to conduct an investigation for the surety's benefit,²⁶⁷ but when the creditor is chargeable with knowledge of facts increasing the surety's contemplated risk, awareness of the surety's ignorance of those facts, and an opportunity to notify the surety, then the elements of a defence for the surety based on the creditor's non-disclosure are present.

261 *Bank of Santa Ana v Molina* 1 Cal App 3d 607 81 Cal Rptr 885 (1969 4th Dist); *American Security Bank v Clarno* 151 Cal App 3d 874 199 Cal Rptr 127 (4th Dist 1984); *Kawasaki Motors Corp USA v Navratil Ct App 3d Dist No 5-84-26* (1985 Ohio); *Warren v Washington Trust Bank* 19 Wash App 348 575 P 2d 1077 (Wash1978).

262 *Sumitomo Bank of California v Iwasaki* 70 Cal 2d 81 73 Cal Rptr 564 447 P 2d 956 (1968).

263 *Peoples National Bank of Washington v Taylor* 42 Wash App 518 711 P 2d 1021 (1985).

264 67 NY 2d 845 501 NYS 2d 651 492 NE 2d 779 (NY 1986).

265 *State of New York v Peerless Insurance Co* 67 NY 2d 845 501 NYS 2d 651 492 NE 2d 779 (NY 1986).

266 See 74 Am Jur 2d *Suretyship* par 256.

267 Comment b to s 124 of the Restatement of Security; *Kawasaki Motor Corp USA v Navratil Ct App 3d Dist No 5-84-26* (1985 Ohio).

4.8.3.5 Disclosure: conclusion

US courts have the advantage of legislation and the covenant of good faith to ameliorate the harshness of the law in regard to non-disclosure cases. However, the courts have tended to apply these legal tools conservatively.

In summary, although the defence of misrepresentation or concealment by the bank can be a viable defence, it is one which is difficult to sustain. The surety has the burden of investigating its principal's condition prior to undertaking an obligation. The bank has the duty to notify the surety of information which the bank thinks the surety should know, but does not know. In order to assert this defence successfully, the surety would probably have to demonstrate that it had sought information from the bank on a vital point regarding its decision whether to sign a suretyship and that it had signed in reliance upon the response received from the bank. If the surety did not make a specific inquiry concerning some factor, that factor would not be considered vital to the underwriting process.

4.8.4 Good faith: the conjuror's tool²⁶⁸

4.8.4.1 Recognition

Despite its widespread recognition in the USA,²⁶⁹ the implied covenant of good faith and fair

268 Grant Gilmore once stated that: "Good faith and the like are words to conjure with, whenever we feel like conjuring." See Gilmore 1981 *Georgia LR* 605 at 629.

269 The covenant of good faith and fair dealing is recognized by s 205 of the Restatement (Second) of Contracts:

"Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."

It is codified by s 1-203 of the the Uniform Commercial Code:

"Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."

The overwhelming majority of jurisdictions apply it as a matter of common law. See, eg, *Keffer v Keffer* 852 P 2d 394 at 398 (Alaska 1993); *Carma Developers (California) Inc v Marathon Development California Inc* 826 P 2d 710 726 (Cal 1992); *Ervin v Amoco Oil Co* 885 P 2d 246 at 250 (Colo Ct App 1994); *Habetz v Condon* 618 A 2d 501 at 505 (Conn 1992); *Southern Business Machines Inc v Norwest Financial Leasing Inc* 390 SE 2d 402 at 405 (Ga Ct App 1990); *Abbott v Amoco Oil Co* 619 NE 2d 789 795 (III App Ct 1993); *Kansas Baptist Convention v Mesa Operating Ltd Partnership* 864 P 2d 204 at 210-11 (Kan 1993); *Blank v Chelmsford OB/GYN* 649 NE 2d 1102 at 1105 (Mass 1995); *Ferrell v Vic Tanny International Inc* 357 NW 2d 669 at 672 (Mich Ct App 1984);

dealing is shrouded in mystery. Efforts to devise workable standards or relevant criteria for determining when the covenant has been violated have been unavailing. The doctrine has been criticised for being applied in an *ad hoc* fashion, yielding inconsistent results and depriving parties of the ability to predict what conduct will violate the covenant.²⁷⁰ It is beyond the scope of this thesis to analyze the concept in detail, but reference will be made here to some of the methods in which good faith has been conceptualised in the USA.

4.8.4.2 The covenant of good faith and fair dealing

The implied covenant of good faith and fair dealing has been described as the residual gap-filling default rule of contract law.²⁷¹ It imposes limits upon one contracting party's ability to impact on the contract's value to the other contracting party. It determines when a party may no longer pursue his own self-interest, but must instead engage in cooperative behavior by deferring to the

Weldon v Montana Bank 885 P 2d 511 at 515 (Mont 1994); *Perry v Jordan* 900 P 2d 335 at 338 (Nev 1995); *Planning & Design Solutions v City of Santa Fe* 885 P 2d 885 P 2d 628 at 635 (NM 1994); *Dalton v Educational Testing Serv* 614 NYS 2d 742 743 (App Div 1994); *Bicycle Transit Authority Inc v Bell* 333 SE 2d 299 at 305 (NC 1985); *Pacific First Bank v New Morgan Park Corporation* 876 P 2d 761 at 762 (Or 1994); *Parker v Byrd* 420 SE 2d 850 at 853 (SC 1992); *St Benedict's Development Co v St Benedict's Hospital* 811 P 2d 194 at 199 (Utah 1991); *Carmichael v Adirondack Bottled Gas Corporation* 635 A 2d 1211 at 1216 (Vt 1993); *Miller v United States Bank* 865 P 2d 536 at 542 (Wash Ct App 1994).

Only Texas has expressly refused to recognize the covenant's relevance to arms' length contracts and limited its application to cases in which a special relationship between the parties is found, such as in insurance contracts. See, eg, *Natividad v Alexis Inc* 875 SW 2d 695 at 697 (Tex 1994).

270 See Diamond & Foss 1996 *Hastings LJ* 585 at 586.

271 See *Chrysler Credit Corporation v Marino* 63 F 3d 574 at 579 (7th Circuit 1995) where it was held that good faith applies only as a method by which gaps are filled and that good faith is not applied to block the use of terms that actually appear in the contract; *Oregon RSA No 6 Inc v Castle Rock Cellular of Oregon Ltd Partnership* 840 F Supp 770 at 778-79 (D Or 1993) where it was held that when the contract is silent as to the permissibility of conduct, the covenant of good faith may be used to fill the gap; *Foley v Interactive Data Corporation* 765 P 2d 373 at 389 (Cal 1988) where it was held that the duty of good faith is "a kind of safety valve that judges may turn to fill gaps" in the contract; *Jacobs v Great Pacific Century Corporation* 499 A 2d 1023 at 1024 (NJ Super Ct App Div 1985) where it was held that "an implied covenant can fill a gap in an agreement where the terms of the covenant can be inferred from the subject matter" of the contract; *Bourgeois v Horizon Healthcare Corp* 872 P 2d 852 at 856 (NM 1994) where the court declined to apply an implied covenant of good faith and fair dealing to override express provisions addressed by the terms of an integrated written contract; *Hauer v Union State Bank* 532 NW 2d 456 at 464 (Wis Ct App 1995) where the court held that "as a method to fill gaps, it has little to do with the formation of contract". See, also, Lillard 1992 *Mo LR* 1233 at 1237 recognizing that the covenant of good faith serves a gap-filling function.

other party's contractual interests.²⁷²

Because it is a gap-filling default rule, the covenant applies only when the propriety of the conduct is not resolved by the terms of the contract²⁷³ or by another default rule.²⁷⁴ That situation ordinarily arises when the contract is silent or ambiguous about the permissibility of the conduct,²⁷⁵ or when the conduct is undertaken pursuant to a grant of discretion and the scope of

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- 272 It has been recognized that the covenant of good faith and fair dealing is designed to foster cooperation between the parties to a contract. The requirement of good faith performance sets parameters for conduct and limits maximization of self-interest by one party when the contract is silent on the subject. As a general concept and explicit requirement, good faith performance is a tool used by the courts to police bargains in order to ensure cooperation by one party so that the other may obtain the expected benefits of the contract. See Jenkins 1991 *Oklahoma LR* 661 at 674.
- 273 The covenant cannot be used to override or contradict the express terms of the contract. See *General Aviation Inc v Cessna Aircraft Co* 915 F 2d 1038 at 1041 (6th Circuit 1990); *Kham & Nate's Shoes No 2 Inc v First Bank of Whiting* 908 F 2d 1351 at 1357 (7th Circuit 1990); *Hubbard Chevrolet Co v General Motors Corporation* 873 F 2d 873 (5th Circuit) cert denied 493 US 978 (1989); *Grand Light & Supply Co v Honeywell Inc* 771 F 2d 672 at 679 (2d Circuit 1985); *AI Transport v Imperial Premium Finance Inc* 862 F Supp 345 at 348 (D Utah 1994); *Van Arnem Co v Manufacturers Hanover Leasing Corporation* 776 F Supp 1220 at 1223 (ED Mich 1991); *Carma Developers (California) Inc v Marathon Development California Inc* 826 P 2d 710 at 727 (Cal 1992); *Wells Fargo Realty Advisors Funding Inc v Uioli Inc* 872 P 2d 1359 at 1363 (Colo Ct App 1994); *Neiditz v Housing Authority* 654 A 2d 812 at 819 (Conn Super Ct 1994); affirmed 651 A2d 1295 at 1296 (Conn 1995); *Indian Harbor Citrus Inc v Poppell* 658 So 2d 605 at 606 (Fla Dist Ct App 1995); *Peterson v First Clayton Bank & Trust Co* 447 SE 2d 63 at 66 (Ga Ct App 1994); *Resolution Trust Corporation v Holtzman* 618 NE 2d 418 at 424 (III App Ct 1993); *Waller v Maryland National Bank* 620 A2d 381 at 388 (Md Ct Spec App 1993); *Murphy v American Home Products Corporation* 448 NE 2d 86 at 91 (1983).
- 274 Even when the conduct at issue is not covered by the terms of the contract, a default rule other than the covenant of good faith may be used as a gap filler to determine the permissibility of that conduct. If so, the covenant of good faith would be inapplicable. For example, a dispute about whether the delivery of goods was timely would be resolved by the UCC default rule, which provides that delivery must be within "a reasonable time". See s 2-309(1) of the UCC. Similarly, if the quality of goods were in dispute, and the contract did not specify quality requirements, the issue would be resolved by the UCC default rules regarding implied warranties. See s 2-314(2)(c) of the UCC requiring that goods be fit for their "ordinary purpose" to satisfy the implied warranty of merchantability; See s 2-315 requiring that goods be fit for the buyer's "particular purpose" to satisfy the implied warranty of fitness for particular purpose.
- 275 See, eg, *Continental Bank NA v Everett* 964 F 2d 701 at 705 (7th Circuit); *Hubbard Chevrolet Co v General Motors Corporation* 873 F 2d 873 at 876-77 (5th Circuit); *Beacham v Macmillan Inc* 837 F Supp 970 at 975 (SD Ind 1993); *Zeno Buick-GMC Inc v GMC Truck & Coach* 844 F Supp 1340 at 1349 (ED Ark 1992); *LLMD Inc v Marine Midland Realty Credit Corporation* 789 F Supp 657 at 660 (ED Pa 1992); *Rodie v Max Factor & Co* 256 Cal Rptr 1 5 (Ct App 1989); *Dave Greytak Enters v Mazda Motors Inc* 622 A 2d 14 at 22-23 (Del Ch 1992); *Indian Harbor Citrus Inc v Poppell* 658 So 2d 605 at 606 (Fla Dist Ct App 1995); *Bowen v Heth* 816 P 2d 1009 at 1011 (Idaho Ct App

that discretion has not been designated.²⁷⁶ When, however, terms of the contract, whether express or derived from extrinsic sources such as usage of trade²⁷⁷ and admissible parol evidence,²⁷⁸

1991); *Castle v McKnight* 866 P 2d 323 at 326 (NM 1992).

276 See, eg, *Chrysler Credit Corp v Marino* 63 F 3d 574 at 579 (7th Circuit 1995) where it was held that application of the covenant of good faith is limited to instances in which a party is given discretion in enforcing certain provisions of the contract; *Occusafe Inc v EG & G Rocky Flats Inc* 54 F 3d 618 at 624 (10th Circuit 1995) where it was held that a court's inquiry focuses on whether the defendant's conduct violated the contracting parties' justified expectations; *Travelers International v Trans World Airlines Inc* 41 F 3d 1570 at 1575 (2d Circuit 1994) where it was held that "even when a contract confers decision-making power on a single party, the resulting discretion is nevertheless subject to an obligation that it be exercised in good faith"; *Los Angeles Memorial Coliseum Commission v National Football League* 791 F 2d 1356 at 1361 (9th Circuit 1986) where it was held that when one party retains a right of approval over the other party to a contract, "such powers must be exercised within the parameters of the duty of good faith"; *Southwest Savings & Loan Association v Sunamp Systems Inc* 838 P 2d 1314 at 1319 (Ariz Ct App 1992) where it was held that "a contract thus would be breached by a failure to perform in good faith if a party uses its discretion for a reason outside the contemplated range" of the parties; *Carma Developers (California) Inc v Marathon Development California Inc* 826 P 2d 710 at 726-27 (Cal 1992) where it was held that the covenant requires the party holding discretionary power to exercise it "for any purpose within the reasonable contemplation of the parties at the time of formation — to capture opportunities that were preserved upon formation of the contract"; *Neiditz v Housing Authority of the City of Hartford* 654 A 2d 812 at 819 (Conn Super Ct 1994) Affirmed 651 A2d 1295 (Conn 1995) where it was held that the covenant of good faith presupposes that the terms of the contract are agreed upon and what is in dispute is the party's discretionary application; *Chemical Bank v Paul* 614 NE 2d 436 at 442 (III App Ct 1993) where it was held that parties with unfettered discretion cannot be allowed to exercise that discretion in bad faith; *Julian v Christopher* 575 A 2d 735 739 (Md 1990) where it was held that if a lease does not spell out any standard for exercising discretion then the implied covenant of good faith and fair dealing should imply a reasonableness standard; *Anthony's Pier Four Inc v HBC Assocs* 583 NE 2d 806 at 820-21 (Mass 1991) where it was held that the use of a discretionary right under the contract as a pretext to "sweeten the deal" is a breach of the covenant of fair dealing and good faith; *Weldon v Montana Bank* 885 P 2d 511 at 515 (Mont 1994) where it was held that "when the discretion conferred by the contract has been misused to deprive the other party of the benefit of the bargain" then there is a breach of the covenant of good faith; *Centronics Corporation v Genicom Corporation* 562 A 2d 187 at 193 (NH 1989) where it was held that the exercise of discretion by one contracting party must be limited in so far as it is in accord with the parties' purpose in contracting; *Uptown Heights Associates Ltd Partnership v Seafirst Corporation* 891 P 2d 639 at 644 (Or 1995) where it was held that parties normally contemplate that discretion will be exercised for particular purposes; if the discretion is exercised outside these purposes then the party exercising the discretion has performed in bad faith; *Olympus Hills Shopping Center Ltd v Smith's Food & Drug Centers Inc* 889 P 2d 445 at 450 (Utah Ct App 1995); see, also, Burton 1980 *Harvard LR* 369 at 379-84, stressing the importance of the covenant of good faith when a party engages in conduct allegedly pursuant to a grant of discretion; but, see *National Bank v Lynch* 36 F 3d 370 at 373 (4th Circuit 1994) where it was held that when the contract expressly gives one party "sole discretion" the implied duty of good faith cannot be used to renegotiate the terms of the contract.

277 Trade usage may resolve the permissibility of conduct either by explaining an ambiguous contractual reference to such conduct or by adding a supplemental term. See s 222(3) of

determine the permissibility of the conduct, no gap filler is needed²⁷⁹ and the covenant does not apply.

4.8.4.3 Current approaches

Although there is agreement that the covenant of good faith and fair dealing applies when the permissibility of conduct otherwise is unclear,²⁸⁰ authorities differ about the methodology for determining whether conduct violates the covenant. Several approaches have been proposed by commentators and adopted by the courts.²⁸¹

the Restatement (Second) of Contracts; s 2-202(a) of the UCC; see, also, *Precision Steel Warehouse Inc v Anderson-Martin Machine Co* 854 SW 2d 321 at 325 (Ark 1993), a case of trade usage explaining an ambiguous term; *Varni Brothers v Wine World Inc* 41 Cal Rptr 2d 740 at 745-46 (Ct App 1995), a case of trade usage adding a term permitting termination only for good cause; *Hayter Trucking Inc v Shell WE&P Inc* 22 Cal Rptr 2d 229 at 241 (Ct App 1993) (explaining an ambiguous term); *C-Thru Container Corporation v Midland Manufacturing Co* 533 NW 2d 542 at 544-45 (Iowa 1995), a case of trade usage adding a term that seller must supply buyer with product sample to prove seller's capacity to produce the product. A usage of trade is defined as "a usage having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to a particular agreement". See s 222(1) of the Restatement (Second) of Contracts.

In addition to usage of trade, a prior course of dealing between the parties may be used to explain or supplement the parties' agreement. See s 223 of the Restatement (Second) of Contracts; s 2-202(a) of the UCC. It is also provided under s 202(a) of the UCC that the course of performance between the parties in the transaction at issue may be used to explain or supplement the parties' agreement.

- 278 One source for determining the permissibility of conduct is an agreement regarding that conduct made by the parties prior to their contract. Such a prior agreement would only be admissible if it was consistent with the parol evidence rule. Under the Restatement (Second) of Contracts version of the parol evidence rule, the admissibility of such an agreement depends on whether the parties' contract was "integrated". See s 213(1)-(2) of the Restatement (Second) of Contracts. The UCC parol evidence rule does not use the term "integrated" but resolves the admissibility of prior agreements depending on whether the parties intended their written contract as "final" or "complete and exclusive". See s 2-202 of the UCC.
- 279 This limitation on the application of the covenant is consistent with the general contract principle that in interpreting a contract, "an implication... should not be made when the contrary is indicated in clear and express words". Corbin *Contracts* 298.
- 280 See, eg, *Cessna Aviation Inc v Cessna Aircraft Co* 915 F 2d 1038 at 1041 (6th Circuit 1990); *Hubbard Chevrolet Co v General Motors Corporation* 873 F 2d 873 at 877 (5th Circuit).
- 281 See Zimmermann & Whittaker (eds) *Good Faith* 121 *et seq*. It would appear as if all these approaches fail to provide workable guidelines for resolving good faith cases, and *ad hoc* decision making results. See Diamond & Foss 1996 *Hastings LJ* 585 at 590.

4.8.4.3.1 The excluder approach

One approach, introduced by Summers²⁸² and adopted by many courts,²⁸³ attempts to identify conduct that is excluded²⁸⁴ from the realm of good faith. This approach assumes that it is impossible to formulate standards²⁸⁵ or even relevant criteria²⁸⁶ for determining when conduct is to be excluded. Instead, the approach offers descriptive categories and anecdotal examples of conduct that can be excluded. These bad-faith categories include evasion of the spirit of the bargain,²⁸⁷ lack of diligence and slacking off,²⁸⁸ willfully rendering only substantial performance,²⁸⁹ abuse of a power to determine compliance,²⁹⁰ and interference with or failure to cooperate in the other party's performance.²⁹¹ However, there is no standard for determining when conduct falls into any of these categories. For instance, describing bad-faith conduct as an evasion of the spirit of the bargain, even with an anecdotal example,²⁹² offers little guidance on

282 Summers 1968 *Virginia LR* 195.

283 See, eg, *Occusafe Inc v EG & G Rocky Flats Inc* 54 F 3d 618 at 624 (10th Circuit 1995); *Bank of China v Chan* 937 F 2d 780 at 789 (2d Circuit 1991); *Kedra v Nazareth Hospital* 868 F Supp 733 at 737 (ED Pa 1994); *Coca-Cola Bottling Co v Coca-Cola Co* 769 F Supp 599 at 652 (D Del 1991); *Kleiner v First National Bank* 581 F Supp 955 at 960 (ND Ga 1984); *Larson v Larson* 636 NE 2d 1365 at 1368 (Mass App Ct 1994); *Bourgeois v Horizon Healthcare Corp* 872 P 2d 852 at 856 (NM1994); *Somers v Somers* 613 A 2d 1211 at 1213 (Pa Super Ct 1992); *Garrett v Bankwest Inc* 459 NW 2d 833 at 845 (SD1990); *Carmichael v Adirondack Bottled Gas Corporation* 635 A2d 1211 at 1216-17 (Vt 1993).

284 Summers 1968 *Virginia LR* 195 at 196, contends that good faith "is best understood as an 'excluder' — it is a phrase which has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith".

285 Summers 1968 *Virginia LR* 195 at 215 stating that "[i]f an obligation of good faith is to do its job, it must be open-ended rather than sealed off in a definition".

286 Summers 1968 *Virginia LR* 195 at 206 arguing that "criteria must vary from context to context".

287 Summers 1968 *Virginia LR* 195 at 234-35.

288 *Ibid*, at 235-37.

289 *Ibid*, at 237-38.

290 *Ibid*, at 240-41.

291 *Ibid*, at 241-43.

292 Professor Summers offers this example of evasion of the spirit of the bargain; Suppose a seller develops and builds a market for product X and then sells his rights to manufacture and market it; the buyer of these rights is to pay royalties according to a rate based on the sales he makes. Later, the buyer develops product Y, which competes with X. Can the buyer keep X under his control until the market for Y has been built up and

how to determine the spirit of the bargain or how to evaluate when it is being evaded.²⁹³

This approach compels the courts to resolve cases on an intuitive and *ad hoc* basis, without guidelines,²⁹⁴ except in those rare cases in which patterns of conduct have become generally recognized as violating the covenant.²⁹⁵ Such an *ad hoc* approach has been criticised as deficient because it promotes capricious and unpredictable decision making²⁹⁶ while increasing transaction

then safely forget X? The answer is "no" for the buyer would be evading the spirit of the deal and therefore would be acting in bad faith. Summers 1968 *Virginia LR* 195 at 235.

293 See Diamond & Foss 1996 *Hastings LJ* 585 at 590-591.

294 Summers acknowledges the *ad hoc* nature of his excluder approach. He states:

"If an obligation of good faith is to do its job, it must be open-ended rather than sealed off in a definition. Courts should be left free, under the aegis of a statutory green light, to deal with any and all significant forms of contractual bad faith, familiar and unfamiliar."

See Summers 1968 *Virginia LR* 195 at 215; see, also, Cook 1986 *Iowa LR* 893 at 899-900, criticizing Professor Summer's excluder approach on the ground that it requires *ad hoc* decisions without guidelines.

295 Two types of conduct are most widely recognized as violating the covenant. The first occurs when defendant intentionally prevents a plaintiff from performing its contractual duties or satisfying contractual conditions. See *Monotype Corporation v International Typeface Corporation* 43 F 3d 443 at 451 (9th Circuit 1994); *Crossland v Canteen Corporation* 711 F 2d 714 at 728 (5th Circuit 1983); *Sharma v Skaarup Ship Management Corporation* 916 F 2d 820 (2d Circuit 1990); *Bonanza International Inc v Restaurant Management Consultants* 625 F Supp 1431 at 1445 (ED La 1986); *Knudsen v Northwest Airlines Inc* 450 NW 2d 131 at 133 (Minn 1990). This conduct would fall within Professor Summers's broad category of interference with or failing to cooperate in the other party's performance. See Summers 1968 *Virginia LR* 195 at 241-43. The second type of conduct occurs when a defendant's duty to perform is dependent on his personal satisfaction and he misrepresents his dissatisfaction. See *Greenwood v Koven* 880 F Supp 186 at 199-200 (SDNY 1995); *Mike Naughton Ford Inc v Ford Motor Co* 862 F Supp 264 at 269 (D Colo 1994); *International Minerals & Mining Corporation v Citicorp NA Inc* 736 F Supp 587 at 595 (D NJ 1990); *Jones v Hollingsworth* 560 P 2d 348 at 351-52 (Wash 1977). This conduct would fall within Summers's broad category of abuse of a power in order to determine compliance. See Summers 1968 *Virginia LR* 195 at 235.

296 "The need for predictable results is magnified by the litigiousness of society. We are a litigious people, but our litigiousness need not produce a mass of vague rules capriciously applied to produce unpredictable results. Our litigiousness argues instead for clear rules consistently applied to produce predictable results. This would discourage frivolous litigation, encourage prompt settlement of well founded litigation, and facilitate the just resolutions of those few lawsuits that did not settle."

Per Robinson & Huber 1994 *JC & UL* 157 at 303; see, also, Calfee & Craswell 1984 *Virginia LR* 965 at 968 stating that when parties cannot determine the legal consequences

costs.²⁹⁷ Without a definitive rule, courts can impose unexpected burdens on either party. A plaintiff cannot determine when a defendant may permissibly undermine its contractual interests. The defendant cannot determine when he will be prohibited from promoting his own contractual interests. Without the ability to make those determinations, the parties cannot assess contractual risks²⁹⁸ and may find themselves with unexpected contractual obligations to which they would not have agreed.²⁹⁹

It is said that an *ad hoc* system also increases the likelihood of breach and fosters litigation.³⁰⁰ It increases the likelihood of breach because, without guidance about the limits of acceptable conduct, a defendant will not know how to avoid a breach.³⁰¹ It fosters litigation because the

of possible courses of action because of vague or unpredictable rules, they will tend to overcomply or undercomply; See, also, Lillard 1992 *Mo LR* 1233 at 1236 recognizing criticism that the covenant is vague and subject to uneven results; Morant 1995 *Tulane LR* 715 at 727-28 stating that vague standards lead to inconsistent results, uncertainty, and insecurity among bargainers in the marketplace.

297 Rules that are uncertain in result increase transaction costs because parties must expend time and resources to bargain around them.

"The imposition of a default term whose effect is uncertain will not reduce transaction costs. On the contrary, it will increase them; parties will attempt to exclude by contract the added uncertainty of unpredictable judicial intervention."

Per Kull 1991 *Hastings LJ* 1 at 47; see, also, Frankel 1993 *BULR* 389 at 395 stating that:

"the policies of both contract and property law include creating certainty and predictability to reduce the parties' planning and transaction costs."

298 See Kronman & Posner *Economics* 4 stating that a contract can be viewed as an agreed-upon allocation of risks; See, also, Kelly 1992 *Wisconsin LR* 1754 at 1772 stating that:

"[c]ontract law revolves around agreements among parties allocating the risks of a business transaction."

299 See Kull 1991 *Hastings LJ* 1 at 47. Even courts that justify the vagueness of the covenant as an unavoidable necessity concede that:

"if contracting parties cannot profitably use their contractual powers without fear that a jury will second guess them under a vague standard of good faith, the law will impair the predictability that an orderly commerce requires."

In Olympus Hills Shopping Centre Ltd v Smith's Food & Drug Shopping Centers Inc 889 P 2d 445 at 450 (Utah Ct App 1994) quoting *Southwest Savings & Loan Association v Sunamp Systems Inc* 838 P 2d 1314 at 1319 (Ariz Ct App 1992).

300 Diamond & Foss 1996 *Hastings LJ* 585 at 592.

301 Kelley 1994 *S Illinois University LJ* 357 at 365 states:

parties cannot determine the legal consequences of conduct and may be forced to seek judicial resolution of resulting disputes.³⁰²

4.8.4.3.2 The foregone-opportunity approach

Another approach, introduced by Professor Burton,³⁰³ contends that the covenant is violated when a party attempts to recapture a foregone opportunity.³⁰⁴ A foregone opportunity is one that defendant bargained away as the price for entering into the contract.³⁰⁵ Whether that opportunity has been foregone depends on the reasonable expectations of the parties.³⁰⁶ Only if the parties reasonably expected that defendant would not attempt to reap the benefits sought by his conduct, will an opportunity be deemed foregone.³⁰⁷

"Legal rules that are fixed, definite, and certain will be more effective than rules that are vague, indefinite and uncertain because people can better predict the legal consequences of fixed definite, and certain rules and thus can better conform their conduct to the rule"

citing Oliver W Holmes Jr *Common Law* 88-90.

302 See Kull 1991 *Hasting LJ* 1 note 29, at 47 stating that "the uncertainty of outcome under any such [unpredictable] legal rule will encourage litigation"; see, also, Robinson & Huber 1994 *JC & UL* 157 note 28 at 303 stating that vague rules promote litigation; Snyderman 1988 *University of Chicago LR* 1335 stating that:

"[an] unrequited cost of court interference is the wasteful litigation produced when courts demonstrate their willingness to rewrite contracts and create vague and inconsistent rules".

See, also, Weis Jr 1992 *Notre Dame LR* 1385 at 1396 stating that "[t]he ability of lawyers to advise their clients with some degree of certainty is critical in avoiding disputes".

303 Burton 1980 *Harvard LR* 369 at 387-92.

304 *Ibid*, at 387.

305 *Ibid*, at 387.

306 *Ibid*, at 390-91.

307 For cases adopting this approach, see *Hubbard Chevrolet Co v General Motors Corporation* 873 F 2d 873 at 876 (5th Circuit) cert denied 493 US 978 (1989); *Richard Short Oil Co v Texaco Inc* 789 F 2d 415 at 422 (8th Circuit 1986); *James v Whirlpool Corporation* 806 F Supp 835 at 843 (ED Mo 1992); *Three D Dep'ts Inc v K Mart Corporation* 670 F Supp 1404 at 1408 (ND III 1987); *Carma Developers (California) Inc v Marathon Development California Inc* 826 P 2d 710 at 727 (Cal 1992); *Warner v Konover* 553 A 2d 1138 at 1141 (Conn 1989); *Anthony's Pier Four Inc v HBC Assocs* 583 NE 2d 806 at 820-21 (Mass 1991); *Centronics Corporation v Genicom Corporation* 562 A 2d 187 194 (NH 1989); cf *United States National Bank v Boge* 814 P 2d 1082 at 1091 (Or 1991).

The difficulty with this approach is that the determination whether particular conduct represents such a foregone opportunity is frequently beyond the court's ability to ascertain, for the very reason that the conduct is not referred to in the contract.³⁰⁸ When the contract does not indicate the permissibility of conduct, there is no agreed-upon source for determining whether the parties reasonably expected that the conduct would constitute a foregone opportunity.³⁰⁹ Without guidelines, courts are forced to apply this approach on an intuitive basis with all the pitfalls of an *ad hoc* system.³¹⁰

4.8.4.3.3 The reasonable-expectations approach

Many courts have adopted half of Professor Burton's approach³¹¹ by focusing on the question whether the conduct was beyond the reasonable expectations of the parties, while ignoring the

308 Farnsworth *et al Contracts* 546-47.

309 Diamond & Foss 1996 *Hastings LJ* 585 at 594.

310 Burton acknowledges the deficiencies of a pure reasonable expectations test to determine when conduct violates the covenant because those unfocused expectations:

"direct attention to the amorphous totality of the factual circumstances at the time of formation [of the contract], and fail to distinguish relevant from irrelevant facts within that realm."

Burton 1980 *Harvard LR* 369 at 371-72.

By directing attention to the specific issue of whether opportunities were foregone, Burton believed analysis would be advanced (at 391). The problem, however, is that even knowing the relevant circumstances existing at the formation of the contract does not lead to a resolution of whether particular conduct is consistent with the parties' reasonable expectations.

It has been propounded that a party frequently contracts with the expectation that the other will be permitted to exploit his own self-interest to the extent that the contract does not expressly preclude such opportunistic behavior. See Gillette 1990 *J of Legal Studies* 535 at 540 and 560. Frequently he expects that the other will forego his self-interest and engage in cooperative behavior. Whether a particular party expected one over the other and to what extent he expected it frequently cannot be fathomed from the circumstances surrounding the formation of the contract.

"The transactional signals parties send are too ambiguous to permit uniform interpretation."

See Gillette, *ibid*, at 581 who feels that, despite its theoretical appeal, Burton's test ultimately demands resolution by intuition or individualized value judgments.

311 Burton 1980 *Harvard LR* 369 *et seq*.

issue of foregone opportunities.³¹² Without a standard for determining when one party's expectations are reasonable, this approach suffers from the same deficiencies as the foregone-opportunity approach.³¹³

4.8.4.3.4 The justice approach

It has been proposed that the question whether the covenant has been violated should be determined by judicial concepts of justice rather than by the parties' expectations.³¹⁴ This approach, however, also suffers from the same vagueness as the previously discussed approaches. It does not state the criteria for determining what constitutes justice,³¹⁵ leaving courts with no articulated standards and little besides their intuition to resolve good-faith cases.

4.8.4.3.5 The purpose approach

Some courts find conduct in violation of the covenant if it is inconsistent with the parties' purpose for entering into the contract.³¹⁶ This approach uses the same analysis as that applied to

312 *Tidmore Oil Co v BP Oil Co* 932 F 2d 1384 at 1391 (11th Circuit 1991); *Big Horn Coal Co v Commonwealth Edison Co* 852 F 2d 1259 at 1267 (10th Circuit 1988); *Zeno Buick-GMC Inc v GMC Truck & Coach* 844 F Supp 1340 at 1349 (ED Ark 1992); *Seal v Riverside Federal Savings Bank* 825 F Supp 686 at 689 (ED Pa 1993); *Flight Concepts Ltd Partnership v Boeing Co* 1535 at 1550 (D Kan 1993); *James v Whirlpool Corp* 806 F Supp 835 at 843 (ED Mo 1992); *Eis v Meyer* 566 A 2d 422 at 426 (Conn 1989); *Schaal v Flathead Valley Community College* 901 P 2d 541 at 544 (Mont 1995).

313 Farnsworth *et al Contracts* 546-547n40; Diamond & Foss 1996 *Hastings LJ* 585 at 594.

314 *Koehrer v Superior Court* 226 Cal Rptr 820 at 828 (Ct App 1986) where it was held that "the obligations stemming from the implied covenant of good faith and fair dealing are imposed by law as normative values of society"; *Lowe v Feldman* 168 NYS 674 at 680 (Sup Ct 1957) where it was held that a court will "where justice and expediency demand, infuse the contract with the spirit of good faith and fair dealing". But see *Don King Productions v Douglas* 742 F Supp 741 at 767 (SDNY 1990) where the court distinguished between legal duties and ethical duties in the context of the covenant of good faith and indicated that only legal duties are enforceable.

315 See *Koehrer v Superior Court* 226 Cal Rptr 820 at 828 (Ct App 1986); *Lowe v Feldman* 168 NY S 2d 674 at 680 (Sup Ct 1957). It is unclear whether "justice" should be determined from the societal perspective of notions of fairness and morality, from the parties' perspective based on their reasons for entering into the contract, or from the trade perspective of business ethics.

316 See, eg, *Market St Assocs Ltd Partnership v Fey* 941 F 2d 588 at 596 (7th Circuit 1991); *Ford v Manufacturers Hanover Mortgage Corporation* 831 F 2d 1520 at 1523 (9th Circuit 1987); *Burger King Corp v Weaver* 798 F Supp 684 at 688 (SD Fla 1992); *Ellis v Chevron USA Inc* 246 Cal Rptr 863 at 866 (Ct App 1988); *Bonanza Inc v Mc Lean* 747 P 2d 792 at 800-01 (Kan 1987); *Continental Potash Inc v Freeport-McMoran Inc* 858 P 2d 66 at 80 (NM 1993); *Bicycle Transit Authority Inc v Bell* 333 S 2d 299 at 305 (NC

determine whether conduct violates an ambiguous statute. Courts will construe a statute as prohibiting particular conduct if that prohibition is consistent with the legislature's purpose in enacting the statute.³¹⁷ Unfortunately, this legislative approach is unworkable in a contractual context. Parties have distinct and potentially conflicting purposes for entering into a contractual relationship.³¹⁸ As a consequence, one party may engage in conduct that furthers his own contractual purpose, but undermines the other's. Frequently, in commercial contracts, each party's purpose is to maximize his profits, but those purposes are potentially conflicting. A fictional, non-existent, unitary contractual purpose cannot determine whether conduct violates the covenant. From the perspective of contractual purpose, a violation of the covenant should depend on whether defendant's promotion of his contractual purpose unduly intrudes upon plaintiff's contractual purpose. The purpose approach does not define when that point is reached.³¹⁹

1985).

- 317 *Concrete Pipe & Prods Inc v Construction Laborers Pension Trust* 113 S Ct 2264 at 2281-82 (1993) reasoning that "we turn, as we would in the usual case of textual ambiguity, to the legislative purpose as revealed by the history of the statute, for such light as it may shed"; *Rose v Lundy* 455 US 509 51 (1982) where it was held that "where the statute's language seem[s] insufficiently precise, the 'natural way' to draw the line 'is in light of the statutory purpose'" (quoting *United States v Bacto-Unidisk* 394 US 784 at 799 (1960)).
- 318 Baird 1990 *J of Legal Studies* 583 at 583-84.
- 319 See *Market St Assocs Ltd Partnership v Frey* 941 F 2d 588 at 596 (7th Circuit 1991); *M/A-Com Security Corporation v Galesi* 904 F 2d 134 at 136 (2nd Circuit 1990). Some courts have combined the reasonable expectations approach and the purpose approach by stating that conduct violates the covenant of good faith when it violates an agreed common purpose or is inconsistent with the parties' reasonable expectations. See *Occusafe Inc v EG & G Rocky Flats Inc* 54 F 3d 618 at 624 (10th Circuit 1995); *Maljack Productions Inc v Motion Picture Association of America Inc* 52 F 3d 373 at 375 (DC Circuit 1995); *Cross & Cross Properties Ltd v Everett Allied Co* 886 F 2d 497 at 502 (2d Circuit 1989); *Sheck v Burger King Corporation* 798 F Supp 692 694 (SD Fla 1992); *Blue Jeans Equities West v City & County of San Francisco* 4 Cal Rptr 2d 114 at 119 (Ct App 1992); *Wells Fargo Realty Advisors Funding Inc v Uioli Inc* 872 P 2d 1359 (Colo Ct App 1994); *Perry v Jordan* 900 P 2d 335 at 338 (Nev 1995); *First National Bank & Trust Co of Vinita v Kissee* 859 P 2d 502 at 509 (Okla 1993); *Olympus Hills Shopping Center Ltd v Smith's Food & Drug Centers Inc* 889 P 2d 445 at 451 (Utah Ct App 1995); *Capital Impact Corporation v Munro* 642 A 2d 1175 at 1177 (Vt 1994). This compound approach does not appear to offer any greater clarity than either approach offers separately. See Diamond & Foss 1996 *Hastings LJ* 585 at 596.

4.8.4.3.6 The Restatement³²⁰ approach

The Restatement (Second) of Contracts has described the covenant of good faith in terms that combine elements of each of the foregoing approaches:

"Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party: it excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness."³²¹

The above language from the Restatement, to which numerous courts have referred,³²² specifically adopts the purpose, reasonable-expectations, and excluder³²³ approaches. This approach has been criticised, as it is unlikely that the mere linking of several *ad hoc* approaches would overcome their individual deficiencies.³²⁴

320 Restatement (Second) of Contracts. See Zimmermann & Whittaker (eds) *Good Faith* 123-125 for a brief discussion of this approach.

321 S 205 of the Restatement (Second) of Contracts.

322 See, eg, *Hubbard Chevrolet Co v General Motors Corporation* 873 at 876 F 2d 873 (5th Circuit) cert denied 493 US 978 (1989); *Savers Federal & Loan Association v Home Federal Savings & Loan Association* 721 F Supp 940 at 945 (WD Tenn 1989); *Careau & Co v Security Pac Business Credit Inc* 272 Cal Rptr 387 at 398 (Ct App 1990); *Warner v Konover* 553 A 2d 1138 at 1141 (Conn 1989); *Morriss v Coleman Co* 738 P 2d 841 at 849 (Kan 1987); *Cenac v Murry* 609 So 2d 1257 at 1272 (Miss 1992); *Centronics Corporation v Genicom Corporation* 562 A 2d 187 at 191 (NH 1989); *United States National Bank v Boge* 814 P 2d 1082 at 1091 (Or 1991); *Carmichael v Adirondack Bottled Gas Corporation* 635 A 2d 1211 at 1216-17 (Vt 1993); *Wilder v Cody County Chamber of Commerce* 868 P 2d 211 at 220 (Wyo 1994).

323 The comments to s 205 of the Restatement (Second) of Contracts use examples of bad faith conduct drawn, nearly *verbatim*, from Professor Summers' s 1968 article introducing the excluder approach. Cf comments (d) to (e) to s 205 of the Restatement (Second) of Contracts with Summers 1968 *Virginia LR* 195 note 15 at 216-17. Comment (d) provides, in agreement with Summers' thesis, that "[a] complete catalogue of types of bad faith is impossible". See Summers, *ibid*, note 15 at 206.

324 Diamond & Foss 1996 *Hastings LJ* 585 at 597.

4.8.4.3.7 The fruits-of-the-contract approach

A common aphorism asserts that conduct which would destroy or injure the other party's right to receive the fruits³²⁵ or benefits³²⁶ of the contract violates the covenant. This standard has been criticized as being over-broad to the extent that it suggests that defendant can do nothing that would lessen plaintiff's anticipated contract benefits. For example, in a requirements contract a buyer's reduced requirements would not constitute a violation of the covenant merely because they reduced the seller's anticipated profits.³²⁷ Nor would a court necessarily hold that the restaurant franchisor who opened a new restaurant violated the covenant merely because his new restaurant reduced the profits of the franchisee. This aphorism ignores the fact that occasions will arise when defendant is entitled to injure plaintiff's contractual interests in order to promote his own.³²⁸ Defendant's conduct must unduly injure plaintiff's contractual interests in order to violate the covenant. However, courts have been unwilling or unable to set criteria for determining

325 For cases that phrase the aphorism in terms of a party's right to receive the "fruits of the contract", see *Chambers Development Co Inc v Passaic County Utilities Authority* 62 F 3d 582 at 587 (3rd Circuit 1995) quoting *Bak-A-Lum of America v Alcoa Building Products Inc* 351 A 2d 349 at 352 (NJ 1976); *Public Serv Co v Burlington NRR* 53 F 3d 1090 at 1097 (10th Cir 1995); *M/A — Com Security Corporation v Galesi* 904 F2d 134 at 136 (2d Circuit 1990); *Local 3-7 International Woodworkers v Daw Forest Prods Co* 833 F 2d 789 at 795 (9th Cir 1987); *Oregon RSA No 6 Inc v Castle Rock Cellular of Oregon Ltd Partnership* 840 F Supp 770 at 776 (D Or 1993); *Shannon v Keystone Information Systems Inc* 827 F Supp 341 at 344-45 (ED Pa 1993); *Ripplemeyer v National Grape Coop Association* 807 F Supp 1439 at 1451 (WD Ark 1992) quoting *Gallagher v Lambert* 549 NE 2d 136 141 (NY 1989); *Bank of New York v Sasson* 786 F Supp 349 at 353 SDNY 1992) quoting *Kirke La Shelle Co v Paul Armstrong Co* 263 NY 79 at 87 188 NE 163 (1933); *Kendall v Ernest Pestana Inc* 709 P 2d 837 at 844 (Cal 1985); *Blank v Chelmsford OB/GYN* 649 NE 2d 1102 at 1105 (Mass 1995) quoting *Anthony's Pier Four Inc v HBC Assocs* 583 NE 2d 806 820 (Mass 1991).

326 For cases that phrase the aphorism in terms of a party's right to receive the "benefits of the contract", see *Pan Am Corporation v Delta Air Lines Inc* 175 BR 438 at 508 (SDNY 1994); *Waller v Truck Insurance Exchange Inc* 900 P 2d 619 at 639 (Cal 1995); *Cimino v Firs Tier Bank NA* 530 NW 2d 606 at 616 (Neb 1995); *High Plains Genetics Research Inc v J K Mill-Iron Ranch* 535 NW 2d 839 at 843 (SD 1995).

327 The Official Comments to the UCC provision governing requirements contracts state:

"Reasonable elasticity in the requirements is expressly envisaged by this section and good faith variations from prior requirements are permitted even when the variation may be such as to result in discontinuance. A shutdown by a requirements buyer for lack of orders might be permissible when a shutdown merely to curtail losses would not. The essential test is whether the party is acting in good faith."

See comment 2 (1994) to s 2-306 of the UCC).

328 *Diamond & Foss* 1996 *Hastings LJ* 585 at 598.

undue injury.³²⁹

4.8.4.3.8 The UCC approach

According to the Uniform Commercial Code, good faith always requires honesty in fact in the conduct or transaction concerned.³³⁰ The UCC neither defines the meaning of the term "honesty in fact," nor describes prohibited conduct,³³¹ nor indicates whether the term should be given a broad³³² or narrow³³³ meaning. Judicial interpretations state that the phrase requires defendant to demonstrate a "white heart" even if this conduct reflects an "empty head".³³⁴ The "white heart,

329 See, eg, *Pan Am Corporation v Delta Airlines Inc* 175 BR 438 at 508 (SDNY 1994); *Waller v Truck Insurance Exchange Inc* 900 P 2d 619 at 639 (Cal 1995).

330 The UCC imposes a duty of good faith on all parties. See s 1-203 of the UCC. Good faith is defined to mean "honesty in fact in the conduct or transaction concerned". See s 1-201(19) of the UCC. The honesty-in-fact requirement of s 1-201(19) of the UCC is a baseline requirement for good faith throughout the Code. According to the Official Comment (1994) to s 1-201(19) of the UCC: "Good faith, whenever it is used in the Code, means at least what is here stated." Although special definitions of good faith can be found in the Code, those definitions all include the element of "honesty in fact." See, eg, s 2-103(1)(b) and s 3-103(a)(4) of the UCC.

331 The Official Comment to s 1-201(19) of the UCC offers no elaboration on the meaning of "honesty in fact" or the kinds of conduct that would be prohibited by defining good faith in this way. See comment (1994) to s 1-201(19) of the UCC. The Official Comments to the special definitions of good faith are also silent on the meaning to be ascribed to "honesty in fact". See, eg, comment 4 (1994) to s 2-103 of the UCC; comment 4 to s 3-103 of the UCC).

332 "In its broader meaning, 'dishonesty' is defined as a breach of trust, a 'lack of ... probity or integrity in principle', 'lack of fairness' or 'a disposition to betray'". Quoted from *United States v Brackeen* 969 F 2d 827 at 829 (9th Circuit 1992) citing Webster's Third New International Dictionary 650 (unabridged edition of 1986).

333 "In its narrower meaning, however, 'dishonesty' is defined as deceitful behavior, a 'disposition to defraud [or] deceive,'... or a '[d]isposition to lie, cheat, or defraud'." Quoted from *United States v Brackeen* 969 F 2d 827 at 829 (9th Circuit 1992) citing Black's Law Dictionary 421 (5th edition of 1979).

334 "Some term it the 'white heart, empty head' test. It is not sufficient that there be circumstances or suspicions such as would put a careful purchaser on inquiry. We have traditionally held that subjective good faith is simply 'the honest belief that [your] conduct is rightful'."

See *Schluter v United Farmers Elevator* 479 NW 2d 82 at 85 (Minn Ct App 1992) quoting *Wohlrabe v Pownell* 307 NW 2d 478 at 483 (Minn 1981); cf *Utility Contractors Financial Services Inc v Amsouth Bank NA (In re Joe Morgan Inc)* 985 F 2d 1554 at 1506-61 (11th Circuit 1993) where it was recognized that Alabama applies both subjective and objective analyses of good faith under the UCC; *Shearson Lehman Brothers v Wasatch Bank* 788 F Supp 1184 at 1194 (D Utah 1992); *Bill v Catfish Shaks of America Inc* 727 F Supp 1035 at 1040-41 (ED La 1989); *Kline v Central Motors*

empty head" terminology is amorphous, providing no meaningful guideline for identifying dishonest conduct.

In limited circumstances, the UCC requires, in addition to honesty, "observance of reasonable commercial standards of fair dealing in the trade".³³⁵ The UCC does not define the term "reasonable commercial standards of fair dealing in the trade".³³⁶ If it means that each trade defines fair dealing, this aspect of the UCC is of minimal significance because in most trades there are no generally accepted and well-defined standards of fair dealing.³³⁷ If the term means that standards outside the trade are applicable,³³⁸ it gives no guidelines about which standards to apply. Courts frequently cite the UCC language regarding reasonable standards of fair dealing without explaining the meaning of that language, and then announce a conclusion about whether the conduct at issue is prohibited.³³⁹ Some courts cite this term and then make a selection from

Dodge Inc 614 A 2d 1313 at 1316 (Md Ct Spec App 1992).

335 In Article 2 (Sales):

"good faith' in the case of a merchant is honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."

See s 2-103(1)(b) of the UCC (1994). This definition of good faith is also used in Article 2A (Leases). See s 2A-103(3) of the UCC (1994). In Article 3 (Negotiable Instruments), good faith is defined to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing". See s 3-103(a)(4) of the UCC (1994). This definition is also used in Article 4 (Bank Collections). See s 4-104(c) of the UCC (1994).

336 The UCC fails to define what would constitute observance of reasonable commercial standards, other than to distinguish it from due care.

Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed. Failure to exercise ordinary care in conducting a transaction is an entirely different concept to failure to deal fairly in conducting the transaction. See comment 4 (1994) to s 3-103 of the UCC.

337 There are few decisions in which courts have made an effort to ascertain a given trade's standards of fair dealing. See, however, *Morgold Inc v Keeler* 891 F Supp 1361 at 1368 (ND Cal 1995) where it was held that a dealer in art must take reasonable steps to inquire into the title to a painting.

338 A standard of fair dealing derived from outside the trade would be likely under the definitions of good faith provided in ss 3-103(a)(4) and 4 - 104(c) of the UCC because those definitions do not refer to standards of fair dealing "in the trade".

339 See, eg, *Rayle Tech Inc v De Kalb Swine Breeders Inc* 897 F Supp 1472 at 1477 (SD Ga 1995); *Sonfast Corporation v York International Corporation* 875 F Supp 1099 at 1105-06 (MD Pa 1995); *Brookside Farms v Mama Rizzo's Inc* 873 F Supp 1029 at 1034-35 (SD Tex 1995); *Potomac Plaza Terraces Inc v QSC Products Inc* 868 F Supp 346 at 351-52 (D DC 1994); *Kansas Municipal Gas Agency v Vesta Energy Co Inc* 840 F Supp 814 at 820 (D Kan 1993); *PSI Energy Inc v Exxon Coal USA Inc* 831 F Supp 1430 at 1439

among the above described approaches in order to resolve the issue,³⁴⁰ thereby incorporating the deficiencies of whatever approach is selected.

4.8.4.4 Endnote

It is clearly a difficult, if not an impossible task to devise either standards or criteria for resolving the problem of when conduct violates the covenant of good faith. Some US writers are of the opinion that a workable framework of standards can be created that will substantially reduce *ad hoc* decision making in covenant cases.³⁴¹

(SD Ind 1993); *Hodges Wholesale Cars v Auto Dealers Exch* 628 So 2d 608 at 611 (Ala 1993); *Barn-Chestnut Inc v CFM Dev Corporation* 457 SE 2d 502 at 508-09 (W Va 1995).

340 See, eg, *RW Power Partners LP v Virginia Elec & Power Co* 899 F Supp 149 1498 (ED Va 1995) where the court applied the fruits of the contract approach; *Aylett v Universal Frozen Foods Co* 861 P 2d 375 at 377-78 (Or Ct App 1993) where the court applied the reasonable expectations of the parties approach. Some cases mix UCC good-faith terminology with the common-law approaches, but fail to address whether the applicable UCC good faith entails commercial reasonableness or honesty in fact. See *Bank of China v Chan* 937 F 2d 780 at 788-89 (2d Circuit 1991), mixing UCC, Restatement, and purpose approaches; *Big Horn Coal Co v Commonwealth Edison Co* 852 F 2d 1259 at 1267 (10th Circuit 1988), mixing UCC and reasonable-expectations approaches.

341 See, eg, Boklach 1992 *Oklahoma LR* 647 *et seq.*

4.9 CONCLUSION: RISKS RELATED TO THE US JUDICIAL PROCESSES

In recent years, much has been made of the risks for banking institutions under the US judicial system. Clearly, the environment for the banker-customer relationship (in its many forms as discussed above) unfolds within a highly legal environment. Add to this the propensity for litigiousness of US society, and one can readily understand that the risks of litigation are a real and significant element for banking institutions in order to do business in the USA.³⁴²

To exacerbate the problem, jury trials are common in civil litigation in the USA and most commercial litigation arises in local state (as opposed to federal) courts. Further, in non-contract matters punitive or exemplary damages exist and are determined by the jury (subject to judicial review by the court). Also, in contract-commercial matters consequential damages are similarly determined and can also turn into significant awards. However, the concept that a losing plaintiff pays a defendant's attorney fees has not crept into the US system. Although these aspects of the US judicial system tend to become exaggerated by outside observers, such aspects do present real differences from European modeled systems.³⁴³

Furthermore, the tendency of some US courts to confuse contract causes of actions with tort causes of actions (eg in various lender liability suits) has been disturbing to banking institutions. The effect of this "contort" confusion has been to provide plaintiffs with a means of circumventing normal summary judgment procedures in contract causes of action, to "get" to the jury and to seek tort damages. Although, recently, the judicial trend appears to have been to limit this "contort" approach, the concept of the "duties" and responsibilities of banking institutions has expanded over the past decade of lender liability and consumer litigation. Equally important have been the numerous governmental suits against failed banking institutions and their management for negligence and breach of duty (along with numerous other alleged legal violations).³⁴⁴

Thus, the general nature of the US legal system, the litigious nature of US society, and the spate of private and government litigation over the past decade have come to embrace banker-customer legal relations within a judicial straitjacket, which when added to the regulatory straitjacket within which US banking institutions find themselves, makes the legal dimensions of the banker-

342 Cranston (ed) *European Banking Law* 203; Cranston (ed) *Risk* 1.

343 Cranston (ed) *European Banking Law* 203-204.

344 Cranston (ed) *Risk* 386.

customer relationship in the USA all-encompassing.³⁴⁵

345 Cranston(ed) *European Banking Law* 204.

CHAPTER 5: INDEPENDENT ADVICE: AN AUSTRALIAN PERSPECTIVE

5.1 GENERAL INTRODUCTION

With increasing frequency in recent times, Australian courts have been setting aside, reopening or affording other relief in respect of guarantees, third-party securities and (to a lesser extent) loan contracts.¹ This relief is being afforded under equitable doctrines of unconscionable conduct², undue influence³ and the special equity for wives⁴ and under statutory unjust contracts, misleading conduct or unfair conduct provisions.⁵ Lenders, having become used to the spectacle of their guarantees, third-party securities and loan contracts proving to be impaired on the ground of unfairness and, even more, to such allegations appearing in defences and cross-claims in enforcement actions, are naturally seeking practical mechanisms for protecting their transactions from challenges of unfairness.⁶

1 See, eg, *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *Bawn v Trade Credits* [1986] NSW Conv R 55-290; *Borg-Warner Acceptance Corporation (Australia) v Diprose* [1987] NSW Conv R 55-364; *Commonwealth Bank of Australia v Cohen* [1988] ASC 55-681; *Robinson v Australia and New Zealand Banking Group Ltd* [1990] ASC 58-890; *Parkes v Commonwealth Bank of Australia* [1990] ASC 59-202.

2 *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.

3 See, eg, *Fry v Lane* (1888) 40 Ch D 312 (England); *Blomley v Ryan* (1956) 99 CLR 362; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *Louth v Diprose* (1992) 175 CLR (Australia).

4 See *Yerkey v Jones* (1939) 63 CLR 649; The position of wives is now governed by the general principles of unconscionability. See *Barclays Bank plc v O'Brien and Another* [1994] 1 AC 180 (England); *Akins v National Australia Bank* (1994) 34 NSWLR 155; *National Australia Bank Ltd v Garcia* (1996) 39 NSWLR 577; *Gregg v Tasmanian Trustees Ltd* (1997) 143 ALR 328 (Australia).

5 Eg, ss 51AA and 51AB of the Trade Practices Act of 1974 (Cth) (both prohibiting unconscionable conduct — s 51AB was formerly s 52A) and s 52, the States and Territories Fair Trading Act equivalents of those provisions in regard to misleading and deceptive conduct, the Contracts Review Act of 1980 (NSW) and the UCCC.

6 The Banking Ombudsman has reported that third-party security problems represent a serious issue for banker-customer relations in the business finance area. See Australian Banking Industry Ombudsman's Annual Report 1993-1994 quoted in Weerasooria *Banking Law* par 14.21.

The unfairness complained of commonly consists in some combination of the following factors:⁷

- The guarantor or borrower does not understand (or only imperfectly understands) the nature of the transaction and the documents to be signed and the liability which is being undertaken. This impaired understanding may be caused by lack of English-language facility, lack of general education or lack of business or financial sophistication.⁸
- The guarantor or borrower lacks the information necessary to evaluate the financial risk posed by the transaction.⁹
- The guarantor or borrower lacks the capacity to evaluate the financial risk posed by the transaction¹⁰ and to make a balanced judgment regarding whether or not to proceed with the transaction.
- There has been some misrepresentation or misleading and deceptive conduct (including non-disclosure) by the lender or, in the case of a guarantor, by the borrower.¹¹
- There has been undue influence or other pressure, especially in the case of guarantors who are pressed by a family member to give a guarantee in favour of that family member or a company controlled by the family member.¹²

Before discussing Australian principles in regard to independent advice, it is deemed necessary to look at the common-law roots of the concept.

7 See, eg, O'Donovan 1992 *LIJ* 51-54; Richardson 1994 *Charter* 44; Sneddon 1993 *JBFLP* 92; Sneddon 1996 *ABLR* 5 at 6. The relevance and weighting of these factors in affording relief will vary according to the basis on which the relief is sought; eg, equitable doctrines of undue influence or unconscionable conduct or the particular statutory provision.

8 See, eg, *Harrison v National Bank of Australasia Ltd* (1928) 23 Tas LR 1; *Wilton v Farnworth* (1948) 76 CLR 646; *Blomley v Ryan* (1956) 99 CLR 362; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.

9 *Behan v Obelon (Pty) Ltd* (1985) 157 CLR 326; *Westpac Banking Corporation v Robinson* [1990] ASC 59-027.

10 *Smith v Elders Rural Finance Ltd* (Unreported, Supreme Court NSW, 25 November 1994).

11 *Rhone-Poulenc Agrochimie SA and Another v UIM Chemical Services Pty Ltd and Another* (1986) 68 ALR 77; *Henjo Investments Pty Ltd v Collins Marrickville Pty Ltd* (1988) 79 ALR 83; *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 93 ALR 271; *Commonwealth Bank of Australia v Mehta* (1991) 23 NSWLR 84.

12 Relief has often been awarded where the guarantor is the wife or female *de facto* spouse of the debtor or of a man who controls the debtor company, or where the guarantor is the parent of the adult child debtor. See, eg, *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *European Asian of Australia Ltd v Kurland and Another* (1985) 8 NSWLR 192; *Akins v National Australia Bank* (1994) 34 NSWLR 155.

5.2 COMMON-LAW BACKGROUND

5.2.1 Introduction

From the outset it should be clearly understood that independent advice cannot be a substitute for disclosure. The duty of disclosure relates to material facts, whilst advice is given in regard to conclusions, opinions and expectations which can be derived from these facts. A duty to disclose can be imposed by law and its breach is actionable. There is no general duty to give advice, but advice may play an important role in assessing a stronger party's contractual conduct. At common law, independent advice played an important role in the consideration of the propriety of gifts given by a weaker person to a stronger party, and at some stage it was considered a compulsory element in disproving undue influence in the case of a gift.¹³ In more recent decisions the courts have been much less specific about what is required to satisfy the court of the propriety of the transaction. The leading case on which this view is founded is the advice of the Privy Council in *Inche Noriah v Shaik Allie Bin Omar*, where Lord Hailsham, delivering that opinion, said:¹⁴

"Their Lordships are not prepared to accept the view that independent legal advice is the only way in which the presumption can be rebutted, nor are they prepared to affirm that independent legal advice, when given, does not rebut the presumption, unless it be shown that the advice was taken. It is necessary for the donee to prove that the gift was the result of the free exercise of independent will."

Some judges go further and regard the onus not as a legal burden with clear consequences for the way the case is conducted, but merely as an initial evidentiary burden, leading (after the sifting of all available evidence) to the passing of the ultimate burden to the stronger party in the event that, at the end of the trial, the facts are still unclear.¹⁵

The court must be satisfied ultimately that the transaction is the "spontaneous act of the donor or grantor acting in circumstances which enable him to exercise an independent will and which justify the court's holding that the gift or transaction was the result of the free exercise of his

13 *Wright v Carter* [1903] 1 Ch 27 at 60; *Allison v Clayhills* [1907] 97 LT 709 at 712; *Demerara Bauxite Co v Hubbard* [1923] AC 673; *Spencer Bower Non-Disclosure* 686-689.

14 [1929] AC 127 at 133. Particular reliance was placed by Lord Hailsman on the judgment of Cotton LJ in *Allcard v Skinner* (1887) 36 Ch D 145 at 171

15 See, eg, *Re Craig, Meneces v Middleton* [1971] Ch 95 at 104.

will,"¹⁶ or, more briefly, that the plaintiff has acted with an "independent and informed judgment".¹⁷ The requirement of independent advice in the case of gifts, which Spencer Bower regarded as a proposition of law, is no longer viewed in that way: the procuring of independent advice is "useful, though not essential,"¹⁸ and is only one of several ways in which it may be shown that the transaction is the result of a spontaneous, uninfluenced decision by the weaker party.¹⁹

5.2.2 Independent advice defined

Whatever the strict legal position, often the appropriate course for the stronger party to take will be to see that the weaker party has the advice of a third person entirely independent of the influence of the stronger party. Spencer Bower puts the matter this way:²⁰

"In many situations, that will be a very simple and obvious means of escaping the difficulties of proof, and a means which affords an excellent test of the conscientiousness and propriety of the transaction. This course so plainly suggests itself to an honest and scrupulous man, that, when proved to have been adopted by the stronger party, it goes a very long way, and in most cases is sufficient of itself, to sustain the validity and *bona*

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- 16 *Goldsworthy v Brickell* [1987] 1 Ch 378 at 401; *Re Brocklehurst (Estate)*; *Hall v Roberts* [1978] Ch 14 at 36, *per* Lawton LJ, citing *Allcard v Skinner* (1887) 36 Ch D 145 at 171; in Australia: *Johnson v Buttress* (1936) 56 CLR 113 at 119-120. The critical time is the making of the contract or gift: *Allcard v Skinner*, *ibid*, at 173.
- 17 *Lloyds Bank Ltd v Bundy* [1975] QB 326 at 342, *per* Sir E Sachs. Various similar expressions have been used: see *Zamet v Hyman* [1961] 1 WLR 1442 at 1446; *Re Craig, Meneces v Middleton* [1971] Ch 95 at 105; *Re Brocklehurst (Estate)*; *Hall v Roberts* [1978] 1 Ch 14 at 33; cf *Re Pauling's Settlement Trust*; *Younghusband v Coutts* [1964] 1 Ch 303 at 336. See, also, *Wright v Carter* [1903] 1 Ch 27 at 57, *per* Stirling LJ ("act of rational consideration, an act of pure volition, uninfluenced"), citing *Hatch v Hatch* (1804) 9 Ves 292 at 297.
- 18 *Re Pauling's Settlement Trust*; *Younghusband v Coutts* [1964] Ch 303 at 336; *Re Brocklehurst (Estate)*; *Hall v Roberts* [1978] Ch 14 at 42, *per* Bridge LJ (normally the only way of showing that there has been no exploitation). In Australia: *Haskew v Equity Trustees, Executors and Agency Co Ltd* (1919) 27 CLR 231; *Watkins and Another v Combes and Another* (1922) 30 CLR 180 at 195-196.
- 19 *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127 at 133 at 135; *Lancashire Loans Ltd v Black* [1934] 1 KB 380 at 412-413; *Mcmaster v Byrne* [1952] 1 All ER 1362 at 1369; *Re Craig, Meneces v Middleton* [1971] Ch 95 at 105; *Re Brocklehurst (Estate)*; *Hall v Roberts* [1978] Ch 14 at 36-37.
- 20 Spencer Bower *Non-Disclosure* 691-692.

fides of the transaction.²¹ whereas the omission to resort to it raises an inevitable suspicion that the only reason for the omission must have been a consciousness on the part of the [stronger] party that the transaction was unrighteous and unfair, and that any impartial person would so advise. A party must ordinarily be in a very dubious position who asks a disinterested tribunal to approve, *ex post facto*, the propriety of a transaction which he carefully refrained from submitting to the judgment of an equally disinterested (though an unofficial) tribunal before the transaction was entered into."

If the critical issue is whether the transaction is the result of the exercise, by the weaker party, of a spontaneous and uninfluenced will,²² then it follows as a matter of principle that there can be no legal rules defining what is necessary, or sufficient, when the obtaining of independent advice is put forward, or suggested as necessary, to justify any particular transaction.²³ This, it may be expected, will vary considerably, depending upon the relevant circumstances, in particular the degree of involvement the other party has previously had in the complaining party's affairs, and the ease with which outside advice will detach him from them. The type and quality of advice which meets an acceptable standard will also vary from case to case, and the courts are now reluctant to lay down any specific rules.²⁴

The decisions reflect this diversity, and there is not even a clear rule on how far the stronger party must go in trying to see that there is independent advice. Sometimes it is thought to be sufficient, that the stronger party merely advises the weaker party that legal advice may be taken²⁵ or refers the weaker party to a particular person who is likely to give it.²⁶ On other occasions, it may be

21 *Pratt v Barker* (1826) 1 Sim 1; *Blackie v Clark* (1852) 15 Beav 595 at 603; *Potts v Surr* (1865) 34 Beav 543 at 551-552; *Taylor v Johnston* (1882) 19 Ch D 603 at 609; *Re Coomber, Coomber v Coomber* [1911] 1 Ch 723 at 727-728.

22 *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127 at 133.

23 *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127 at 135-136. This was a Privy Council decision, on appeal from Straits Settlements. Their Lordships declined to lay down any general rule about what type of advice should be given, "further than to say that it must be given with a knowledge of all relevant circumstances and must be such as a competent and honest adviser would give if acting solely in the interests of the donor". For a general description of the actions a solicitor should take, in a fairly standard case, see *Gregg v Kidd* [1956] IR 183 at 203-204.

24 *Spencer Bower Non-Disclosure* 692.

25 *Allcard v Skinner* (1887) 36 Ch D 145 at 184 at 190; *Willis v Barron* [1902] AC 271 at 284; *Lloyds Bank Ltd v Bundy* [1975] QB 326 at 345.

26 *Spencer Bower Non-Disclosure* 692.

important to ensure that the weaker party does receive independent advice, if necessary procuring it.²⁷ There may even be cases where the stronger party should refrain from dealing with the weaker party if, to the former's knowledge, the latter has received defective advice,²⁸ or has received sound advice and is acting against it,²⁹ but that is clearly not the general rule.³⁰

Of this last suggestion, that the stronger party should refrain from dealing with the weaker party if, to the former's knowledge, the latter has received sound advice but is acting against it, Spencer Bower observed³¹ that "this view seems a highly extravagant and illogical one, and it is not surprising to find that it has since been expressly dissented from".³² Nevertheless, it is not difficult to conceive, for example, of domestic situations where the weaker party is under strong and unfair pressure to agree to a transaction which an independent adviser considers imprudent. The fact that the weaker party receives independent advice against the transaction, but decides not to take it, is necessarily inconsistent with the possibility of undue influence.

5.2.2.1 Independence

To carry weight as "independent advice", the advice should of course come from one who is "independent," that is "free from any taint of relationship, or of the consideration of interest which affects the act".³³ Advice offered by the solicitor for both parties will seldom assist,³⁴ and a solicitor who has a close professional connection with the stronger party will not be a

27 *Lloyds Bank Ltd v Bundy* [1975] QB 326 at 345-346.

28 See, eg, *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127. Cf, in Ireland, *Rae v Joyce* (1892) 29 LR IR 500 at 521-522; and compare *Grealish v Murphy* [1946] IR 35 at 48.

29 *Wright v Carter* (1903) 1 Ch 27 at 58; *Powell v Powell* [1900] 1 Ch 243 at 246; Ashburner's *Equity* 301.

30 *Re Coomber, Coomber v Coomber* [1911] 1 Ch 723 at 729-730; *Bruty v Edmundson* (1915) 113 LT 1197 at 1201; *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127 at 135. In Ireland: *Provincial Bank of Ireland v McKeever* [1941] IR 471 at 484-485; *Gregg v Kidd* [1956] IR 183 at 200-203.

31 Spencer Bower *Non-Disclosure* 692-693.

32 Citing *Re Coomber, Coomber v Coomber* [1911] 1 Ch 723.

33 *Re Coomber, Coomber v Coomber*, *ibid*, at 730.

34 See, eg, *Powell v Powell* [1900] 1 Ch 243 at 246-247. In Australia, see *Watkins and Another v Combes and Another* (1922) CLR 180 at 197. In Canada, see *Bertolo v Bank of Montreal* (1986) 33 DLR (4th) 610 at 618.

satisfactory adviser.³⁵ And clearly, a person who is merely called in by the weaker party for the express purpose of approving, and putting into legal form, what has already been determined upon, and from whom any dissuasive counsel or attempted exercise of judgment would be immediately resented, or one who is employed by, or is in the confidence of, both parties, or one who is not likely to act in the sole interests of the weaker party, though ordinarily a natural protector, by reason of some special circumstance, such as a quarrel or estrangement, is not an independent person in this sense.³⁶

5.2.2.2 Competence

The advice should also be "competent". This does not necessarily mean that the advice must come from a lawyer,³⁷ and in one case it was suggested at first instance that the advice of a "man of affairs" may even be preferable.³⁸ The adviser must at least have sufficient information about the weaker party's affairs³⁹ to advise him about the wisdom of the transaction; advice merely about its nature and effect may not be enough.⁴⁰

If the advice was in fact honest and independent, it can hardly be supposed that the [weaker]

35 *Lancashire Loans Ltd v Black* [1934] 1 KB 380 at 399-400.

36 *Clark v Malpas* (1862) 4 De GF & J 401 at 404; *Tate v Williamson* (1866) LR 2 Ch App 55; 1 Eq 528 at 539; *Rae v Joyce* (1892) 29 LR IR 500 at 514, *per* Walker LC (IR) at 525-527, *per* Fitzgibbon LJ (IR); *Powell v Powell* [1900] 1 Ch 243 at 245-247; *Willis v Barron* [1902] AC 271 at 282. *Demerara Bauxite Co Ltd v Hubbard* [1923] AC 673 at 682-683.

37 *O'Rorke v Bolingbroke* (1877) 2 App Cas 814 at 830.

38 *Allcard v Skinner* (1887) 36 Ch D 145 at 159. The Court of Appeal in this case seems to have contemplated advice of a more legal character; see at 173, *per* Cotton LJ.

39 *Wright v Carter* [1903] 1 Ch 27 at 52, 54; *Williams v Johnson* [1937] 4 All ER 34 at 37-38.

40 *Wright v Carter* [1903] 1 Ch 27 at 52, at 58, at 62; *Powell v Powell* [1900] 1 Ch 243 at 247 (England). In Australia: *Adenan v Buise* [1984] WAR 61 at 68. In New Zealand: *Brusewitz v Brown* [1923] NZLR 1106 at 1117. But, see *Re Coomber, Coomber v Coomber* [1911] 1 Ch 723 at 730 (sufficient that supposedly influenced party knew "nature and consequences" of her act). There is an old practice, where large gifts are made to a person who is not in a position of influence, of requiring that person to establish that the transaction is "righteous", that is to say, that the donor "knew and understood what he was doing": *Hoghton v Hoghton* (1852) 15 Beav 278 at 298-299; *Cooke v Lamotte* (1851) 15 Beav 234 at 240-241. But while this distinction between knowing "the nature and consequences of an act" and "knowing and understanding what he is doing" is sometimes helpful, in cases of undue influence at least, the one seems to merge imperceptibly into the other: see, eg, *Willis v Barron* [1902] AC 271 at 275-276; *Lancashire Loans Ltd v Black* [1934] 1 KB 380 at 415-416.

party can make the [stronger] party responsible for his want of skill, unless of course the latter had put the former in communication with one whom he knew to be lacking in judgment, sagacity, and experience, and as likely to give bad counsel as good. Nevertheless, the adviser should be prepared to carry out independent investigations going beyond the facts made available by the stronger party.⁴¹ In summary, the adviser must know all the relevant circumstances, and the advice must be such as a competent adviser would give if acting solely in the interests of the donor or grantor.⁴²

*Inche Noriah v Shaik Allie Bin Omar*⁴³ is still the leading case on these principles, and it offers a good example of their application. The plaintiff was a feeble old woman who for some time had relied on the defendant for advice and the management of her affairs, both business and domestic. Before making the gift in question, she was advised by an independent lawyer, who acted in good faith throughout. Unfortunately, he obtained much of his information from the defendant, and he did not realize that the plaintiff was giving away practically the whole of her estate. He did not, it seems, bring home to her the consequences of her actions, or the fact that she might achieve her objectives by the more orthodox method of leaving the defendant her property in her will.⁴⁴ The Privy Council held that the transaction should be set aside, independent advice in these circumstances being no answer to the plaintiff's claim. It should not, however, be assumed that in every case the defendant is going to be answerable for shortcomings in the advice received by the plaintiff; there is a clear difference between the case where the appointment of an independent adviser severs the relationship of influence altogether, and those where it continues, albeit in a muted form.⁴⁵

5.2.2.3 Recent Canadian cases

In *MacKay v Bank of Nova Scotia*,⁴⁶ Lederman J suggested that a bank has a positive duty to require that a person incurring indebtedness for another obtain independent legal advice. Relying

41 *Wright v Carter* [1903] 1 Ch 27 at 51-52. Sometimes it may be that the advice should be against the transaction; *Wright v Carter*, *ibid*, at 62.

42 *Inche Noriah v Schaik Allie Bin Omar* [1929] AC 127 at 136.

43 [1929] AC 127.

44 *Ibid*, at 136.

45 Eg, *Wright v Carter* [1903] 1 Ch 27. *Tate v Williamson* (1866) 2 Ch App 55 at 65 (where material information not disclosed, defendant's suggestion to plaintiff that he should take independent advice was no answer to the plaintiff's claim).

46 (1995) 20 BLR (2d) 304.

on this decision, numerous debtors and guarantors have brought suits seeking to avoid their obligations on the ground that they had not received independent legal advice. However, in each of these cases, the court has refused to interpret the *MacKay* case as mandating independent legal advice. Indeed, with each new decision, the *MacKay* case and the requirement of independent legal advice appears to be disappearing.

In the *MacKay* case, the plaintiff had borrowed \$45,000 from the Bank of Nova Scotia in order to finance the purchase of a trailer for her daughter and her daughter's common-law husband. The bank had advised the plaintiff to obtain independent legal advice, but she had declined to do so on the basis that it was too expensive and that she did not require it. The bank requested, and the plaintiff signed, a waiver of independent legal advice.

Some two years after the plaintiff had taken out the loan, her daughter and son-in-law made an assignment into bankruptcy. Their secured creditors repossessed the trailer and the plaintiff was left liable for the entire bank loan.

The plaintiff brought an action for a declaration that the loan was invalid and of no force and effect, since no-one that she had dealt with had advised her whether the loan was prudent from her point of view. While the bank claimed that it had met its obligations to the plaintiff by advising her to obtain independent legal advice, the court was of the opinion that the bank owed her a much higher duty:

"A bank, however, cannot escape its responsibility by merely recommending independent legal advice in this situation. It must insist on it. If a customer refuses, the obtaining of a waiver of independent legal advice cannot ameliorate the circumstances. The plaintiff should have been advised in no uncertain terms that if she did not obtain independent legal advice, then the bank would decline the loan."

The court held that the bank's failure to ensure that the plaintiff had independent legal advice was fatal to the bank's position.

Predictably, the *MacKay* case spurred litigation by debtors and guarantors attempting to escape their liability on the ground that they did not have independent legal advice. In *Merchants Consolidated Ltd (Receiver of) v Team Sports & Trophies (1984) Inc*,⁴⁷ the corporate defendant's former principal (Brill) attempted to prevent the plaintiff receiver from realising on his (Brill's)

47 [1995] OJ No 84.

personal guarantee of the corporation's indebtedness. Brill raised several defences including the fact that he had not received independent legal advice before executing the guarantee. He relied on the *McKay* case as support for the argument that there is an onus on the entity receiving the guarantee to ensure that the guarantor receives advice as to the wisdom and effect of giving such a guarantee. The court disallowed Brill's claim on the grounds that he was businessman of some experience who appeared to have understood the nature of his obligations under the guarantee at the time he executed it and that he was a principal of the entity whose obligations were being guaranteed.

Similarly, in *Community Trust Co Ltd v Issajenko*,⁴⁸ the court held that Mrs Issajenko was liable under the personal guarantees she had given in respect of loans made by the plaintiff to a private corporation operated by her husband. While it was conceded that Mrs Issajenko had not received independent legal advice before executing the guarantees, the court found that she was well educated and would have understood the significance of the guarantees. Accordingly, the court did not permit her to rely on the *MacKay* case to avoid her obligations under the guarantees.

The court's willingness to enforce guarantees, notwithstanding the absence of independent legal advice, has not been limited to cases where the guarantor is sophisticated and/or well educated. In *Royal Bank of Canada v Domingues and Another*,⁴⁹ the defendant, Carlos Martins had signed a promissory note in order to secure a loan from the Royal Bank for the defendant Manuel Domingues. When Domingues ceased making payments and was noted in default, the Royal Bank proceeded against Martins on the promissory note. Martins, who could not speak or read English and had had only an elementary school education in his native Portugal, pleaded *non est factum* and argued, citing the *MacKay* case that the bank should have advised him to seek independent legal advice. He claimed that he had not understood the significance of his signature on the promissory note and that no-one had explained to him his obligations on default.

Notwithstanding the absence of independent legal advice, the court held Martins liable under the promissory note. The evidence indicated that the Royal Bank employees had spoken with Martins in Portuguese and had fully explained to him his obligations under the promissory note. Accordingly, the court concluded that the Royal Bank, through its employees, had made every necessary disclosure to Martins, that he knew and understood his obligations and that he had signed the promissory note in terms of which he was being sued with a full understanding of his liability. Given these circumstances, the court held that it was not necessary for the bank to have

48 [1995] OJ No 2874.

49 (1995) 21 BLR (2d) 79.

insisted that Martins obtain independent legal advice.

The courts have therefore moved away from the attitude in the *MacKay* case and have correctly apprehended that the real issue is the knowledge, understanding and relative bargaining position of the guarantor and/or debtor.

In the recent decision of *Hong Kong Bank of Canada v Amormino*,⁵⁰ Abbey J reconciled the more recent cases with the *MacKay* case and adopted the following approach to the issue of independent legal advice:

"Putting aside circumstances in which there exists a fiduciary obligation, there is no general obligation on the part of a bank to require independent legal advice for a guarantor as a precondition of enforcing security documents executed by the guarantor. In certain circumstances, however, the failure to insist upon independent legal advice may be fatal to a bank's position in that, for example, the evidence otherwise may suggest *non est factum* or undue influence in relation to the document in issue. Circumstances, for example, which suggest an inequality of bargaining position together with a manifestly unfair bargain may, in the absence of independent legal advice, give rise to a presumption of undue influence... *MacKay v Bank of Nova Scotia* is [an] example of a case in which the circumstances, absent independent legal advice, were considered unconscionable and fatal to the bank."

5.3 AUSTRALIAN CONCEPTS IN REGARD TO INDEPENDENT ADVICE

5.3.1 Introduction

As we have seen, for many years, English and Canadian courts have cited independent legal advice as a means of curing the taint of undue influence or unconscionable conduct on a transaction.⁵¹ Statutory provisions also direct attention to whether independent legal or other advice was obtained⁵² and the cases under those provisions attest to the beneficial (but not

50 [1995] OJ No 2116.

51 Eg, *MacKay v Bank of Nova Scotia* (1995) 20 BLR(2d) 304 (Canada); *Powell v Powell* [1900] 1 Ch 243; *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127 (England); In Australia, see *Yerkey v Jones* (1939) 63 CLR 649; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.

52 Eg, the Contracts Review Act of 1980 (NSW); s 147 (2)(g) of the Credit Acts of NSW, Vic, Qld, WA and ACT; s 51AB of the Trade Practices Act of 1974 (Cth). This section

conclusive) effect of independent legal advice in protecting a transaction.⁵³ It is not surprising, therefore, that lenders have placed their hopes upon independent advice as a key element of a safe lending procedure.

Independent legal advice is not a certain protection for all guarantees and loan contracts. It can make those transactions safer against attack on the grounds of unfairness, but it cannot make all such transactions completely safe.⁵⁴ Independent legal advice is also not the only available means of protecting transactions. Independent financial advice may be more useful than independent legal advice in some cases.⁵⁵ Guarantors and borrowers can be required to certify that they understand the obligations and risks of the transaction.⁵⁶ Bankers themselves could provide explanations and warnings in order to address some of the "unfairness" factors listed above. But independent advice is perceived as more effective than these other methods and some bankers fear that giving their own explanations or warnings would open them up to claims of deficient or misleading explanation or warning.⁵⁷

does not expressly mention independent advice, but such advice will be relevant to s 51AB (2)(c) ("whether the consumer was able to understand any documents") and s 51 AB (2)(d), ("whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the consumer"). See, also, s 44 of the Consumer Transactions Act of 1972 (SA).

53 Eg, *West v AGC (Advances) Ltd* (1986) 5 NSWLR 610; *Collier v Morlend Finance Corporation (Vic) Pty Ltd* [1989] ASC 55-716.

54 Usually independent advice will be relevant at two points in the analysis of an unconscionable-conduct case. Firstly, actual adequate independent advice could negative an alleged special disadvantage. See *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 476 where Deane J referred to the absence of independent advice as one factor establishing a special disadvantage. Secondly, independent advice could negative an alleged unconscientious taking of advantage, particularly where the creditor is proceeding with the transaction knowing or suspecting that the surety has a deficient understanding of the transaction. See the *Amadio* case, *ibid*, (1983) 151 CLR 447 at 468.

55 Eg, where the guarantor or borrower is incapable of assessing the financial risks of the transaction. See *Smith v Elders Rural Finance Ltd* (Unreported Supreme Court NSW 25 November 1994).

56 The former State Bank of Victoria used such a "Guarantor's Acknowledgement".

57 S 52 of the The Trade Practices Act of 1974 (Cth) is a formidable weapon in a debtor's defence armoury. The pervasive influence of the section, supplemented by the Fair Trading Act, upon modern commercial activity is now notorious. Thus it is now widely used in cases of precontractual misrepresentation, negligent misrepresentation, passing off, false or misleading advertising, and fraudulent misrepresentation. See French 1989 ALJ 250 at 268; Clarke 1989 ABR 109. The reluctance of financial institutions to assume a liability or duty to advise a surety is therefore understandable. See Pengilly 1992 QUTLJ 35 *et seq*, on how financial institutions have already been targeted by s 52

5.3.2 Certain lender strategies in regard to unfairness

Independent advice has figured prominently in lenders' strategies for dealing with attacks on transactions based on unfairness. One strategy is to recommend independent advice as part of a package of procedures⁵⁸ to protect transactions. The Australian Code of Banking Practice⁵⁹ establishes protective procedures for taking guarantees, which involve a combination of written warning and disclosure by the lender, a recommendation that the prospective guarantor obtain independent legal advice and a stated ceiling on the guarantor's liability.⁶⁰

A second strategy, which could stand alone or could be used as part of a combination protective procedure as in the Code of Banking Practice, would be to require some guarantors and borrowers to obtain independent legal advice and to require the legal adviser to certify that advice and the client's understanding of it, to the lender, in a *pro-forma* certificate.⁶¹ In recent times, lenders have relied more on certified independent advice, which has increased demands on solicitors to give certificates in the various forms required by lenders.⁶²

As lenders' reliance on independent legal advice has increased, there has been a growing awareness within the legal profession that a solicitor's professional responsibility to a client seeking independent advice on a guarantee transaction extends beyond merely explaining the documents, and includes advice on the financial propriety of entering into the transaction.⁶³ It

litigation. See Sneddon 1996 *ABLR* 5 at 6, and the problems discussed in the chapter on Australia, in regard to s 52 of the Trade Practices Act of 1974 (Cth).

58 See Sneddon 1993 *JBFLP* 92 *et seq.*

59 The Code of Banking Practice was promulgated by the Australian Bankers' Association (ABA) on 3 November 1993 and many of its provisions were adopted by member banks of the ABA by December 1994. See Weerasooria *Banking Law* par 15.3. The Code contains a specific section relating to guarantees.

60 S 17.5 of the Australian Code of Banking Practice requires that a bank shall recommend that a prospective guarantor obtain independent legal advice.

61 S 44 of the Consumer Transaction Act of 1972 (SA) requires that certain guarantees be executed in the presence of an independent legal practitioner and that that practitioner must certify in writing that he or she is satisfied that the guarantor understands the purport and effect of the agreement and that the guarantor has voluntarily executed the agreement in the practitioner's presence.

62 See O'Donovan 1992 *LIIJ* 51 at 52.

63 Some recent cases have also suggested that in certain, quite limited, circumstances a solicitor should provide warnings on the risks or financial propriety of a loan contract to clients who are prospective borrowers: *O'Brien v Hooker Homes Pty Ltd* [1993] ASC 56-

follows that a "quick-fix" interview with a client which does not go beyond a straight explanation of the documents may amount to professional negligence in some cases. But the significant duties which the law imposes on solicitors giving independent advice are at odds with the expectations of lenders and of borrower and guarantor clients as to the nature of the solicitor's task, and the fees these clients expect to pay often do not permit recovery of costs for the quite complex legal service the courts require.⁶⁴

Law societies have become greatly concerned about the potential liability of their members to borrower and guarantor clients for inadequate independent advice, whether certified or not.⁶⁵ Law societies are equally concerned about liability their members may incur to lenders through the certification process should the transaction later be successfully attacked for unfairness. The latter concern has led to some tension with lenders about whether solicitors should give such certificates at all and to lengthy debate over the wording of such certificates, including the use of disclaimers in the certificates.⁶⁶ The various law societies have been engaged in negotiations with lenders' associations seeking a solution to this difficult issue, a solution which appropriately balances the sometimes conflicting interests of lenders and solicitors. The Law Institute of Victoria (LIV) and the Australian Bankers' Association (ABA) have agreed on the form of certificates to be used for advice to guarantors and borrowers.⁶⁷ The New South Wales Law Society previously declared that the primary responsibility for explaining a guarantee lies with the lender and cautioned its members against advising prospective guarantors about the commercial aspects of the transaction.⁶⁸ That Law Society has now recommended certificates and

217. See, also, O'Donovan 1992 *LIJ* 52-54 on the solicitor's duty.

64 See O'Donovan 1992 *LIJ* 51 at 52-54; Sneddon 1996 *ABLR* 5 at 7.

65 For cases against solicitors in this regard, see *Farnham v Orrell and Others* [1989] NSW Conv R 55-443; *Albury and Others v Gulror Pty Ltd and Others* [1992] A & NZ Conv R 482; *Clark and Others v Barter and Others* [1989] A & NZ Conv R 212; *Demetrios v Gikas Dry Cleaning Industries Pty Ltd* (1991) 22 NSWLR 561.

66 Eg, the Law Society of NSW issued "Guidelines Concerning Independent Solicitors' Certificates of Explanation of Loan Documents" July 1992. For a criticism of these Guidelines see *Duggan Guide*, which guide was prepared for the Australian Finance Conference and Australian Equipment Lessors Association.

67 These forms and an accompanying Practice Note recommending their use were published in (1994) 68 *LIJ* 907-911 and 927 (October 1994). There is also a form of certificate for a translator/interpreter and a form of acknowledgment to be given by a borrower or surety to the certifying solicitor.

68 This caution seems to ignore the professional duty of solicitors to advise guarantors of the propriety of entering into the transaction. Sneddon 1996 *ABLR* 5 at 8.

procedures which are similar to the LIV-ABA certificates.⁶⁹ The Law Council of Australia has published a discussion proposal for a Guarantor's Acknowledgment which requires no certification by solicitors. As yet there is no national approach on the issue.⁷⁰

Much of the debate among lenders, solicitors and law societies has been characterised by some confusion over the following issues:⁷¹

- in what circumstances it is necessary or desirable for lenders to recommend or require that guarantors or borrowers obtain independent advice in order to protect transactions from attacks based on the Australian law of undue influence, the special equity for wives, the equitable doctrine of unconscionable conduct and statutory provisions proscribing unfair contracts or conduct;
- the effect (if any) of the House of Lords' decision in *Barclays Bank v O'Brien and Another*⁷² and subsequent English Court of Appeal decisions on Australian law;⁷³
- the nature of a solicitor's obligations to a guarantor or borrower client who seeks independent advice (including the issue of whether or not a solicitor should advise on the propriety of the transaction for the client);
- whether or not, and how, solicitors could effectively limit their clients under a retainer to provide independent advice;

69 Law Society of NSW Caveat No 153, 21 July 1995 quoted in Sneddon 1996 *ABLR* 5 at 8.

70 The difficulties posed by requiring independent advice and certification of that advice for a non-client party to a transaction are not confined to transactions within the finance industry. The franchise industry has adopted a code of practice which requires either that a franchisee produce a certificate from a solicitor certifying that the solicitor has explained the franchise agreement to her or him or that the franchisee sign a statement that the franchise agreement has been explained by a solicitor. The Victorian Solicitors Liability Committee has advised solicitors not to provide these certificates or, if they do so, to modify the certificate so that it refers only to an explanation of the general effect of the document and the franchisee's appearing to understand that explanation. See "Solicitors Liability Committee Update" Victorian Law Institute News, No 5 of 1994 quoted in Sneddon 1996 *ABLR* 5 at 8.

71 For a summary see Sneddon 1996 *ABLR* 5 at 8.

72 [1993] 4 All ER 417

73 To a large extent this issue has been laid to rest. The fact of being a wife has been held not to constitute "special disability" for the purposes of unconscionability. See *European Asian of Australia Ltd v Kurland and Another* (1985) 8 NSWLR 192 at 200; *Akins v National Australia Bank* (1994) 34 NSWLR 155. The position of wives is now governed by the general principles of unconscionability. *National Australia Bank Ltd v Garcia* (1996) 39 NSWLR 577; *Gregg v Tasmanian Trustees Ltd* (1997) 143 ALR 328.

- the potential liability of a solicitor to a lender through a certificate of advice, and ways of minimising that liability, including the use of disclaimers in such certificates;
- the level of fees for independent advice and certificates and the question of who pays; and
- protective lending strategies other than independent advice, when they should be used, and the relative costs and benefits to lenders of recommending or requiring independent advice as compared with those other protective strategies.

These issues will be investigated hereunder.

5.3.3 The necessity of independent advice⁷⁴

It must be stressed that the absence of independent advice does not of itself make a transaction unfair under the equitable doctrines or the statutory provisions.⁷⁵ The presence of independent advice may protect a transaction from the taint of unfairness suffered by a guarantor owing to other circumstances. Independent advice is therefore not needed in cases which are free of unfairness. If there is a hint of unfairness in a transaction, independent advice will very often be desirable for the guarantor, and from the lender's viewpoint, it will be desirable if unfairness exists and if the lender will be fixed with the consequences of that unfairness; for example, where the lender had notice of the borrower's undue influence over the guarantor.⁷⁶

The need for independent advice and its curative role vary according to the basis on which a transaction is attacked for unfairness: undue influence, unconscionable dealing and statutory provisions proscribing unfair conduct or contracts. Each of these will be examined in turn.

74 It would appear as if almost all the reported cases on the need for independent advice, relate to sureties.

75 Sneddon 1990 *UNSWLJ* 302 at 319. See, however, s 44 of the Consumer Transaction Act of 1972 (SA) requiring a lender to ensure that a prospective guarantor obtains a certificate along the lines that a solicitor has satisfied himself that the borrower understands the purport and effect of the guarantee. For a discussion of this requirement, see O'Donovan 1992 *LJ* 51-54.

76 See Sneddon 1996 *ABLR* 5 at 8.

5.3.4 Independent advice and undue influence⁷⁷

If the borrower has procured the guarantor's consent to the transaction by exercising undue influence over the guarantor then the guarantor has a remedy in equity to have the transaction set aside as against the borrower.⁷⁸ The issue is whether that remedy in equity of the guarantor will prevail against the lender. The relevant test to determine this issue in Australian law, drawn from the judgment of Dixon J in *Yerkey v Jones*⁷⁹ is: did the lender have reasonable grounds to believe that both the consent to the transaction and the execution of the relevant document were fairly obtained from a surety who sufficiently understood the purport and effect of the documents? If the lender had such a reasonable belief then the surety's remedy in equity will not prevail against the lender. This test was propounded in a case concerning the relationship between borrower husband and surety wife and was expressed to cover the equities in favour of the surety arising from undue influence and misrepresentation as well as the special equity principle relating to wives. Because of the generality of its expression, it is submitted that the test is not confined only to equity principles arising between wife and husband, but applies to the equities in favour of all guarantors whom lenders should realise are, like wives to husbands, in a potentially vulnerable relationship *vis-à-vis* the borrower. The same generality of application is found in the English law of undue influence. In *Barclays Bank v O'Brien and Another*⁸⁰ Lord Browne-Wilkinson held that lenders were under a similar *onus* where:

- the lender has notice either that the guarantor and borrower are in an emotional relationship and are cohabiting or that the guarantor reposes trust and confidence

77 An attack could be based on the lender's own undue influence on the guarantor, but this seems to be a rare phenomenon because the lender usually is not in a relationship of influence with the surety. A lender is more likely to be in a relationship of influence with a borrower.

78 *Allcard v Skinner* (1887) 36 Ch D 145; *Tate v Williamson* (1866) LR 2 Ch App 55; *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127 (England); *Union Bank of Australia Ltd v Whitelaw* (1906) VLR 711 at 720; *Bank of New South Wales v Rogers* (1941) 65 CLR 42; *Bester v Perpetual Trustee Co Ltd* [1970] 3 NSW 30 (Australia).

79 (1939) 63 CLR 649 at 686. *Yerkey v Jones*, *ibid*, is perhaps better known for establishing the special equity principle for a wife who guarantees her husband's debts. This special equity principle has been criticised in recent times. See *Warburton v Whitely* [1989] NSW Conv Rep 55-453 at 58-287. *Akins v National Australia Bank* (1994) 34 NSWLR 155, Williams 1994 *J of Contract Law* 67. *Yerkey v Jones* (1939) 63 CLR 649 is not cited here for the special equity principle, but for the test to determine when an equity in favour of the surety (which may be an equity arising from undue influence by the borrower as much as the special equity principle of wives) prevails against the lender. The criticisms of the special equity principle do not affect this other aspect of *Yerkey v Jones*.

80 [1994] 1 AC 180; [1993] 4 All ER 417.

- regarding financial affairs in the borrower; and
- the transaction was not to the financial advantage of the surety.

The necessary reasonable belief in a lender, required by the *Yerkey v Jones*⁸¹ test, can be established other than by independent advice. The lender could undertake its own explanation and probe to its own satisfaction the genuineness and circumstances of the guarantor's consent. There are some risks for lenders in such a course of creating further exposure if their explanation or investigation is careless or involves a misrepresentation.⁸² If independent advice is to be used to establish the necessary reasonable belief in the lender, the lender must have reasonable grounds to believe that independent advice was actually given to the guarantor and that the advice adequately addressed the genuineness of the guarantor's consent and adequately explained the purport and effect of the documents. One obvious way to ensure that the lender has reasonable grounds to so believe is to have the independent adviser certify these matters to the lender. Merely urging a guarantor to take independent advice would not of itself give the lender reasonable grounds⁸³ to believe in the fairness of the obtaining of consent or in the guarantor's understanding of the documents under the *Yerkey v Jones*⁸⁴ test.⁸⁵

It has been suggested that, in most cases, certified adequate independent advice should protect the transaction from attacks based on the borrower's undue influence in most cases. It will not protect in all cases; for example, if the lender knew of other circumstances which suggested that undue influence arose after the advice or persisted in spite of the advice, then the transaction would still be vulnerable to attack.⁸⁶

5.3.5 Independent advice and unconscionable conduct

Relief is available in equity for unconscionable transactions if two elements are present:⁸⁷

81 (1939) 63 CLR 649.

82 The Trade Practices Act of 1974 (Cth) s 52 can present massive problems for a creditor advising a customer or surety, if the advice is deemed misleading or deceptive.

83 See Sneddon 1990 *UNSWLJ* 302 at 324-325.

84 (1939) 63 CLR 649.

85 Unlike the test in *Coldunell Ltd v Gallon* [1986] 1 QB 1184; [1986] 1 All ER 429.

86 See Sneddon 1996 *ABLR* 5 at 9-10.

87 *Blomley v Ryan* (1956) 99 CLR 362 at 415; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.

- (1) one party to a transaction is at a special disadvantage in dealing with the other party (for example, because of age,⁸⁸ physical or mental infirmity, lack of English language facility, financial hardship,⁸⁹ ignorance or lack of business experience, drunkenness⁹⁰ misunderstanding of the transaction); and
- (2) the other party takes unconscientious advantage of the first party's special disadvantage (for example, as in *Commercial Bank of Australia Ltd v Amadio*⁹¹ where the lender proceeded with the transaction while knowing of the guarantor's situation of disadvantage and did nothing to correct it).

If these two elements are established the transaction will be set aside unless it can be shown that the transaction was fair, just and reasonable in all the circumstances.⁹²

Again, independent advice is not essential in order to protect a transaction. If there is no special disadvantage or the lender has no notice of a special disadvantage then the transaction will not be impeachable under this doctrine.⁹³ If the lender does have notice of a special disadvantage, the lender could itself redress some types of special disadvantage, for example, by giving an adequate explanation of the documents and the risks of the transaction and having these translated into the guarantor's native language if necessary. Lenders may consider that they run more risks taking such a course, in view of the wide statutory protection against misleading or deceptive advice and unconscionability, and prefer to use independent advice. If independent advice is used, it may assist by negating one or both of the above elements. First, it could neutralise an alleged special disadvantage. To do this there would have to be actual independent advice given which was adequate to counteract the special disadvantage.⁹⁴ It would not be enough merely to urge that

88 *Archer v Cutler* [1980] 1 NZLR 386; *Clark v Malpas* (1862) 4 De GF & J 401.

89 *Sturge v Sturge* (1849) 12 Beav 229; *Familiar Pty Ltd v Samarkos* (1994) 115 FLR 443.

90 *Blomley v Ryan* (1956) 99 CLR 362.

91 (1983) 151 CLR 447.

92 *Fry v Lane* (1888) 40 Ch D 312; *Earl of Aylesford v Morris* (1873) 8 Ch App 484 (England); in Australia, see *Harrison v National Bank of Australasia Ltd* (1928) 23 Tas LR 1; *Bank of Victoria v Mueller* [1925] VLR 642; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 474; *Louth v Diprose* (1992) 175 CLR 621 at 637; *Familiar Pty Ltd v Samarkos* (1994) 115 FLR 443.

93 *Hart v O'Connor* [1985] AC 1000; [1985] 2 All ER 880.

94 *Fry v Lane* (1888) 40 Ch D 312 at 322.

independent advice be taken.⁹⁵

Secondly, independent advice could negative an unconscientious taking of advantage by the lender. This would depend on the nature of the alleged unconscientious taking of advantage. If it consisted (as in the *Amadio*⁹⁶ case) of the lender's proceeding with the transaction, knowing or suspecting some element of special disadvantage (for example, a deficient understanding of the transaction), then there would be no unconscientious taking of advantage if the lender could show that it reasonably believed that the special disadvantage had been negated by the guarantor's receiving adequate independent advice. If the lender reasonably believed the guarantor had taken independent advice which was adequate to redress the special disadvantage, it would not be unconscientious to proceed with the transaction.⁹⁷

The reasonable belief could be established by having an independent adviser certify to the lender that the matters giving rise to the special disadvantage had been adequately addressed.⁹⁸ As surmised above, it must be doubted whether merely urging the guarantor to take advice would ground the necessary reasonable belief.⁹⁹

In theory, independent advice may be relevant in a third way, by helping to establish that the transaction was fair, just and reasonable in all the circumstances. But in practice it is difficult to see how independent advice could do this other than by the two methods described above: negating a special disadvantage or giving the lender a reasonable belief that the special disadvantage had been redressed.¹⁰⁰

95 Sneddon 1990 *UNSWLJ* 302 at 325.

96 (1983) 151 CLR 447.

97 Sneddon 1990 *UNSWLJ* 302 at 327-328; Sneddon 1996 *ABLR* 5 at 10-11.

98 S 44 of the Consumer Transaction Act of 1972 (SA) requires a lender to ensure that a prospective guarantor obtains a certificate from a solicitor certifying that the guarantor understands the true purport and effect of the transaction. See, also, O'Donovan 1992 *LJ* 51 at 52; *Nolan v Westpac Banking Corporation* [1989] ASC 55-930.

99 Sneddon 1990 *UNSWLJ* 302 at 327-328.

100 Overall fairness in other transactions may be established by showing that the weaker party received a substantial material benefit from the transaction. See *European Asian of Australia Ltd v Kurland and Another* (1985) 8 *NSWLR* 192. The existence of a substantial benefit does not automatically exclude relief. See *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 475; *Blomley v Ryan* (1956) 99 CLR 362 at 405.

It is important to note that the ordinary case in which all the lender knows is that a wife is guaranteeing her husband's debts (or a person is guaranteeing a relation's debts) and the transaction is not, on the face of it, for the guarantor's benefit, will not, by virtue of those facts alone, involve unconscionable conduct. To be married or otherwise related to a borrower and to receive no benefit from a guarantee are not factors which by themselves establish a special disadvantage.¹⁰¹ More is needed, such as the advanced age of the guarantor, financial or business inexperience, misunderstanding of the transaction or poor facility in English, or some wrongdoing such as misrepresentation by borrower or lender.¹⁰²

Strictly then, a guarantor in the ordinary case needs no special treatment from the lender. However, the risk is that the lender's officers know or have notice of more than the minimal facts of the standard case. Under the *Amadio*¹⁰³ case, if the lender is aware of the possibility that a special disadvantage may exist or is aware of facts that would raise that possibility in the mind of any reasonable person, the lender still cannot proceed with the transaction without taking steps to redress the special disadvantage.¹⁰⁴ Thus a prudent lender, in devising a lending procedure, cannot always assume that it is dealing only with the minimal facts of the ordinary case. It needs to construct a procedure for taking guarantees based on the wider knowledge of which its officers will have actual or constructive notice. That procedure should have several levels appropriate to what is known by the lending officers and, hence, appropriate to the risk of the transaction being set aside.¹⁰⁵

101 *Akins v National Australia Bank* [1994] 34 NSWLR 155.

102 *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *Nolan v Westpac Banking Corporation* (1989) 51 SASR 496; *National Australia Bank Ltd v Nobile and Martelli* (1988) ATPR 40-856.

103 (1983) 151 CLR 447.

104 (1983) 151 CLR 447 at 467 per Mason CJ, at 479 per Deane J. There is authority for the argument that these passages ought not to be read as establishing the argument that constructive notice of the weaker party's disadvantage is sufficient for the doctrine of unconscionable conduct. There must be a dishonest, rather than a merely careless failure to inquire. See Privy Council authority (*Hart v O'Connor* [1985] AC 1000 and *Royal Brunei Airlines sdn bhd v Tan* [1995] 3 WLR 64), but this view is not consistent with most Australasian judicial interpretations of the *Amadio* case. See eg, *Akins v National Australia Bank* (1994) 34 NSWLR 155; *Broadlands International Finance Ltd v Sly* [1987] NSW Conv R 55-342; *Nichols v Jessup* [1986] 1 NZLR 226; *Contractors Bonding Ltd v Snee* [1992] 2 NZLR 157.

105 Sneddon 1996 *ABLR* 5 at 11.

5.3.6 Independent advice and statutory relief

The UCCC, the Contracts Review Act of 1980 (NSW), and s 51AB of the Trade Practices Act of 1974 (Cth)¹⁰⁶ require a court to weigh a variety of factors in order to determine whether or not a contract is unfair, or conduct unconscionable. The presence or absence of independent advice is only one of those factors. The cases thus far have established the following:

- Independent advice is most often relevant for its curative effect. The absence of independent advice and the failure of a lender to recommend independent advice are factors which, of themselves, will not render a contract unjust. A lender is not required as a matter of ordinary practice to ensure that independent advice is taken by a guarantor. However, the absence of independent advice is a factor which, taken together with other factors, such as a borrower's undue influence over a guarantor, may lead to a conclusion that a contract is unjust.¹⁰⁷
- If independent advice is to be used to cure a transaction, the advice must address the relevant vitiating factors and be adequate to redress those factors.
- Many of the factors listed in the statutes are matters of objective fact requiring objective evaluation rather than an evaluation of the lender's state of mind regarding those factors (for example, whether the guarantor or borrower understood the documents). This means that if independent advice is to cure a vitiating factor then advice must have actually been given and not merely urged and must have been adequate to address the relevant vitiating factor.¹⁰⁸
- It has been held under the Contracts Review Act of 1980 (NSW) that a lender's reasonable belief that adequate independent advice had been given would not necessarily prevent a finding that a contract was objectively unjust if in fact advice had not been given or was inadequate.¹⁰⁹ But the decision that a contract is unjust is an exercise of discretion based on all the facts of a case. In *Younan and Bechara v Beneficial Finance*

106 The application of s 51AB (formerly s 52A) of the Trade Practices Act of 1974 (Cth) to guarantees was confirmed in *Begbie v State Bank of New South Wales* [1994] ATPR 41-881.

107 For decisions under the Contracts Review Act 1980 (NSW), see *West v AGC Advances* (1986) 5 NSWLR 610; *Younan and Bechara v Beneficial Finance Corporation Ltd* (Unreported, Court of Appeal, NSW, 21 November 1994). For a decision under Pt IX of the Credit Act 1984 (NSW), see *Esanda Finance Corporation v Murphy* [1989] ASC 55-703.

108 Sneddon 1990 UNSWLJ 302 at 328.

109 *Collier v Morlend Finance Corporation (Vic) Pty Ltd* [1989] ASC 55-716.

*Corporation Ltd*¹¹⁰ a lender's reasonable belief, based on a solicitor's certificate, that adequate independent advice had been given (when in fact the advice was inadequate to negative the borrower's undue influence upon the surety) was a factor taken into account in determining that the contract was not unjust in all the circumstances. Even if a contract is objectively assessed as unjust, the court will usually exercise its discretion against granting relief if the lender's conscience was (subjectively) clear.¹¹¹

Adequate independent advice actually given will objectively cure many vitiating factors. Even if the advice does not in fact address all the vitiating factors, the adviser's certificate to the lender can provide the lender with reasonable grounds to believe that the vitiating factors have been cured.¹¹² That reasonable belief will influence the court against granting relief even if, objectively, the vitiating factors were not cured.¹¹³

5.3.7 Independent legal advice: the solicitor's duties in regard to independent advice

5.3.7.1 Advice must be independent

The advice must be independent of the interests of the lender and, where a prospective guarantor is being advised, of the borrower. In the case of advice to a prospective guarantor, King CJ in *McNamara v Commonwealth Trading Bank of Australia*¹¹⁴ said:

110 Unreported Court of Appeal NSW, 21 November 1994, quoted in Sneddon 1996 *ABLR* 5 at 12.

111 *Collier v Morlend Finance Corporation (Vic) Pty Ltd* [1989] ASC 55-716.

112 The question of independent advice is full of pitfalls for a bank. In *Guthrie v Australia and New Zealand Banking Group Ltd* [1989] NSW Conv R 55-463, eg, Mrs Guthrie had a serious drinking problem and her marriage was not harmonious. Mr Guthrie obtained a loan for 15,000 Australian dollars to buy a boat and the bank wanted a mortgage over the Guthrie home as security. Mrs Guthrie reluctantly agreed to sign the mortgage and at the bank's request, she consulted a solicitor who explained the mortgage to her and signed the requisite certificate. The mortgage was an "all accounts" mortgage, which included Mr Guthrie's liability as a guarantor of the debts of his business.

The Court found that the bank was aware of Mrs Guthrie's position of special disadvantage and that it should have advised her of the potential liabilities under the bond. In the result her liability under the mortgage was limited to 15,000 dollars.

113 Sneddon 1990 *UNSWLJ* 302 at 327-328; Sneddon 1996 *ABLR* 5 at 12.

114 (1984) 37 SASR 232 at 241. See, also, *Powell v Powell* [1900] 1 Ch 243 at 246-247. In the recent English Court of Appeal cases of *Massey v Midland Bank plc* [1995] 1 All ER 929; *Banco Exterior Internacional v Mann* [1995] 1 All ER 936; *Bank of Baroda v Rayarel* (Unreported, CA, 13 January 1995 (published in *The Times*, 19 January 1995),

"It is essential that the solicitor act and be understood to act solely for the prospective surety ... sound professional practice requires also that the solicitor be and be seen to be free to advise the prospective surety unencumbered by any ties to the principal debtor. The solicitor, moreover, should be at pains to ensure that his client's decision is as free of the influence of the debtor as he can arrange sound professional practice requires that the debtor should not be present when the solicitor is advising the client and receiving his instructions."

The fact that the solicitor is nominated by the lender to advise the guarantor does not, of itself, prevent the advice from being independent.¹¹⁵ However, the advice should not be given in the presence of the lender or at the lender's premises.¹¹⁶

Advice which does not conform to these standards of independence may still benefit the guarantor and preserve the transaction if it adequately redresses the relevant vitiating factors or gives the lender reasonable grounds to believe they have been redressed.¹¹⁷ However, the less independent the advice is, the less likely it is to be considered adequate to redress a vitiating factor (especially any influence of a party from whom the solicitor is not independent) and, if the lack of independence is known by the lender, the less likely it is to form a sufficient basis for a reasonable belief in the lender that any vitiating factors have been redressed. In addition, a

the surety transaction was upheld because the surety received legal advice even where the solicitor was not independent of the borrower and advised the surety in the presence of the borrower. Those decisions did not endorse such conduct by solicitors and did not change the standards of professional conduct, leaving open the possibility of an action by a surety against a solicitor who does not observe proper standards of independence.

115 See *Collier v Morlend Finance Corporation (Vic) Pty Ltd* [1989] NSW Conv R 58-438 at 58-443.

116 *McNamara v Commonwealth Trading Bank of Australia*, *ibid*, at 241; *Nolan v Westpac Banking Corporation* (1989) 51 SASR 496. In this case a mortgage was declared void because the bank had pressed the plaintiff to sign the guarantee and security documents and had advised her only at the last minute about the need for a solicitor to be present. Ligertwood AJ held that in the circumstances the solicitor had not been independently instructed and employed. The solicitor saw the plaintiff for the first time in the branch manager's office and in the presence of the branch manager. He did not have an opportunity to explain the guarantee in his own office and without the presence of the branch manager.

117 See *Beneficial Finance Corporation v TAB Constructions Pty Ltd* (Unreported Supreme Court NSW, Giles J, 11 August 1993) and on appeal in *Younan and Bechara v Beneficial Finance Corporation Ltd* (Unreported Court of Appeal, NSW 21 November 1994) with regard to advice to Mrs Younan, at 17 per Mahoney JA. The test of adequacy of advice given is whether it places the weaker party in a position of reasonable equality with the superior party, in terms of capacity to look after his own interests. See *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 477.

disgruntled guarantor might sue a solicitor who gave advice when he or she was not truly independent.¹¹⁸ For all these reasons, the standards of independence outlined above should be observed.

Principles of independence for advising borrowers are analogous to those for advising guarantors. If the borrower has come to the solicitor for advice, or it becomes apparent to the solicitor that advice on the propriety of the transaction is required even if the original retainer did not expressly require such advice, the solicitor is in dangerous waters if he or she is also acting for the lender,¹¹⁹ and sound professional practice would suggest that advice to the borrower on the propriety of the transaction must come from a solicitor who is not acting for the lender.¹²⁰

The relevant jurisdiction's professional conduct rules for solicitors should also be considered. For example, in Victoria, r 10(2) of the Solicitors' (Professional Conduct and Practice) Rules 1984 forbids a solicitor to act for both the lender and the borrower in connection with a loan, unless both parties agree to this in writing. Rule 10 (6a) forbids a solicitor to act for a guarantor if the solicitor is also acting for the borrower or lender, subject to certain exceptions.

5.3.7.2 Contents of solicitor's advice

A clear and understandable explanation of the main terms of the documents and the obligations being undertaken is required. The practical effect of those obligations should be brought home to the client; for example, whether the client's home may be sold to meet the obligations, whether the documents provide that interest rates will rise or that repayments will be accelerated upon a default being made, whether the liability being guaranteed is limited or unlimited and how it may increase.¹²¹

118 See O'Donovan 1992 *LJ* 51 at 52-54; Sneddon 1996 *ABLR* 5 at 22. The solicitor owes the client/guarantor a duty to exercise all reasonable care and skill in connection with the client's business. See *Howard Ltd v Woodman Matthews & Co* [1983] BCLC 117. A solicitor's duty in Australian law cannot be limited strictly to the scope of the retainer because a duty may also lie in tort, and the solicitor may be required to take positive steps, beyond the specifically agreed professional task or function, to avoid a real and foreseeable risk. See *Hawkins v Clayton* (1988) 164 CLR 539 at 579.

119 In *Powell v Powell* [1990] 1 Ch 243 at 246-7, it was held that the advising solicitor must be independent of the stronger party to the transaction in fact as well as in name and hence cannot act for both parties.

120 *Howard Ltd v Woodman Matthews & Co* [1983] BCLC 117; O'Donovan 1992 *LJ* 51 at 54. On the solicitor's duty of care, see *Waimond (Pty) Ltd v Byrne* [1989] NSWLR 642.

121 Sneddon 1990 *UNSWLJ* 302 at 321.

The extent to which a solicitor should go beyond explanation to canvass the propriety of the transaction for the client depends upon whether the client is a prospective guarantor or borrower. The advice required by a borrower depends upon the nature of the solicitor's retainer. Often the terms of the retainer are not explicit and the scope of the retainer is then determined by the terms the law implies. The law on a solicitor's obligation to advise a prospective borrower regarding the financial propriety of the transaction is still developing and there is some conflict in the case law. An investigation into the duties of advice to a borrower falls outside the scope of this thesis.¹²²

5.3.7.3 Advice to prospective guarantors:¹²³ advice on the propriety of the transaction.

It is clearly established that a solicitor advising a prospective guarantor, as well as explaining the documents, ought to advise on the propriety of the transaction for the guarantor, that is, the nature and extent of the risk presented by the transaction and the wisdom of the guarantor's entering into the transaction.¹²⁴ This is not financial advice in the sense of advising on the suitability of

122 For leading cases on the subject, see *Hogan v Howard Finance Ltd* [1987] ASC 55-594; *Esanda Finance Corporation v Murphy* [1989] ASC 55-703; *O'Brien v Hooker Homes Pty Ltd* [1993] ASC 56-217. In summary of these cases, the present law appears to be as follows: Unless the retainer expressly requires it, the obligation does not extend to canvassing a range of possible sources of finance and advising which is best. The principal obligation is to warn the borrower client if the proposed transaction is improvident or unlikely to succeed. This will involve a discussion of the borrower's capacity to repay given the terms of the finance and the borrower's other commitments, an assessment of these matters and, if necessary, firm advice against entering into the transaction on the terms proposed. Finally, it may be appropriate to recommend that the client take independent financial advice. Certainly, lenders may wish to ensure that some borrowers receive independent financial advice as well as independent legal advice.

123 In *Shotter v Wespac Banking Corporation and Villars* [1987] BCL 352, Wylie J of the High Court of New Zealand created a new duty:

"A duty of explanation, warning or recommendation of separate advice arises 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 that person's decision to enter to the guarantor."

This is not part of Australian law.

124 This is clear in the case of undue influence: see *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127 at 135-136 (England); *Bester v Perpetual Trustee Co Ltd* [1970] 3 NSW 30; *Yerkey v Jones* (1939) 63 CLR 649 at 684. In regard to unconscionability, see, in regard to propriety, *Commercial Bank of v Australia Ltd v Amadio* (1983) 151 CLR 447 and *Guthrie v Australia and New Zealand Banking Group Ltd* [1989] NSW Conv R 55-463. In regard to the solicitor's duties, see *McNamara v Commonwealth Trading Bank of Australia* (1984) 37 SASR 232 at 241.

a range of financial options and their tax implications. It is a warning about and a discussion of:

- the financial risk posed by the particular transaction;
- the factors and information relevant to evaluating that risk;
- the ability of the guarantor to cover that risk if it eventuates;
- the right of the guarantor not to proceed; and
- in appropriate cases, advice about whether the guarantor should sign.¹²⁵

In *Collier v Morlend Finance Corporation (Vic) (Pty) Ltd*¹²⁶ independent advice was tendered to elderly parents (the Colliers) who were, in substance, providing a third-party security for a loan to their son. In form the parents sold their home to the son for a stated consideration which no one expected him to pay. In substance they gave him the home on the understanding that they would be able to live there until they died and that the son would use the property as security to raise a loan to finance the purchase of a business. The finance broker had told the son that the lender would not accept a third-party security from the Colliers and that they should transfer the property to the son. The son and his mother were referred to a solicitor chosen by the finance broker for independent advice on the "sale" of the house. The solicitor verified that the parties understood that the transaction was really a gift, verified the son's undertaking that the parents could continue to live in the house, and had them execute the contract of sale and transfer. Meagher JA said that the advice tendered seemed somewhat deficient:

"There seems to have been no discussion about who would repay the mortgage and from what source of funds; no discussion about the sham nature of the so-called "sale"; and no discussion about what steps the lender might take if the mortgage were not repaid according to its tenor."¹²⁷

In other words, the risks of the transaction and its propriety for the Colliers should have been addressed in the advice. However, no relief was given in the *Collier* case because the lender was

125 A duty to advise under this item is supported by *McNamara v Commonwealth Trading Bank of Australia* (1984) 37 SASR 232 at 241. In *Banco Exterior Internacional v Mann* [1995] 1 All ER 936 (England), all the members of the Court of Appeal considered that a solicitor should advise a surety that he or she is under no obligation to sign the documents, (at 944, 948 and 950). Hobhouse LJ (at 948) said that in some cases a solicitor may need to advise the guarantor not to sign. Bingham MR (at 950) said it was no part of a solicitor's duty to advise a surety not to sign and Morritt LJ did not comment on the point. See, also, *Bester v Perpetual Trustee Co Ltd* [1970] 3 NSW 30 (Australia).

126 [1989] NSW Conv R 55-473; ASC 58-428.

127 *Ibid*, at 58-443. The Judge noted that the solicitor was not called to give evidence and that the court was deprived of the benefit of what he would wish to say.

ignorant of the actions of the finance broker and the inadequacy of the advice given. The court held that it is not necessary to establish knowledge by the lender of the vitiating factors to entitle a plaintiff to relief, but lack of knowledge by the lender is relevant to the court's exercise of its discretion whether or not to grant relief. Here the lender was considered an innocent party and it would not have been just to deprive him of the benefit of his contract.¹²⁸

In *Banco Exterior Internacional v Mann*¹²⁹ Bingham MR said:

"It is an ordinary incident of a solicitor's duty to explain the obvious potential pitfalls of legal transactions to those about to take part in them and there is no clear dividing line between explanation and advice. If the certifying solicitor did his job with reasonable competence...[the surety] would appreciate quite clearly that if the worst happened she could lose her rights in the house and that it was for her to decide whether she was willing to take that risk or not."

In the *McNamara*¹³⁰ case King CJ spoke of the duty of a solicitor to a client who consults the solicitor for advice about signing a guarantee, as follows:¹³¹

"The solicitor should raise with the client questions relating to the prudence of entering into the guarantee and should ascertain whether the client wishes to be advised as to such questions. The client may, of course, indicate that he does not wish advice as to those matters and that he is prepared to rely upon his own judgment. But unless the client so instructs the solicitor, the instructions from the client should be regarded as extending to advice on all matters relating to it from a particular point of view. The state of the financial affairs of the principal debtor should be discussed as well as the extent of the assets of the client. A client whose assets are few and who will be putting the whole of his assets, perhaps including his home, at risk obviously needs careful and perhaps quite forthright advice. The need is even greater when, as so often is the case, the affairs of the principal debtor are precarious. Solicitors undertaking to advise clients in relation to guarantees would do well to study the cases as to the type of independent advice which is required to rebut a presumption of undue influence."

128 See Sneddon 1990 *UNSWLJ* 302 at 337 for a discussion of the case.

129 [1995] 1 All ER 936 at 950.

130 (1984) 37 SASR 232.

131 *Ibid*, at 241.

The duty set out here will require a discussion of the extent of the risk that the surety is undertaking as measured against the resources of the surety. Matters relevant to the extent of the surety's risk will include:

- the terms of the liability set out in the documents;
- the borrower's financial position; and
- the viability of any business venture of the borrower which is expected to repay the debt.¹³²

Solicitors may not have access to information about the last two matters nor the expertise to assess the third. In such cases, it has been suggested, solicitors have three options:

- (1) limit their advice on the propriety of the transaction to the matters about which they do know; advise the guarantor of the factors relevant to the risk being undertaken; advise the guarantor, in writing, on what information was not available for the purposes of the advice; advise that the guarantor may wish to make inquiries about the matters not known and seek independent financial advice on the viability of the borrower's business venture;
- (2) limit their retainers to avoid advising on the propriety of the transaction altogether;
- (3) seek the missing information from the lender; if it is not forthcoming, advise the client in writing of the lender's non-co-operation and note it on any certificate to the lender so that the lender will bear whatever flows from the impairment in the quality of the advice caused by the absence of the information.¹³³

If the lender does not provide the solicitor with sufficient information to advise the guarantor adequately as to the risk being run, the lender will not be able to assume that the guarantor has received adequate independent advice.¹³⁴

132 Sneddon 1996 *ABLR* 5 at 23.

133 Sneddon 1990 *UNSWLJ* 302 at 322-324; Sneddon 1996 *ABLR* 5 at 23-24; *Guthrie v Australia and New Zealand Banking Group Ltd* [1989] NSW Conv R 55-463.

134 This was the exact situation in *Levett and Others v Barclays Bank plc* [1995] 2 All ER 615 (England). In *Allied Irish Bank v Byrne* [1995] 1 FCR 430, a woman was induced by her former husband's misrepresentation to open a joint account with him to be used solely for his benefit and to execute an all-moneys charge, expressed to secure only her own indebtedness, but which by virtue of the joint account secured his debts also. The bank sent the wife, with the charge document only, to a solicitor for independent advice. The solicitor was not given any information about the amount, purpose or terms of any

It is clear that there are real risks and dangers confronting solicitors dealing with loan security documentation generally and a duty to provide independent advice will add to the burden.¹³⁵

5.3.7.4 Limitation of solicitor's retainer

In *McNamara v Commonwealth Trading Bank*,¹³⁶ King CJ stated that a solicitor who is consulted by a prospective guarantor should advise on all matters relating to the guarantee, including the prudence of entering into the guarantee from a practical point of view, unless the client instructs the solicitor otherwise. In other words, the retainer will be viewed as impliedly including advice on the propriety of the transaction. Advice on the financial propriety of a loan transaction may also be an implied part of a retainer from a client who has requested the solicitor to arrange finance or where the client's circumstances necessitate such advice. Of course, a solicitor may be expressly retained to give such advice.

If a solicitor does not wish to advise on the financial propriety of a transaction, can the solicitor limit the retainer to exclude such advice? From the general principles of Australian contract law the answer should be in the affirmative because a retainer is a contract for services, the terms of which can be negotiated and agreed to by the parties. Thus, a solicitor and client should be able to agree on express limitations on the services to be provided. However, the fiduciary nature of the relationship would suggest that the client must be fully apprised of any such limitation and its effect. The limitation of the retainer must be explicit and its effect must be brought home to the client at the commencement of that retainer, otherwise the solicitor may be open to an action for professional negligence. In *Collier v Morlend Finance Corporation (Vic) Pty Ltd*¹³⁷ Hope JA addressed this issue as follows:

facilities to be secured by the charge, nor could he be aware from the terms of the charge that the woman was entering into a suretyship arrangement. It was thus impossible for the solicitor to advise the woman about the risk she was running. The bank ought to have realised that the solicitor was unlikely to have obtained this information from the wife or any other source and it was therefore not entitled to assume that the wife had been adequately advised.

135 The following cases are illustrative of instances where the solicitor was sued: *Demetrios v Gikas Dry Cleaning Industries Pty Ltd* (1991) 22 NSWLR 561 (fraudulent misrepresentation); *Clark and Others v Barter and Others* [1989] A & NZ Conv R 212 (withholding from the client relevant knowledge; failure to disclose important facts); *Albury and Others v Gulror Pty Ltd* [1992] A & NZ Conv R 482 (failure to explain transaction and risks; acting for both lender and borrower); *Farnham v Orrell and Others* [1989] NSW Conv R 55-443 (solicitor acting for both parties; failure to advise).

136 (1984) 37 SASR 232.

137 [1989] ASC 58-428 at 58-441.

"[I]f a client goes to a solicitor to get independent advice about a transaction and its effect, the solicitor cannot limit his responsibility to give that advice by having the client sign a piece of paper which restricts the solicitor's retainer to giving something which is or may be less than appropriate independent advice, unless the solicitor makes it plain to the client that he will not, or will not necessarily, be giving that appropriate advice to the client as to the transaction and its effect."¹³⁸

Any limitation of the retainer should be explained to the client at the outset, agreed to in writing by the client and reflected in any certificate which the solicitor may give to the lender about the advice.

Hope JA went on to point out that advice given under an expressly limited retainer may not be adequate to cure a taint of unfairness in a transaction.¹³⁹ This would be true under both the equitable doctrines and under the statutory unfairness provisions. Thus a retainer could explicitly exclude advice as to the financial propriety of a transaction, but if part of the operative unfairness in a transaction were the fact that the guarantor or borrower lacked the capacity to fully appreciate and evaluate the financial risk involved in the obligations being undertaken, such limited advice would do nothing to cure that unfairness. In cases such as these the lender would need to ensure that the guarantor or borrower received advice about the financial propriety of the transaction from some other source, such as the lender or a financial adviser.

5.3.7.5 Solicitor's liability to lender on a certificate of advice

In Australian law, concurrent liability in contract and tort may exist between parties in a contractual or commercial relationship.¹⁴⁰ A solicitor may be liable to a lender for the statements made in a certificate of advice if they are made negligently (on the basis of negligent misstatement):¹⁴¹ or if they involve a misrepresentation or are otherwise misleading and deceptive (under s 52 of the Trade Practices Act of 1974 (Cth) or State Fair Trading Act equivalents).¹⁴²

138 *Ibid.*

139 *Ibid.*

140 *Hawkins v Clayton* (1988) 164 CLR 539.

141 *Howard Ltd v Woodman Matthews & Co* [1983] BCLC 117 (England); *Waimond Pty Ltd v Byrne* [1989] 18 NSWLR 642; O'Donovan 1992 *LJ* 51 at 53-54 (Australia).

142 S 13 of the Fair Trading Act of 1992 (ACT); s 43 of the Fair Trading Act of 1987 (NSW); s 43 of the Consumer Affairs and Fair Trading Act of 1990 (NT); s 39 of the Fair Trading Act of 1989 (Qld); s 57 of the Fair Trading Act of 1987 (SA); s 15 of the Fair

The existence of a duty of care in tort would depend upon whether there was a sufficient relationship of proximity between the solicitor and lender.¹⁴³ Given that the lender is provided with the certificate, at the lender's request for the purpose of assuring the lender that the guarantee or loan is likely to withstand attack and that it concerns advice given to a prospective counterparty to the lender in a transaction, the requisite relationship of proximity would usually exist. If the statements in the certificate were negligently made and were relied upon by the lender in proceeding with the transaction and the transaction was later set aside or relief was given against the lender because of unfairness to the counter party, which the certificate would have led the lender to believe had been cured or no longer existed, then the solicitor would be *prima facie* liable to the lender for the loss that flowed from the lender's reliance on the negligently made statements.¹⁴⁴

Under s 52 of the Trade Practices Act of 1974 (Cth), if the statements in the certificate were misleading and deceptive and caused loss to the lender (usually by the lender's relying¹⁴⁵ on them in order to proceed with the transaction), the lender could recover the amount of that loss by an action under s 82. An unincorporated solicitor not engaged in interstate trade and commerce might escape the reach of Pt v of the Trade Practices Act of 1974 (Cth)¹⁴⁶ but would still be caught by the equivalent Fair Trading Act provisions in each State and Territory.

Trading Act of 1990 (Tas); s 11A of the Fair Trading Act of 1985 (Vic); s 11 of the Fair Trading Act of 1987 (WA). A solicitor could also be liable in the tort of deceit for knowingly making false statements in a certificate.

143 *Bond Corporation Pty Ltd v Thiess Contractors Pty Ltd* (1987) 14 FCR 215; *Schepis and Others v Elders IXL Ltd* (1986) 70 ALR 729.

144 *H G & R Nominees Pty Ltd v Fava* [1995] V Conv R 66- 155 at 66-200; 66-201. The solicitor's negligence in this case did not cause the lender any damage because the surety's mortgage was held to be enforceable. See, also, *Waimond Pty Ltd v Byrne* [1989] 18 NSWLR 642.

145 The loss must have been caused by the misleading and deceptive conduct. It is not necessary that the claimant itself relied on the conduct. See *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd* [1992] ATPR 41-186, but in this context it is most likely that if the certificate causes the lender loss, it will be because the lender relied on it.

146 Note that s 6(3) extends the application of some of the consumer protection provisions of the Trade Practices Act of 1974 (Cth), including s 52, to catch conduct by natural persons involving the use of postal, telegraphic or telephone services. The mailing or faxing of a certificate of advice could bring a solicitor's conduct within s 52.

5.3.7.6 Suggested solution of the problems for bankers and solicitors¹⁴⁷

There would seem to be three possible strategies for preserving the protective benefit of proven independent advice for the lender without exposing the solicitor to liability to the lender:¹⁴⁸

- (1) The solicitor certifies the advice to the lender in carefully circumscribed terms.
- (2) The solicitor certifies the advice to the lender with a disclaimer.
- (3) The guarantor or borrower certifies the advice to the lender.

5.3.7.6.1 Certification: circumscribing the terms of the certificate

Recent English Court of Appeal cases¹⁴⁹ have held that a general certificate that the surety has been advised entitles the lender to assume that the certifying solicitor has provided all the necessary explanation, advice and warning, even if that is not the case. To avoid such a shifting of responsibility and risk from lender to solicitor, the certificate should carefully state what has and has not been advised to the client. The Law Institute of Victoria has asked its members to use standard forms of certificates agreed to by the Institute and the Australian Bankers Association.¹⁵⁰ Almost identical certificates have been recommended by the Law Society of New South Wales.¹⁵¹

There is also provision for a certificate of advice to a borrower and a certificate by a

147 The suggestions are those of Sneddon 1996 *ABLR* 5 at 29-34. A solicitor will always be potentially liable to the guarantor or borrower client for professional negligence. The risk of negligence in giving advice is not increased by the act of certifying the advice to a lender. However, the risk of being sued for negligence by the client may be increased if, as a result of the certificate, the lender can uphold a transaction tainted with unfairness. The best way to minimise this risk is to treat the giving of such advice as a serious business, have a good set of procedures in place and keep adequate records, including a written record of the advice or a written acknowledgment from the client of verbal advice given. The Victorian Solicitors Liability Committee has published recommended procedures for this purpose: see *Learning From Amadio* (booklet published June 1995) and quoted by Sneddon 1996 *ABLR* 5 at 29.

148 Sneddon 1996 *ABLR* 5 at 29; O'Donovan 1992 *LIJ* 51 at 54 for a checklist.

149 *Massey v Midland Bank plc* [1995] 1 All ER 929; *Banco Exterior Internacional v Mann* [1995] 1 All ER 936; *Bank of Baroda v Rayareel* [1995] 2 FLR 376.

150 The certificates were published in 1994 *LIJ* 907-911 (October 1994).

151 See Lang, Anderson & Skinner *Protecting Mortgagors and Guarantors* 91 for an example, and at 62-91 for a discussion on the aspect of explanation of loan documents and certificates of explanation.

translator/interpreter. For the protection of the solicitor, there is also a form of written acknowledgment by the borrower or guarantor client that the client has received and understood the advice and explanations provided.

5.3.7.6.2 Certification: adding a disclaimer to the certificate

In negotiations between the ABA and the LIV, lenders have resisted the inclusion of disclaimers in solicitors' certificates because they believe it will reduce the value to them of the certificate. Lender representatives have also stated that lenders will not sue solicitors on their certificates.¹⁵²

5.3.7.6.3 Certification: disclaimer: liability in negligence

In general, a properly drafted disclaimer in a certificate to another person can exclude the liability in negligence of the author of the certificate to the recipient, for the contents of the certificate.¹⁵³ This is subject to one exception. Liability for negligent misstatements was originally thought to be based on an assumption of responsibility by the person making the statement and it was thought that an express disclaimer of such responsibility would then prevent a duty of care arising.¹⁵⁴ The modern Australian view is that a duty of care is imposed by law¹⁵⁵ if information or advice has been sought in the course of business and the person giving the information knew or ought to have known that it would be relied upon by the person for whom it was intended and it was reasonable for that person to so rely.¹⁵⁶ In the modern view, a disclaimer of liability might not be effective if the defendant should have known that the plaintiff would rely on the statement despite the disclaimer; for example, if the defendant was the only possible source of the information or advice.¹⁵⁷ That exception does not apply to independent solicitors' certificates. Any one solicitor is not the only possible source of a certificate about advice given to a prospective guarantor or borrower. The lender could ask the guarantor or borrower what they had

152 Sneddon 1996 *ABLR* 5 at 32.

153 *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 where the House of Lords held that the defendants were not liable to the plaintiffs because their advice was given "without responsibility".

154 *Ibid*, at 486.

155 *Mutual Life and Citizens Assurance Co Ltd v Evatt* (1968) 122 CLR 556 at 570.

156 *L Shaddock & Associates Pty Ltd and Another v Parramatta City Council (No 1)* (1981) 150 CLR 225; *San Sebastian Pty Ltd and Another v Minister Administering Environmental Planning and Assessment Act 1979 and Another* (1986) 162 CLR 340.

157 Davies 1991 *UNSWLJ* 171 at 195.

been advised or send them to another solicitor and seek a certificate from that other solicitor, without a disclaimer.

Therefore, an appropriately drafted disclaimer in a solicitor's certificate should exclude the liability of the solicitor to the lender, for negligence.

5.3.7.6.4 Certification: disclaiming liability for misleading and deceptive conduct in terms of s 52 of the Trade Practices Act or Fair Trading Act equivalents

In order to determine whether conduct is misleading or deceptive, the conduct must be considered as a whole, taking account of both the representation made and any disclaimer. A disclaimer might prevent persons from relying on misleading conduct and thus deprive them of a cause of action under s 82 of the Trade Practices Act of 1974 (Cth) because their loss was not suffered by conduct in breach of the Act. But if, as a matter of fact, the person relied on the misleading conduct notwithstanding the disclaimer, the disclaimer will not save the person who engaged in the conduct.¹⁵⁸

Because the lender will in fact rely on the certificate notwithstanding the disclaimer suggested above (and that is the purpose of the lender's taking the certificate) the disclaimer will not negative reliance. Nor will it render a misleading statement in the certificate, not misleading.

It is therefore likely that the liability of a solicitor for a misleading or deceptive statement in the certificate under s 52 cannot be excluded.¹⁵⁹ The only remedy is to be careful in drawing the terms of the certificate and in making the statements in the certificate. Given the terms of the Law Institute certificate set out above, there seems little scope for misrepresentation on the part of a solicitor who is reasonably careful in doing what the certificate requires.

5.3.7.7 Guarantor certifies advice to lender

Another option which has been suggested,¹⁶⁰ is to require the guarantor or borrower to take independent advice and have the guarantor or borrower certify that fact and the content of that

158 *Karawi Construction Pty Ltd v Bonefind Pty Ltd* [1993] ATPR 41-265.

159 There are some other possibilities which could be explored, such as a covenant by the lender not to sue the solicitor or an agreement that the lender bears the risk of reliance on the certificate. See Sneddon 1996 *ABLR* 5 at 33.

160 By the Perth branch of the Banking Finance and Consumer Credit Committee of the Law Council of Australia in May 1994. See Sneddon 1996 *ABLR* 5 at 35.

advice, to the lender. This method would give the lender a reasonable belief that independent advice had been obtained, with all that flows from that, without producing a direct representation from solicitor to lender that could be the basis for later action. If the guarantor or borrower lied or misstated the fact that advice had been sought or the content of the advice, this would be an obstacle in the path of establishing that the lender bore any liability for unfairness in the transaction.¹⁶¹

One problem with this alternative approach is that if the solicitor knows that the client will be certifying the fact that advice was sought and the content of the advice, to the lender, there is a possibility that the solicitor may have a duty of care to the lender to provide that client with reasonably careful advice.¹⁶² If that were the case the solicitor would have to tell the client that the advice was given, without responsibility to the lender, and either trust the client to pass that disclaimer on to the lender or communicate that disclaimer directly to the lender. Obviously both these courses are attended by practical difficulties. If there was the significant risk of a solicitor's owing a duty of care to a lender in such circumstances, it would seem to be safer for the solicitor to provide the certificate and include a disclaimer rather than to have the client provide the certificate, with a separate disclaimer by the solicitor trailing behind and possibly never arriving.

In summary, each of the three methods described preserves the beneficial effect of independent advice for the client and the lender while reducing the exposure of solicitors to loss-sharing with the lender. The "best" method or combination of methods will have to be determined in negotiations between lenders and solicitors' bodies.¹⁶³

161 There remains the hard case of the wife who will execute whatever document she is told to execute by her husband without reading it because of his undue influence over her. This may be a particular risk in the case of couples from some Asian and southern Mediterranean cultures. In such a case, if the lender had notice of the undue influence, a court may hold that no document signed by the wife will assist in upholding the transaction. But a solicitor's certificate would not necessarily improve matters for the lender if the wife did what the husband said regardless of the solicitor's advice and the lender had notice of that degree of undue influence. In this type of hard case the lender is probably forced to take its chances on the transaction or reject the wife as guarantor.

162 Authority in Victoria (*Lowe R Lippman Figdor & Franck v AGC (Advances) Ltd* [1992] 2 VR 671 and South Australia (*Esanda Finance Corporation Ltd v Peat Marwick* (1994) Aust Torts Rep 81-243): all cases involving the liability of auditors to third parties would suggest that the solicitor had no duty of care to the lender in the *Esanda* case unless the solicitor intended to induce the lender to rely on the advice provided to the client and represented in the client's certificate. But the *Lowe Lippman* case has been criticised and may be distinguishable. See Davies 1993 *Torts LJ* 114 who doubts whether the decision will have any effect as a precedent outside the narrow confines of its particular facts.

163 Sneddon 1996 *ABLR* 5 at 33-34.

5.3.7.8 Payment for independent advice

Unless someone is prepared to pay the solicitor a reasonable remuneration for the onerous obligations the law requires of the independent adviser and the risks involved in certifying that advice to a third party, solicitors will be reluctant to give independent advice and certificates at all or will seek to limit their retainers so as to provide much less than the courts would expect a solicitor to provide.¹⁶⁴

The cost of independent advice to borrowers and guarantors, when required by a lender, should be viewed as a cost of borrowing which, like fees for property valuation and insuring the lender's interest in real security, will usually be paid ultimately by the borrower. Guarantors are likely to object to paying any fee. They are proposing to incur a liability for no return and should not have to pay for the privilege. Independent advice to a guarantor is of economic benefit to the lender and the borrower and should be paid by the lender and may be passed on to the borrower. To avoid conflict-of-interest problems, the lender and solicitor must agree in advance that the solicitor's fee will be paid for the advice, not for the certificate, and will be paid whether or not the advice is in favour of proceeding with the transaction, whether or not the guarantor does decide to proceed with the transaction and whether or not the guarantor's understanding of the advice and answers to questions enable the solicitor to provide a certificate in the form the lender wants.¹⁶⁵

If the advice and certificate enable the guarantee to proceed, no doubt the cost of the advice will be passed on by the lender to the borrower as a cost of borrowing. If the guarantee does not proceed the lender may still choose to pass on the cost of the advice to the borrower or may choose to pass it on to all borrowers by building it into an application fee or other general fee.¹⁶⁶

If the fee for certified independent advice is set at an appropriate remunerative level with a profit

164 In Victoria, solicitors are charging between \$100 and \$400 with an average of \$220 for independent advice on guarantees. This was quoted by the Victorian Law Institute Working Party at a Law Institute Seminar on Guarantees and Independent Solicitors' Certificates 27 October 1994. Fees at the lower end of this scale would barely cover the costs of opening the file, interviewing the client, providing verbal advice and executing the various Law Institute certificates, let alone cover the costs of written advice or any genuine attempt to evaluate the practical risks of entering into the guarantee. One Victorian solicitor is offering an independent advice video on the general nature of the transaction which can be supplemented with a personal interview on the specifics of the particular transaction. See Sneddon 1996 *ABLR* 5 at 34; O'Donovan 1992 *LIJ* 51 at 54

165 Sneddon 1996 *ABLR* 5 at 34.

166 Sneddon 1996 *ABLR* 5 at 34.

component, solicitors will not view the task as a loss-making favour to a good client or influential lender and will have the incentive to give the task the full time and attention it demands in order to be done properly.¹⁶⁷

5.4 CONCLUSION

If one summarizes the above discussion, the following stands out:

- Independent advice to guarantors and borrowers can be an important tool for protecting the interests of some guarantors and borrowers and therefore for protecting bankers' transactions with those guarantors and borrowers. Independent advice does not give complete protection to all transactions, but appears to be preferable to bankers' own explanations and warnings. It offers the most protection when it is used as part of a package of protective measures such as those contained in s 17 of the Code of Banking Practice, and is coupled with the assumption of a fair duty of disclosure. It is not necessary to require independent advice in all cases and its use should be limited to transactions with a high risk of impeachment for unfairness.
- If independent advice is to be used, then to maximise its benefit lenders need some proof that adequate independent advice has been given to the guarantor or borrower. Merely urging that advice be taken is insufficient. Although the guarantor or borrower could certify the advice, lenders may continue to prefer independent solicitors' certificates as proof that advice was actually taken and was adequate.
- The courts require independent advice to go beyond an explanation of the nature of the transaction and the general effects of the documents, and to warn of the practical implications of the transaction and to address its risks and its propriety for guarantor clients and, in some limited cases, for borrower clients. This full-bodied independent advice must be better remunerated than the "quick-fix" advice which some lenders currently seem to expect and some solicitors provide. The fee should reflect the professional task to be undertaken, and not the reverse. In the case of guarantors and perhaps some borrowers, the fee for the advice should be paid by the lender and later charged to the borrower.
- Like any professional task, properly remunerated independent advice is not without risk

167 Sneddon 1996 *ABLR* 5 at 34.

or reward. With a proper understanding of the law on a solicitor's obligations to a client seeking advice, a careful advice procedure and a carefully drawn certificate, the risks to solicitors can be controlled. For a banker, the risk of its transactions being later impugned is minimized (not eliminated) by certified independent advice and, of course, the interests of vulnerable guarantors and borrowers are protected. Independent advice and independent solicitors' certificates are not fail-safe protection mechanisms; nor need they be a crude loss-sharing device. If lenders are discerning about when independent advice is required, if solicitors address carefully the legal and practical aspects of advice as required by the courts and are adequately remunerated for doing so and the certificate of advice is properly drafted, then independent solicitors' certificates provide all parties involved with a balance of benefit and risk which is superior to any of the currently available alternatives.¹⁶⁸

168 See pars 5.3.7.1; 5.3.7.2; 5.3.7.3; 5.3.7.4; 5.3.7.5 *supra*.

CHAPTER 6: THE BANKER'S DUTIES OF DISCLOSURE AND ADVICE TO CUSTOMERS AND SURETIES: GERMANY

6.1 A COMPARATIVE NOTE

6.1.1 European legal families

The aim of this sub-chapter is to give some background information on the legal system of Germany.

Until recently it was common to divide the European legal systems into five groups — so-called "legal families".¹ Many authors² distinguished on the continent:

- (1) the French legal family;
- (2) the German legal family;
- (3) the Nordic legal family;
- (4) the Socialist legal family; and
- (5) the Anglo-American legal family.

The British Isles and Ireland were described as countries belonging to the Anglo-American legal family. However, some authors have stressed that since there exist so many similarities between the first three-mentioned legal families — especially in comparison with the other legal families — it would be better to speak about a Romano-Germanic legal family with three sub-families.³

Since developments in Eastern Europe in 1989 and 1990 the former socialist legal systems have been in a period of transition. Many new statutes, influenced by regulations and ideas from other continental European legal systems are gradually being enacted in the former socialist countries and in a few years it is likely that these countries will no longer constitute a separate legal

1 Malström 1969 *Scandinavian Studies in Law* 127 *et seq.*

2 See, eg, Zweigert & Kötz *Introduction* 63-73.

3 See, for instance, De Cruz *Comparative Law* 27-40; Arminjon *et al Traité* 47 *et seq* are of the opinion that modern systems of law should be grouped according to substance and, in applying such a formula, arrived at seven legal families.

family.⁴ In this sub-chapter no remarks will be made about the codifications still in force during the actual transition period of these countries. Although some remarks will be made about procedural law, this introduction will focus primarily on civil and commercial law.⁵ Studying European legal systems in the fields of the law of contracts, torts and property, one should realize that all legal systems were largely influenced by Roman law.⁶ These influences are obvious in the continental European systems.⁷ Some rules can be traced back to regulations of the *Corpus Iuris Civilis* of Emperor Justinian. But it should also not be forgotten that some points of English and Irish law have been influenced by the manner of thought of Roman law, mainly because during the Middle Ages judges often had an ecclesiastical background and were educated in the principles of canon law, which was largely influenced by principles of Roman law.⁸ It can be said that private law in Europe is in the process of acquiring a genuinely European character.⁹

The law of the European Communities, in the form of treaty, council regulations and directives, plays a large role in the legal systems of the Member States today, especially in the area of commercial law.¹⁰

European Community law also indirectly influences the commercial law of non-Member States, since most of these States are members of the European Free Trade Association (EFTA), which has concluded an important treaty with the European Community on this matter, namely the

4 Hartkamp *et al* (eds) *European Code* 97.

5 For short descriptions of the procedural laws of the Member States of the EC, see Sheridan *et al* *EC Legal Systems*.

6 Koschaker *Europa* 70 *et seq*; Zweigert & Kötz *Introduction* 133-135.

7 See Coing *Einheit*; Coing *Grundlagen*; Koschaker *Europa* 70 *et seq*; Zweigert & Kötz *Introduction* 133.

8 Roman Law and Canon Law were quite closely connected to one another. Historian Maitland, quoted in Hartkamp *et al* (eds) *European Code* 72, stated that:

"The Imperial mother and her papal daughter were fairly good friends".

On the Roman influences on the common law see Zweigert & Kötz *Introduction* 186 and 194 *et seq*; Zimmermann in Hartkamp *et al* (eds) *European Code* 75-76.

9 Zimmermann & Whittaker (eds) *Good Faith* 8.

10 See Kramer 1988 *JB* 477; Müller-Graff *Gemeinschaftsrecht*; Remien 1992 *JZ* 277; Starck (ed) *Rechtsvereinheitlichung* 90; Hommelhoff 1992 *AcP* 71; Ulmer 1992 *JZ* 1; Müller-Graff *NJW* 13-23; Flessner 1992 *RabelsZ* 243-260; Zimmermann & Whittaker (eds) *Good Faith* 8-10.

European Economic Area Treaty.¹¹

In the following sub-chapters the background to German law will be investigated.

6.1.2 The German group¹²

6.1.2.1 Introduction¹³

The reception of Roman law which took place during and after the Middle Ages had an important influence on the legal systems which belong to the German group. This was caused by the fact that there was no central power in the German Empire; local landlords and cities held most of the power. Even though there was an emperor, the court was not fixed in one place, it moved from town to town. Contrary to the situation in for instance France or England, no centres were developed where lawyers and legal academics were educated. Owing to this situation the easiest way to develop one's own legal system was to update Roman law¹⁴. Furthermore, the German emperors considered themselves as direct successors of the Roman emperors.¹⁵ In Germany in particular, the so-called Pandectists tried to elaborate a scientific system of private law based on the principles of the *Digesta* (or *Pandects*) of the *corpus iuris civilis* of the Roman-Byzantine emperor Justinian. The school of Pandectists tried to transform the old Roman law into a contemporary legal system. A good example of these attempts was the important treatise of Von Savigny on the system of modern Roman law¹⁶ published in 1840. In particular, this treatise and the works of Puchta and Windscheid influenced the content of the legal systems of the German group and of the commentaries written on the Civil Codes, which continue the tradition of the Pandectists.¹⁷ The consequence of this tradition has been that the codes of the German group are much more systematic than the codification within other groups. Moreover, the "general

11 Hartkamp *et al* (eds) *European Code* 98

12 Apart from Germany, Austria, Greece, and Switzerland also fall into this group.

13 On the history of German Law, see Zweigert & Kötz *Introduction* 132-142.

14 *Zweigert & Kötz Introduction* 140.

15 Koschaker *Europa* 70 *et seq*; Zweigert & Kötz *Introduction* 135; Hartkamp *et al* (eds) *European Code* 104.

16 *System*.

17 Zweigert & Kötz *Introduction* 138-141; Hartkamp *et al* (eds) *European Code* 104.

principles" play a considerably more important role.¹⁸

6.1.2.2 Germany

Before 1870 Germany did not exist as one State, and seven independent States existed within the territory of Germany.¹⁹ Some of these States had Civil Codes in the French tradition (Baden; Rhineland); others knew codifications of another older tradition like Prussia (Allgemeines Landrecht für die preussischen Staaten of 1794 (General Land Law)²⁰ or Bavaria (Codex Maximilianus Bavaricus of 1756²¹). Other States again, had no codification and the received Roman law was applied next to local statutes (*usus modernus pandectarum*).²² At the beginning of the nineteenth century there was a discussion on the advantages and disadvantages of a codification of private law for the whole territory of Germany (Thibault and Von Savigny). A Uniform Commercial Code, the Allgemeines Deutsches Handelsgesetzbuch²³ had already been created in 1861 before the establishment of the German empire in 1870. This code was replaced by a new one on 1 January 1900. In 1877 a Code on Civil Procedure (Zivilprozessordnung or ZPO) and a law on bankruptcy (Konkursordnung)²⁴ were put into force, followed by a Civil Code (Bürgerliches Gesetzbuch) on 1 January 1900.²⁵ This code was highly influenced by the received Roman law.²⁶

After the decline of the German Empire in 1918 the Civil Code remained in force during the period of the Weimar republic and the subsequent Third Reich. After the Second World War two separate German States arose within the territory of Germany: the Federal Republic of Germany

18 Hartkamp *et al* (eds) *European Code* 104; Zweigert & Kötz *Introduction* 140.

19 German law was, to a large extent fragmented. See Markesinis *Torts* 21-22.

20 General Land Law of 1794. For a discussion of this Act, see Luig 1994 *AcP* 521; Dilcher 1994 *ZeUP* 446.

21 Codex Maximilianus Bavaricus of 1756.

22 Medicus 1972 *Int Encyclopedia of Comp Law* F1; Kokkini-Latridou (ed) *Inleiding* 221-237.

23 Allgemeines Deutsches Handelsgesetzbuch of 1861 (ADHGB); See Palandt *BGB* 2.

24 Konkursordnung (KO).

25 See Münchener Kommentar *BGB* 8.

26 Fikentscher *Schuldrecht* 8 822 states that the current law of obligations (*Schuldrecht*) is composed of Roman and Germanic institutions. See, also, Schuster 1896 *LQR* 17; Freund 1899-1900 *Harvard LR* 627.

and the German Democratic Republic. The Civil Code remained in force in both States, until an independent Zivilgesetzbuch²⁷ was enacted in the German Democratic Republic in 1975, which came into force on 1 January 1976. After the reunification of Germany in 1990 the Civil Code came into force in the whole territory again.²⁸

A special feature of the German Civil Code is the fact that it has as its first book a general part giving the rules applicable to the matters regulated by all the following books. The structure of the Bürgerliches Gesetzbuch is definitely more systematic than the structure of the French Civil Code. Many commentaries in Germany follow the order of the articles of the Civil Code.²⁹

6.2. BANKER-CUSTOMER RELATIONSHIP

6.2.1. Introduction: the main legal sources

As in other legal systems, German law also has several theories on what constitutes a "banker-customer relationship".³⁰ For the purposes of this thesis, it is accepted that the relationship between banker and customer is not limited to one type of transaction, but is mostly a relationship³¹ which endures for a period and which can consist of several types of business transaction.³² If these conditions are present, a *Geschäftsverbindung*³³ or business relationship

27 ZGB.

28 Hartkamp *et al* (eds) *European Code* 105.

29 See, in general, Medicus 1972 *Int Encyclopedia of Comp Law FI*; Drobnič in Kokkini-Latridou (ed) *Inleiding* 221-237; Wieacker *Privatrechtsgeschichte* 237 *et seq*; Hartkamp *et al* (eds) *European Code* 105.

30 See, in general, Canaris *Bankvertragsrecht* 3. S 1 AGB-Banken of 1993 makes it clear that a relationship comes into being. The text of the AGB-Banken of 1993 is contained as an annexure, *inter alia*, in Fischer & Klanten *Bankrecht* 399.

31 A relationship, akin to a fiduciary relationship or *Vertrauensverhältnis* comes into being. See Canaris *Bankvertragsrecht* 3.

32 Canaris *Bankvertragsrecht* 2-3; Sandkühler *Bankrecht* 9; Schwintowski & Schäfer *Bankrecht* 11.

33 Canaris *Bankvertragsrecht* 3. See, in general, Sandkühler *Bankrecht* 9-18; Fischer & Klanten *Bankrecht* 96; Schwintowski & Schäfer *Bankrecht* 15. This relationship is referred to by German lawyers as the "Geschäftsverbindung als gesetzliches Schuldverhältnis ohne primäre Leistungspflicht und als Grundlage einer Vertrauenshaftung".

Liability flowing from this relationship is neither a contractual liability nor a pure

comes into existence.

The banker-customer relationship is typically based on one or more contracts concluded between a bank and its customer.³⁴ Accordingly, the legal regime of this relationship is constituted by the principles of general contract law as found in the German Civil Code³⁵ and Commercial Code.³⁶ These codes do not contain special provisions on banking transactions. Instead, the general provisions on contracts, for example on credit contracts,³⁷ agency contracts,³⁸ purchase contracts,³⁹ commission contracts⁴⁰ and others, as well as the general principles of good faith,⁴¹

delictual liability, but similar to liability for *culpa in contrahendo* — a fiduciary liability standing between both categories, and which forms the basis of a *gesetzliches Schuldverhältnis* or statutory obligation. See Canaris *Bankvertragsrecht* 9, but for criticism see Rümker 1983 ZHR 27 at 31 *et seq.* Fiduciary liability, cannot arise between disconnected (*unverbundenen*) parties, but only where the parties are in a special relationship or *Sonderverbindung*, which entails a definite contact (*Kontakt*). This contact or relationship must be of a legal nature and not merely of a social nature. See Canaris *Bankvertragsrecht* 9. Canaris, *ibid*, is of the opinion that this fiduciary liability arises from partaking in the legal business sphere (*Teilnahme am rechtsgeschäftlichen Verkehr*).

This *Schuldverhältnis ohne primäre Leistungspflicht* or duty without a primary duty of performance which came into existence as a result of the relationship, brings about certain clear duties of care or *Schutzpflichten*, such as duties of secrecy, and duties to disclose and advise (*die Auskunft- und die Beratungspflicht*). Canaris *Bankvertragsrecht* 9 points out that as these duties are not contractual, but are of a statutory nature (*gesetzlicher Natur*), they exist independent from the individual contracts which may be entered into between the bank and the customer, such as a loan agreement, giro agreement or discounting agreement. This would mean that these duties exist even before a contract is entered into, and may exist even after the particular contracts have been fulfilled. These duties therefore exist in conjunction with the *Geschäftsverbindung*. See Canaris *Bankvertragsrecht* 10; RGZ 122 351 at 356; RGZ 126 50 at 52; RGJW 1930 2927 at 2928.

34 It is generally well known that the German banks only contract with a customer on the basis that the AGB-Banken of 1993 is of application in its agreements. See RGZ 112 253; BGH WM 1966 973; 19 70 632; Schütz *Formularbuch* 3; Schönle *Bank- und Börsenrecht* par 2 I 1 b 2(a); Fischer & Klanten *Bankrecht* 94-95.

35 Bürgerliches Gesetzbuch (BGB).

36 Handelsgesetzbuch (HGB).

37 Ss 607 *et seq* BGB.

38 Ss 675 BGB, and 662 *et seq* BGB.

39 Ss 433 *et seq* BGB; SS 373 *et seq* HGB.

40 Ss 383 *et seq* HGB.

41 S 157 BGB.

and on the interpretation of contracts⁴² are applicable. In addition, the rules and principles on pre-contractual duties and on tort liability under the German Civil Code come into play.⁴³ Courts and legal doctrine have adapted the general provisions and principles of private and commercial law to the special needs and problems of banking transactions and have special duties and obligations that, as a whole, constitute the special field of private law of banking transactions.⁴⁴

This private law of banking transactions is modified and completed by special legislation on the protection of customers and investors. The most important laws in this regard are the law on General Conditions of Contracts of 1976,⁴⁵ the Law on Consumer Credits of 1990,⁴⁶ and the Securities Trading Act of 1994.⁴⁷ The AGB-Gesetz does not focus on the banker-customer relationship, but deals with all kinds of general conditions of contract or standard form contracts as used in the various areas of commerce and industry.⁴⁸ But it is true that many court decisions in terms of this law deal with the making of banking contracts. Equally, the Securities Trading Act of 1994 is not confined to banking transactions in the proper sense, but includes the wider subject of financial services. Only some provisions of this Act can be qualified as private law; the major part deals with the supervision and control of financial services.

The prudential supervision of banks in Germany is carried out through the Federal Office for the Supervision of Credit Institutions (Bundesaufsichtsamt für das Kreditwesen) in terms of the Law on the Supervision of Credit Institutions of 1961.⁴⁹ The law does not establish a legal distinction between commercial and investment banking. German banks, as a rule, are allowed to carry on, simultaneously, all kinds of banking transactions (under what is known as a universal banking system). Supervision laws, although they protect the bank customer, do not give him the right to bring claims against the State or supervisory office on the grounds of a violation of supervisory

42 S 157 BGB; s 346 HGB.

43 On pre-contractual liability or *culpa in contrahendo*, see Ballerstedt 1950/1951 *AcP* 151; Markesinis (ed) *Contract* 65-71; RGZ 78 239; BGHZ 66 51. Delictual liability is covered in ss 823 (I)BGB; 823 (II) BGB and 826 BGB.

44 On the German private law of banking transactions, see Canaris *Bankvertragsrecht* 1-99; Nobbe *Bankrecht* 16; Schwintowski & Schäfer *Bankrecht* 3-8.

45 Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen (AGB-Gesetz).

46 Verbraucherkreditgesetz.

47 Wertpapierhandelsgesetz. (WpHG)

48 Schwintowski & Schäfer *Bankrecht* 649 *et seq.*

49 Kreditwesengesetz; Fischer & Klanten *Bankrecht* 31-37.

duties. Thus, the German Law on the Supervision of Credit Institutions provides that the Supervisory Office exercises its supervision exclusively in the public interest.⁵⁰

6.2.2 The banker-customer relationship: various contracts

The bank customer normally enters into a number of different contracts with his bank, for example those relating to the opening of a bank account, a loan, the buying and selling of securities, or the use of a safe. The typical basic contract is on the use of a bank account for receiving and executing payments by remittance, cashing cheques, debit notes, or the use of cheque cards and credit cards. The relationship created on opening a bank account has been described in German law as a contract of agency.⁵¹

As a result, the typical banker-customer relationship can be described as a bundle of different contracts.⁵² The role of the bank is different in each of these contracts. Sometimes the bank renders its services on a continuing basis when carrying out payments and receiving money for the customer in terms of contract relating to a bank account. A continuing and often long-term contractual relationship over a certain period of time is established also by a credit contract; in a typical consumer credit contract, repayment is to be made by instalments together with interest payment. In other cases, the contact between bank and customer is short-lived, for example when a bank buys or sells securities for its customer. In such a case the bank may act as a broker or as an investment adviser, or the bank may itself become the seller or buyer of the securities involved. The assumption of the role of investment banker may bring about specific duties for the bank.⁵³

Besides these differences, the various contracts between bank and customer normally have some similarities and common features. Invariably, the bank must act in good faith,⁵⁴ must be

50 S 6 III Kreditwesengesetz.

51 Or *Geschäftsbesorgung*, s 675 BGB; BGH ZIP 1996 1079 at 1081; Fischer & Klanten *Bankrecht* 96; Nobbe *Bankrecht* 16 refers to a *Geschäftsverbindung*.

52 Fischer & Klanten *Bankrecht* 96; Nobbe *Bankrecht* 16; Schwintowski & Schäfer *Bankrecht* 11.

53 Cranston (ed) *European Banking Law* 64-65; Schwintowski & Schäfer *Bankrecht* 787.

54 In terms of s 242 BGB, a debtor is bound to perform according to the requirements of good faith, giving consideration to common usage.

reasonable,⁵⁵ and not act contradictorily⁵⁶ when handling the customer's affairs. Another common feature of these different contracts is the fact that the banks invariably use uniform general conditions of contract as a basis for the contractual relationship with the customer.⁵⁷

The common features of the different contracts existing between a bank and its customer and the fact that, normally, general conditions of contract are used in these contracts, have led some authors to develop a theory that the relationship between a customer and his bank is based on a so-called general banking contract.⁵⁸ This general banking contract is said to be concluded when the first contract between the bank and its customer takes place. The contract is seen as the source of duties of care and diligence and as the contractual basis for the application of the general conditions of contract used by banks.⁵⁹

German private international law recognizes the principle of party autonomy, that is the freedom of the parties to a contract to choose the law applicable to this contract.⁶⁰ In their general conditions of contract,⁶¹ the banks propose German law as the applicable law, and if the customer accepts these conditions, a choice of law to this effect is agreed. Even if these general conditions are not made part of the contract, an express or implicit choice of German law can often be found because, normally, the banks would conclude contracts only under the law of their main place of business.

In the absence of an express or implicit choice of law, s 28 EGBGB prescribes that national law is applicable where the gravity of the contract can be found. The decisive criterion here lies in which party owes the performance characteristic for this type of contract. This normally leads again to the law of the German bank.⁶²

55 *Zumutbarkeit*. See BGH WM 1956 217; BGH WM 1978 234.

56 *Venire contra factum proprium*. See BGH WM 1978 234 at 236.

57 AGB-Banken of 1993.

58 See, however, Canaris *Bankvertragsrecht* 3-4.

59 Herold & Lippisch *Bank-und-Börsenrecht* 33; Pikart WM 1957 1238; Rümker 1983 ZHR 147 27 at 27-28; Claussen *Bank-und Börsenrecht* 60 *et seq*; Horn in Wiegand (ed) *Aktuelle Probleme* 89 *et seq*; and see the discussion on the relationship and fiduciary liability in Canaris *Bankvertragsrecht* 9-10.

60 S 27 EGBGB.

61 S 6(1) AGB-Banken of 1993.

62 Reithmann & Martiny *Internationales Vertragsrecht* 1066.

Many contracts between the bank and its customer are long-term contracts, for example, the contract in respect of a bank account or a loan contract. During the lifetime of such contracts, the need arises quite frequently to adapt them to changed market conditions or other circumstances. In such cases, the bank and the customer have to enter into negotiations about the variation of the contract. In many areas of the banking business, where one finds many thousands of contracts, individual negotiations about a contract variation are not feasible. Here, the General Conditions of Contract offer two solutions:

- (1) The bank may send information about the proposed change and ask its customer to contradict within a fair period of time, if he does not agree.⁶³
- (2) The bank may have reserved a contractual right to change unilaterally a certain condition of the contract, for example, the interest rate. Such an agreed right of unilateral variation of a contract is generally recognized.⁶⁴ The party that exercises this right must respect general standards of fairness (*nach billigem Ermessen*); if these standards are violated, the court may be approached for relief.⁶⁵

In terms of the AGB-Banken of 1993, the banks also reserve the right to change these general conditions. Section 1(2)2 AGB-Banken of 1993 determines that if a bank sends new general conditions to its customer, and the customer does not contradict within one month, he is deemed to have agreed to these new conditions. Whilst a right to such change can be recognized under s 315 BGB as to fees, interest, and compensation, it is doubtful whether it can be recognized as to the change of other contractual conditions, where an agreement of the customer other than by mere silence appears to be necessary.

A long-term contract may be terminated by a lapse of time agreed in the contract or by giving notice according to the conditions of the contract. In addition, it is generally recognized in German law that there exists, for all long-term contracts, an extraordinary right of giving notice when a serious change of circumstances or a misconduct by the other party makes the continuity of the contract unfairly burdensome for one party for the future. Such an extraordinary right to give notice is also contained in s 18(2) AGB-Banken of 1993.

63 S 2 AGB-Banken of 1993.

64 S 315 BGB.

65 S 315 (3) BGB; Palandt *BGB* 396.

6.2.3 The banker-customer relationship: the influence of the AGB-Banken of 1993

The banking industry uses uniform standard conditions of contract in their contracts with customers and other banks. These uniform conditions have been drafted by the leading associations of banks and are invariably used by all members of these associations. One uniform set of such conditions has been drafted by the association of German private banks,⁶⁶ another one by the association of saving banks,⁶⁷ and a third one by the association of cooperative banks. These general conditions form an important legal basis for the daily business of banks. In addition to these general conditions used in every contract with the customer, the banks use general conditions confined to particular banking transactions, and standard form contracts.⁶⁸

The banks have constantly reformed and redrafted these uniform conditions. The current set of rules was introduced in 1993 and is, for the first time, well structured according to the main activities and duties for the parties.⁶⁹ Furthermore, it was much more easily understood by the ordinary customer than before. The association of private banks, when drafting these new rules, hired linguists and public media agencies to make the new rules as transparent and understandable as possible. This is in line with legal doctrine promulgated by the Federal Court that general conditions of contract are subject to the general principle of transparency.⁷⁰

The AGB-Banken of 1993 is subject to the AGB-Gesetz.⁷¹ This law applies also to the standard-form contracts used by banks. The law aims at protecting not only the consumer in the proper sense, but the customer in general, that is every person who is confronted with a set of general conditions used by the other party and proposed for inclusion in a contract. The protection of the law extends not only to the private customer, but also to the merchant.⁷² The law is aimed more

66 Allgemeine Geschäftsbedingungen des privaten Bankgewerbes or AGB-Banken of 1993. (Reproduced as annexure IIa in Fischer & Klanten *Bankrecht* 399).

67 Allgemeine Geschäftsbedingungen der Sparkassen of 1993 (Reproduced as annexure IIb in Fischer & Klanten *Bankrecht* 413).

68 Horn *AGB-Banken 1993* 65-133.

69 Horn *AGB-Banken 1993* 65-133.

70 See BGHZ 106 42 at 46; BGHZ 106 259 at 264; Horn *AGB-Banken 1993* 65-133.

71 Wolf Horn Lindacher *AGB-Gesetz Kommentar* s 23; Schwintowski & Schäfer *Bankrecht* 11-12.

72 See S 24 AGB-Gesetz, although to a more limited extent. See Wolf Horn Lindacher *AGB-Gesetz Kommentar* s 24 at par 1.

at maintaining general standards of fairness in contractual relationships than at dealing with special issues of consumer protection alone.⁷³

General conditions of contract form part of the contract with the customer, only if this contract contains an express reference to these general conditions and if the customer has had an opportunity to inspect the text of these conditions before the conclusion of the contract.⁷⁴ Unusual clauses which a customer may not expect, will not become part of the contract.⁷⁵ Clauses that, in an unfair way, are to the disadvantage of the customer are void.⁷⁶

In 1993, the European Union issued a Directive on Unfair Terms in Consumer Contracts,⁷⁷ which is designed for consumer protection. In Germany, it was widely held that the highly developed jurisprudence on the German Law on General Conditions of Contract takes care of most issues addressed in this Directive and that little change in German legislation was needed. Nevertheless, a new article has been inserted into the German law on general conditions of contract. The new article protects a consumer against unfair conditions drafted by the other or a third party, even if such clauses do not form part of the general conditions of contract used in other cases.⁷⁸

Section 9 AGB-Gesetz states that clauses in general conditions of contract are void if they place the other party in a disadvantageous legal position that violates the standards of fairness. An example of the test of fairness being applied by the courts to the general conditions of banks is found in the problem of over-collateralisation of loans. Bank loans to traders and manufacturers are often secured by the transfer of ownership of goods or the assignment of movables to the bank. In terms of a typical contract, ownership of goods in a warehouse is transferred to the bank (the so-called security ownership; *Sicherungsübereignung*), but the borrower is allowed to sell the goods and replace them with new goods, so that the flow of goods necessary for trade is not impeded. Similarly, a borrower, may assign to the bank a certain volume of movables to be obtained by him in the future. This assignment is called a *Globalzession*.

The Federal Court has long held that such security contracts can be illegal and void under s 138

73 See Cranston (ed) *European Banking Law* 69.

74 S 2 AGB-Gesetz.

75 S 3 AGB-Gesetz.

76 Ss 9-11 AGB-Gesetz.

77 EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC: [1993] OJ L 95/29.

78 S 24 AGB-Gesetz.

BGB and s 9 AGB-Gesetz, if the economic value of the security given (movables or goods) grossly exceeds the amount of the credit extended by the bank.⁷⁹ The argument is that such over-collateralisation reduces the borrower's capacity to obtain other loans because of a lack of security which might be offered to new lenders. As a legal consequence, some senates of the Federal Court have tightened the requirements for fair and proper clauses on the securing of loans. They have held that all standard clauses relating to security for loans are void if they do not contain a precise ceiling or *Deckungsgrenze*. The ceiling must reflect the bank's justified need for security and is therefore to be calculated as an amount of the credit extended plus a small margin for interest and costs. Every clause which does not contain such a ceiling is void.⁸⁰ The ceiling must be expressed as a specific amount.⁸¹ Moreover, the contract must contain a clause giving the borrower the right to ask the bank to give back any collateral in excess of the amount required by law.⁸² These requirements are not very practical because, in a typical case, the amount of credit may change every day.⁸³

6.2.4 The banker-customer relationship: the bank's duties

6.2.4.1 Diligence

Under its various contractual and pre-contractual relations with its customer, described above, the bank must exercise diligence when serving the customer.⁸⁴ The duties of care and diligence⁸⁵ need not be expressly agreed upon. Under German legal doctrine and jurisprudence, such duties follow from the pre-contractual relationship under the principle of fairness⁸⁶ and, when a contract is concluded, are implied duties of this contract. The bank must use due diligence and care when handling the customer's affairs. It must provide proper information and disclosure, and must

79 See BGHZ 72 308 at 311.

80 See BGHZ 109 at 240-242; BGH WM 1992 813; BGH WM 1993 at 139-140.

81 See BGH WM 1992 813.

82 The so-called *Freigabeklausel*. See BGHZ 109 240 at 246; BGH WM 1992 813. The bank must keep the interest of the customer in mind. Nobbe *Bankrecht* 7; BGH ZIP 1983 1053; s 16(2) AGB-Banken of 1993.

83 See Horn *AGB-Banken* 1993 121.

84 Nobbe *Bankrecht* 16; Sandkühler *Bankrecht* 12.

85 *Sorgfaltspflichten*.

86 S 242 BGB requires performance in good faith (*Treu und Glauben*) and with cognisance of the common morality (*Verkehrssitte*). See Palandt *BGB* 226 *et seq.*

observe strict standards of fairness.⁸⁷ In particular, it must disclose whether there is a conflict of interest between the bank and its customer; for example, when the customer instructs his bank to buy securities, the bank must make clear whether it is acting as a commission agent⁸⁸ or as a seller of these securities. Furthermore, it must carry out the contract according to the stock-exchange price ruling at the time when the contract is carried out and, finally, it must abstain from any unfair influence on the price.⁸⁹

In Germany, banks have become increasingly active in the field of asset administration.⁹⁰ The bank should ascertain what kind of administration the client wants, which type of investment and what risk he prefers. Once the bank has ascertained the customer's expectations, and which type of investment is suitable for him, the bank's duty is not so much a duty to give current information and advice as to make careful investment decisions on behalf of the customer. The bank must, for example, take care that a portfolio management has an adequate distribution of risks,⁹¹ and it must not expose too large a part of the customer's portfolio to high-risk investments.⁹²

6.2.4.2 Confidentiality or secrecy

As a rule, the bank must keep the customer's affairs confidential; in particular, it must not give information about his assets with the bank or about his plans for certain financial transactions, unless the customer has given his consent.⁹³ The duty does not have an express statutory basis

87 Sandkühler *Bankrecht* 12; Nobbe *Bankrecht* 16 *et seq*; Fischer & Klanten *Bankrecht* 98. On so-called *Nebenrechte und Nebenpflichten* (accessory rights and duties) flowing from the requirements of good faith, see Palandt *BGB* 229-234.

88 See s 383 HGB.

89 Such as front running, that is, a deliberate attempt to deal personally ahead of the bank's investment recommendations, or other manipulative practices. See Cranston (ed) *European Banking Law* 73.

90 Cranston (ed) *European Banking Law* 73.

91 BGH WM 1994 834.

92 OLG Hamm WM 1996 669; Horn & Balzer *EWiR* 1996 499 *et seq*; OLG Frankfurt/M WM 1996 665; Horn & Balzer *EWiR* 1996 499 at 589 *et seq*.

93 BGHZ 27 241; BGHZ 95 362 at 365; Heymann & Horn *HGB* no 44; s 2 of the AGB-Banken of 1993; Sandkühler *Bankrecht* 25; Dirichs *Haftung* 11.

but is derived from the contractual relationship between the bank and the customer,⁹⁴ which implies a general fiduciary duty.⁹⁵ Bank secrecy covers all "facts the customer wants to be held confidentially".⁹⁶ This duty of the bank to observe bank secrecy includes the right of the bank to refuse testimony in a civil procedure.⁹⁷ In a criminal procedure, however, the bank has no such right.⁹⁸ The tax authorities have a limited right to ask for information from the bank;⁹⁹ in a procedure for tax fraud, however, the bank has an unlimited duty to inform the authorities.¹⁰⁰

Various other statutes override the secrecy obligation. See, for example, the WpHG in regard to the prevention of insider trading, whereby insider trading is made subject to sanctions, including criminal prosecution.¹⁰¹ The Act on the Detection of Proceeds of Crime of 1993 also makes provision for reporting in suspicious cases. The duty of secrecy may, conceivably, also be overridden by s 242 BGB, which requires good-faith performance in contract.¹⁰²

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- 94 Secrecy has long been acknowledged as an essential element of the banker-customer relationship. See Canaris *Bankvertragsrecht* 9; Kümpel *Kapitalmarkrecht* 67 *et seq*; Schwintowski & Schäfer *Bankrecht* 16; Sichtermann *et al Bankgeheimnis* 3. The Bundesdatenschutzgesetz aims at protecting the individual's right to determine the use of his personal data. To some extent, the provisions of this Act overlap with the bank's contractual secrecy obligation. See Neate *Bank Confidentiality* 287.
- 95 Rehbein 1985 *ZHR* 139 *et seq*; Sichtermann *et al Bankgeheimnis* 111 *et seq*; Dirichs *Haftung* 12; Sandkühler *Bankrecht* 25; Fischer & Klanten *Bankrecht* 145; Schwintowski & Schäfer *Bankrecht* 49.
- 96 BGHZ 27 241 at 246. In fact, the duty consists of two elements, namely a *Verschwiegenheitspflicht* and an *Auskunftsverweigerungspflicht*. See Schwintowski & Schäfer *Bankrecht* 51.
- 97 S 383(1) no 6 and s 384 no 3 ZPO; Schwintowski & Schäfer *Bankrecht* 54-55; Neate *Bank Confidentiality* 292.
- 98 S 53 StPO; Schwintowski & Schäfer *Bankrecht* 54-55; Neate *Bank Confidentiality* 292-293.
- 99 S 30a AO; Schwintowski & Schäfer *Bankrecht* 54-55; Neate *Bank Confidentiality* 293.
- 100 S 385 AO.
- 101 WpHG s 9 requires credit institutions to report to the Federal Supervisory Authority for Securities Trading, every transaction in securities or derivatives which is admitted for trading on a stock market in the EEC. The WpHG implements, *inter alia*, EC Directive (Insider Dealing) 89/592/EEC: [1989] OJ L 334/30. See further Neate *Bank Confidentiality* 303-304.
- 102 See Palandt *BGB* 226-228; Schwintowski & Schäfer *Bankrecht* 61.

Other exceptions to the secrecy obligation also exist.¹⁰³ The bank may be justified in disclosing information where there is an overriding public duty to do so,¹⁰⁴ or where there is an overriding interest of the bank to do so.¹⁰⁵

It is widely used commercial practice in Germany to ask a bank to give standard information about a customer's general creditworthiness. This information is normally given in general terms without disclosing precise figures.¹⁰⁶ The information is only passed on to another bank representing the party that seeks this information. Furthermore, the information is only given if the customer has agreed to it.¹⁰⁷ Where the bank may give a bank reference, it must do so with the care of *eines ordentlichen Kaufmanns*.¹⁰⁸

Business customers normally agree to such information being given in order to enhance their credit standing, since the refusal of a bank to give any information about that customer might damage his credit standing more than relatively adverse information would.¹⁰⁹ General consent to such information being given is contained in the general conditions of contract agreed between the bank and its customer. The general conditions make a distinction between a business customer and a private customer, the latter being often less inclined to disclose information about his wealth. The bank will not give any information about its private customer unless he expressly agrees to it.¹¹⁰

Besides the principle of confidentiality of banks as part of private law as described, there exists

103 S 2(1) AGB-Banken of 1993 states that the bank may only disclose information concerning the customer if it is legally required to do so or if the customer has consented thereto or if the bank is authorized to disclose banking affairs.

104 Neate *Bank Confidentiality* 288-289.

105 Neate *Bank Confidentiality* 290-291. *Aufgrund überwiegender Eigeninteressen der Bank*. See Schwintowski & Schäfer *Bankrecht* 61; Schraepfer 1972 *NJW* 1836.

106 S 2 (2) of the AGB-Banken of 1993 stipulates that statements of a general nature concerning the economic status, the creditworthiness and solvency of the customer may be divulged.

107 S 2(3) AGB-Banken of 1993.

108 The reasonable, respectable businessman. Fischer & Klanten *Bankrecht* 161 *et seq.*

109 Cranston (ed) *European Banking Law* 74.

110 S 2(3) AGB-Banken; Fischer & Klanten *Bankrecht* 160-161.

a particular duty under the legislation on personal data protection.¹¹¹ This protection of personal data is guaranteed by the German Constitution.¹¹² The duty of confidentiality of a bank is also subject to limitation in special situations of conflict of interest to be described below.¹¹³

If a bank breaches its secrecy obligation, the customer can claim actual damages, but not punitive damages, and the burden of proving damages lies with the customer.¹¹⁴

6.2.4.3. Avoidance of conflicts of interest: the multi-functional bank

The bank must do its best to avoid any conflict between the interest of its customer and its own interest. If the bank sells or buys securities for its customer, acting either as a commission agent¹¹⁵ or as a trader in securities, the bank must see to it that the contract is executed under the conditions most favourable to the customer. The bank must not execute or sell at a higher price than the securities exchange rate at the time of the transaction. Under the new Securities Trading Act of 1994 (Wertpapierhandelsgesetz), banks and other enterprises rendering financial services must organise their business in such a way as to avoid conflicts of interest with their customers. Under the Law on the Supervision of Credit Institutions of 1961,¹¹⁶ German banks are allowed to carry out simultaneously all kinds of financial transactions. In particular, there is no legal division between commercial and investment banks. As a consequence, banks sometimes not only lend money to a business, but also hold shares in it. In addition to owning shares in the company, the bank may also exercise voting rights on behalf of other bank customers who are shareholders of this company. Not infrequently, representatives of banks are members of the supervisory board of the company. As a consequence, banks have considerable internal information which other investors or debtors do not have.¹¹⁷ The legislature has taken various steps to limit the danger of conflicts of interest in this respect; for example, under Article 128 Company Law, the banks are obliged to pass on all relevant information about the shareholders'

111 Federal Law on Data Protection Act (Bundesdatenschutzgesetz of 1990 (BDSchG).

112 Adjudicated by the Federal Constitutional Court. (Bundesverfassungsgericht (BverfGE)); See, also, Fischer & Klanten *Bankrecht* 173 *et seq*; Cranston (ed) *European Banking Law* 74.

113 See sub chapter 6.2.4.3 *infra*.

114 Neate *Bank Confidentiality* 286-287.

115 See s 383 HGB.

116 Kreditwesengesetz.

117 Cranston (ed) *European Banking Law* 74-75.

meeting to the customer, to ask him whether he will give proxy to the bank or wishes to exercise his voting rights himself, and to ask him for his instructions on how to vote.

The use of compliance and Chinese Walls in order to avoid conflicts of interest is often employed by German banks.¹¹⁸ Spurred by the globalisation of banking business, technological progress, new financial instruments, various EC directives, and finally the Securities Trading Act of 1994, the avoidance of conflicting interests has become a most important topic.¹¹⁹ The establishment of Chinese Walls has become a particularly important element of conflict management and is one of the primary organisational obligations imposed by the Securities Trading Act of 1994 s 34. Credit institutions have set up compliance organisations which monitor compliance with the rules of the Securities Trading Act of 1994 and other applicable rules.¹²⁰

A bank, furthermore, may be involuntarily involved in a conflict of interest between two customers. If customer A wants to obtain payment from customer B who is no longer creditworthy, and both A and B are customers of the bank, and the bank knows about customer B's situation, it must warn customer A, thus weighting the interest of both customers in the situation given.¹²¹

6.2.4.4 Liability of banks in respect of advisory and information duties in financial services

A detailed discussion of a bank's duties in regard to investment banking falls outside the scope of this thesis. Suffice it to say that banks must give proper information and advice to their customers as investors when they render financial services to them.¹²²

In a number of decisions,¹²³ the Federal Court insisted on full written disclosure of the risks of limited chances of profit and high risk of loss in the commodities' futures investments. Violation of these duties made the broker or adviser liable to the investor for damages. The violation of

118 Fischer & Klanten *Bankrecht* 342 *et seq.*

119 Neate *Bank Confidentiality* 305.

120 *Ibid.*, at 305.

121 See the facts in BGHZ 107 104. OLG Hamm ZIP 1982 1061; OLG Köln WM 1990 1616.

122 The Bank must advise the customer *sorgfältig, gewissenhaft, und in dessen Interesse* (with care, conscientiously and in the interest of the customer). See Fischer & Klanten *Bankrecht* 340.

123 See, in particular, BGHZ 105 108; BGH ZIP 1991 1207.

such a duty of disclosure and advice constitutes a breach of a pre-contractual duty (*culpa in contrahendo*) as described, and a delictual liability for wrongful prejudice to the investor's property.¹²⁴ The disclosure required in the prospectus or other printed material for sales promotion used by the broker or adviser or banks must point clearly to the high risks of loss and small chances for a profit, and must clearly set out the additional costs resulting from the fees of the German broker or adviser.¹²⁵ Even if these strict disclosure requirements are fulfilled, however, they may not afford protection against pre-contractual and delictual liability, if the text and layout of the prospectus are designed to play down the risks and lead the customer to believe that the particular skills of the adviser or broker or bank would help the investor to overcome the risks and hence make a safe profit.¹²⁶ Section 32 WpHG prohibits the scalping of a customer as well as front- and parallel running.¹²⁷

The courts will deny the existence of a contract to give advice if the customer gives the bank a specific order and the customer explicitly declares that he neither needs nor wants the advice of the bank.¹²⁸ It seems that, in considering the existence of a contract to give advice, the courts rely heavily on the knowledge of the customer concerned. If the customer has a certain knowledge in trading securities, the requirements to be met for the assumption of a contract to give advice seem to be higher.¹²⁹

This is in line with the ideas underlying the new WpHG of 1994. It requires a bank to ask at the beginning of every relationship, for information on the customer's knowledge and the objectives of his investment.¹³⁰ The customer has to be informed about the risks of the class of transactions he wants and is able to effect.¹³¹

124 BGHZ 105 108 at 110; s 826 BGB.

125 *Ibid.*

126 BGH ZIP 1991 1207.

127 Fischer & Klanten *Bankrecht* 341.

128 BGH WM 1996 906; Zeller 1996 *EwiR* 641.

129 OLG München WM 1994 236; Horn 1997 *ZBB* 139.

130 The advisor must know his customer. See s 31 WpHG; Schwintowski & Schäfer *Bankrecht* 849-851. The advisor must have an investment plan, which must be put into operation with *Sachkenntnis, Sorgfalt und Gewissenhaftigkeit*. See Schwintowski & Schäfer *Bankrecht* 853.

131 Fischer & Klanten *Bankrecht* 340; s 31 WpHG; Horn 1997 *ZBB* 139 at 149 *et seq.*

6.3 SURETYSHIP

The BGB provides for a system of securities for creditors. It provides for only one type of personal security (*Personalsicherheit*): the contract of suretyship.¹³² The surety agrees to be liable to the creditor, to stand in (*einzustehen*) for the compliance with the obligation of the third party.¹³³ This undertaking must be in writing¹³⁴ unless the surety is a merchant.¹³⁵ The surety is basically liable only to the extent that the principal debt for which he has stood surety actually exists;¹³⁶ he can use against the creditor any defences available to the third party.¹³⁷ Thus, the liability of the surety is made accessory (*akzessorisch*) to the main debt, and the liability of the surety is a subsidiary one.¹³⁸ A suretyship, therefore, does not always enable the creditor to execute swiftly on the security. Banking practice has developed, however, a type of suretyship where a creditor can ask for payment "on first written demand", and the courts have recognized this unusual type of contract of suretyship, if a merchant is the surety.¹³⁹

For some time, the courts have equally recognized a contract of guarantee, that is, an indemnity, not specifically regulated in the Civil Code. In terms of such a contract of guarantee or *garantievertrag*, the guarantor promises to pay a specified sum of money (or, in rare cases, to perform another duty) if a defined risk materializes. Unlike the surety, the duty of the guarantor is independent of the existence or amount of the underlying debt or, in terms of German legal doctrine, his liability is non-accessory (*nicht akzessorisch*).¹⁴⁰ This type of independent undertaking is also very common in today's practice of securing international trade transactions, and, as such, is widely recognized internationally.¹⁴¹

132 *Bürgschaftsvertrag*. See ss 765-777 BGB; Palandt *BGB* 862-877.

133 S 765 BGB; Gabler *Bankrecht* 590; Müller *Schuldrecht* 308; Palandt *BGB* 865-869.

134 S 766 BGB; Palandt *BGB* 869-870; See, also, Gabler *Bankrecht* 591-592; Fikentscher *Schuldrecht* 8 622; Müller *Schuldrecht* 314; BGH WM 1970 816.

135 S 350 HGB.

136 Fischer & Klanten *Bankrecht* 231.

137 Ss 767 BGB and 768 BGB; Palandt *BGB* 870-871.

138 Gabler *Bankrecht* 590; Müller *Schuldrecht* 308; Fischer & Klanten *Bankrecht* 231; RGZ 59 11; BGH WM 1966 122; BGH ZIP 1985 1257.

139 Gabler *Bankrecht* 595; Fikentscher *Schuldrecht* 8 625; Fischer & Klanten *Bankrecht* 232.

140 Gabler *Bankrecht* 606; Müller *Schuldrecht* 321-322; BGH BB 1967 1020.

141 Horn & Wymeersch *Bank Guarantees*.

Besides the contract of suretyship and the contract of guarantee, German legal practice uses a cumulative assumption of debt or *Schuldbeitritt*. Under such a scheme, the practical debtor finds another person who is willing to be liable to the creditor along with him. Finally, a common form of personal security in commerce occurs when a person accepts, endorses, or even draws a bill of exchange in order to help someone else to obtain credit. Banks themselves offer their customers such an *Aval-Kredit*.¹⁴²

In addition to personal securities, the German Civil Code provides for real security in assets. A discussion of this aspect of German Law falls outside the scope of this thesis.

6.4 CONSUMER AND INVESTOR PROTECTION

In the area of private law, the European Union has issued a number of directives and recommendations on consumer protection. The most important initiative in this field is the Directive on Consumer Credits that has been made part of national consumer credit legislation.¹⁴³ The German legislature has enacted a law on consumer credits.¹⁴⁴ Under this legislation, banks are obliged to conclude credit contracts with private customers, in writing, and to include in the contract certain precisely prescribed information about the most important conditions of the credit, in order to give the borrower a full picture of his rights and duties, and in particular, about the economic burden of the credit. The German Law on Consumer Credit has extended the scope of its application to all private credit, irrespective of the credit amount, and thus goes markedly beyond the scope of the EC Directive.¹⁴⁵

Another important piece of legislation on consumer protection is the previously mentioned German Law on General Conditions of Contract (AGB-Gesetz).¹⁴⁶ The German law is not just a consumer protection law, but is aimed at protecting every customer against the restriction of his or her contractual freedom that would result from unilateral formulation of the contractual

142 Cranston (ed) *European Banking Law* 78.

143 EC Directive (Consumer Credit) 87/102/EEC:[1987] OJ L42/48; EC Directive (Consumer Credit) amending the previous directive, 90/88 EEC: [1990] OJ L 61/14.

144 Verbrauchercreditgesetz of 1990 (VKG).

145 See Schwintowski & Schäfer *Bankrecht* 649 *et seq* for a detailed discussion of the VKG. In regard to its practical implications, see Bülow 1991 *NJW* 129; Canaris 1978 *NJW* 1891; Claussen 1993 *NJW* 564; Canaris 1993 *ZIP* 401.

146 For a detailed discussion of the Act, see Raiser *AGB* (1961 reprint); Wolf Horn Lindacher *AGB-Gesetz Kommentar*; Münchener Kommentar *BGB* 1615 *et seq*.

conditions.¹⁴⁷ We have seen that under this law German courts and legal doctrine have developed a highly sophisticated system of customer protection against unfair or surprising general conditions and form contracts. The new EC Directive of 1993 on Unfair Terms in Consumer Contracts¹⁴⁸ has been implemented in the German law by the insertion of a new s 24a AGB-Gesetz. As the German Law on General Conditions of Contract already protects the consumer to a large extent, only a few changes were necessary to make the law applicable also to cases where no general conditions are used, but a contract is pre-formulated by one party, and to cases where the consumer is unfairly influenced when entering into the contract.¹⁴⁹

The Wertpapierhandelsgesetz¹⁵⁰ is equally inspired by EEC Law, namely the Council Directive of 10 May 1993, on investment services in the security field.¹⁵¹ This law lays the foundation for a German capital-market law or securities law as a new body of law that is close to banking law but not entirely a part of it. The new law provides for a federal authority for the supervision of the trade in securities and it establishes a number of duties for all enterprises active in the field of financial services. These enterprises must exercise due diligence¹⁵² when serving the customer. They must organize their business in a way that enables them to render the necessary information and advice, and to avoid conflict of interest with their customers.¹⁵³ They furthermore must gather the necessary information about the customer, his knowledge, experience, and investment expectations.¹⁵⁴ On the basis of this information, the enterprise rendering the financial service can give the customer the information and advice appropriate to him and recommend those investments that suit his needs and expectations. These duties are established in the public interest and are not private law in the proper sense. But they support and underline the private-law duties of due diligence, disclosure and advice that a bank owes to its customer and that are

147 See Markesinis (ed) *Contract* 211.

148 EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC: [1993] OJ L 95/29.

149 See, in general, Wolf Horn Lindacher *AGB-Gesetz Kommentar* 51-52; Zweigert & Kötz *Introduction* 336-337; Markesinis (ed) *Contract* 211-214.

150 WpHG of 1994.

151 EC Directive (Investment Services in the Security Field) 93/22/EEC: [1993] OJ L141/27.

152 They must act with *Sachkenntnis, Sorgfalt und Gewissenhaftigkeit*. Schwintowski & Schäfer *Bankrecht* 795.

153 S 32 WpHG; Fischer & Klanten *Bankrecht* 341; Schwintowski & Schäfer *Bankrecht* 801-802.

154 S 31 WpHG; Fischer & Klanten *Bankrecht* 340; Schwintowski & Schäfer *Bankrecht* 795.

a basis for its contractual and tort liability.¹⁵⁵

Besides the protection granted on the level of the individual contract between the bank and its customer, some additional protection is provided by the supervision laws. Though the Law on the Supervision of Financial Services explicitly states that the supervision is carried out only in the public interest, the deposit guarantee funds for the protection of savings in case of a collapse of a bank, grant the customer at least minimal compensation. This type of fund, which has existed in Germany for some time, is now made mandatory at the European level, by a Council Directive.¹⁵⁶

The aforementioned legislation as well as the jurisprudence on the liability of banks towards customers and investors follow two principal ideas: to protect the customer of a bank as well as the investor taking from a bank, and to contribute to the transparency of the markets for banking and other financial services. The principle of freedom of contract is maintained as a basis of a free-market economy. But this principle of freedom of contract is put into a new framework. In this respect, German law is in line with the tendencies to harmonize the legal systems of the members of the European Union on the basis of EEC directives and recommendations.¹⁵⁷

6.5 THE BANKER'S DUTY OF DISCLOSURE AND OTHER ASPECTS OF BANKER LIABILITY

6.5.1 The German law of obligations

6.5.1.1 Tort and breach of contract

In German law the institutions known as breach of contract and delict are arranged in separate paragraphs of the BGB.¹⁵⁸ Breach of contract is usually treated under the general rules relating to improper compliance with an obligation.¹⁵⁹ An obligation (*Schuldverhältnis*) is described as

155 Cranston (ed) *European Banking Law* 80; Schwintowski & Schäfer *Bankrecht* 763 *et seq*; Schäfer 1991 *ZIP* 1557; Schiereck 1996 *ZBB* 185.

156 EC Directive (Deposit Guarantee Schemes) 94/19/EEC:[1994] OJ L135/5.

157 Cranston (ed) *European Banking Law* 81; Hommelhoff 1992 *AcP* 71 *et seq*; Schlechtriem 1993 *ZeUP* 217.

158 Thoma *Schuldrecht* 15-17; Markesinis *Torts* 23-27.

159 Markesinis (ed) *Contract* 418.

a relationship between a debtor and creditor, with a duty of performance (*Schuld*, or *Leistungspflicht*) and a corresponding right to performance (*Forderung*), as content.¹⁶⁰

S 242 BGB creates a general duty to perform according to the dictates of good faith (*Treu und Glauben*). This principle has been used in various ways by the courts to develop a control mechanism for the whole law of contract.¹⁶¹ It has been said, however, that the idea as far as s 242 BGB is concerned, is not to elevate good faith as a general measure of human relations in law.¹⁶²

An obligation can arise, *inter alia*, out of agreement.¹⁶³ The BGB only provides for two forms of improper compliance, namely causing impossibility (*zu vertretenden Unmöglichkeit*) and *mora* (*Verzug*);¹⁶⁴ although the courts also recognize a third form namely *Schlechtleistung*, also known as *Positive (Vertrags) verletzung*.¹⁶⁵ In terms hereof all forms of performance contrary to the duty of performance, such as defective or partial delivery as well as repudiation, resort hereunder.¹⁶⁶

160 See s 241 BGB, in which an obligation and performance is defined. (See, also, Larenz *Lehrbuch I* 6-19; Medicus *Schuldrecht I* 1-4; Fikentscher *Schuldrecht* 8 19-30; Palandt *BGB* 225-226; Staudinger *Kommentar* s 241 140-158).

161 See Larenz *Lehrbuch I* 125-129; Medicus *Schuldrecht I* 64-70; Palandt *BGB* 226-250; Horn *et al Introduction* 135-145; Ebke and Steinhauer in Beatson & Friedmann *Good Faith* 171; Zimmermann & Whittaker (eds) *Good Faith* 24-26.

162 Fikentscher *Schuldrecht* 8 127 sees s 242 BGB as a default mechanism which only finds application where a higher duty of care exists in a legal relationship. Horn *et al Introduction* 135 considers the section a statutory enactment of a general requirement of good faith (see, also, RGZ 85 108 and BGHZ 58 147), a principle of legal ethics which dominates the entire legal system. The content of good faith is reliance, which acts as an integrating element in an organized legal culture, especially reciprocal reliance, which takes into account the legitimate interests of others. See Fikentscher *Methoden* 109 *et seq.*, and 179 *et seq.* Zimmermann & Whittaker (eds) *Good Faith* 24 states that it is generally recognized that s 242 BGB operates as a supplement to the law.

163 Fikentscher *Schuldrecht* 8 64-85. The creation of a contract is regulated in ss 305-319 BGB. See in general Cohn *Manual I* 111-117; Larenz *Lehrbuch I* 39-85; Medicus *Bürgerliches Recht* 27-40; Palandt *BGB* 378-401.

164 *Unmöglichkeit* is dealt with in ss 275-283 BGB; 306-309 BGB; 323-325 BGB and *Verzug* in ss 294-292 BGB and 326 BGB. See Cohn *Manual I* 120-122; Zweigert & Kotz *Introduction* 488-494; Larenz *Lehrbuch I* 332-362; Medicus *Bürgerliches Recht* 144; 146 and 166-179; *Schuldrecht I* 135 162-169 172-180 214-223; Fikentscher *Schuldrecht* 8 216 *et seq.*; Palandt *BGB* 326-363; 384-387; 407-413; Markesinis (ed) *Contract* 401 *et seq.* and 413 *et seq.*

165 BGHZ 8 239; BGHZ 27 236.

166 RGZ 54 98; RGZ 66 289 at 291; BGH NJW 1968 2238; BGHZ 47 312; Cohn *Manual I* 122-123; Zweigert & Kotz *Introduction* 494-496; Larenz *Lehrbuch I* 363-376; Medicus

Defective performance (*Leistungsstörungen*) which in the case of obligations arising from contract would constitute breach of contract, can therefore take one of these three forms. The exact consequences of breach of contract, which include a claim for specific performance, cancellation and damages, depend on the form of breach of contract as well as the type of obligation (unilateral or multilateral).¹⁶⁷ In general a claim for damages arises when one of the three types of *Leistungsstörung*, caused by the fault of the wrongdoer,¹⁶⁸ causes damage.¹⁶⁹ Breach of contract, being one or the other *Leistungsstörung* therefore always exists in the breach of a contractual obligation (*Leistungspflicht*) or, seen from the other side, a breach of a contractual right to performance (*Forderung*) by the debtor.¹⁷⁰

General liability for damages in delict, is dealt with in ss 823 BGB-853 BGB. There is no single general delictual ground for liability with specific liability requirements. Apart from certain specifically described delicts,¹⁷¹ certain cases of liability without fault,¹⁷² and the regulation of

Bürgerliches Recht 179-184; *Schuldrecht I* 136; 181-187; 223-224; Fikentscher *Schuldrecht* 8 258 *et seq*; Palandt *BGB* 346-350.

167 Ss 279 BGB-281 BGB; 284 BGB-286 BGB; 292 BGB; 300 BGB; 304 BGB; 320 BGB; 322 BGB; 324 BGB-327 BGB; 336 BGB-361 BGB are devoted to these consequences for the differing types of situations

168 S 276 BGB. Note that intent or negligence is required. S 279 BGB provides for liability without fault in the case of generic obligations. See, also, Palandt *BGB* 356-357. The parties can also agree to be bound for breach of contract without fault. See Larenz *Lehrbuch I* 278-279; Medicus *Schuldrecht I* 155; Fikentscher *Schuldrecht* 150 *et seq*; Palandt *BGB* 339; Schlechtriem *Vertragsordnung* 30.

169 The claim for damages on the grounds of breach of contract, in the case of *Unmöglichkeit* is based upon ss 280 BGB and 325 BGB and in regard to *Verzug* on ss 286 BGB and 326 BGB and in regard to *Positive Vertragsverletzung*, upon legal decisions.

170 Medicus *Schuldrecht I* 138; Fikentscher *Schuldrecht* 8 208 *et seq*. Apart from the principal duty to perform, the duty of performance consists also of certain ancillary duties or *Nebenleistungspflichten*, *Verhaltungspflichten*, being additional duties which contribute to making performance possible. Breach of any of these duties constitutes breach of contract. See Esser-Schmidt *Schuldrecht I* 39-40; Larenz *Lehrbuch I* 8-14; Palandt *BGB* 229-230. Depending on the content of the duty of performance, breach can be constituted by an omission. See Esser-Schmidt *Schuldrecht I* 37; Palandt *BGB* 226. Unlawfulness in contract consists of the breach of one of these duties by the debtor. See Fikentscher *Schuldrecht* 317; Medicus *Schuldrecht I* 138.

171 Namely an injury to another's creditworthiness by the publication of untruths (s 824 BGB), and official dereliction of duty by State officials (s 839 BGB). See in general, Cohn *Manual I* 159 167-169; Medicus *Schuldrecht II* 400-404; 352; 353-355; Fikentscher *Schuldrecht* 8 769-772; Palandt *BGB* 982-984; 1006-1029; Larenz *Lehrbuch II* 565-568; 576-587; Esser-Weyers *Schuldrecht II* 491-494; 508-512.

172 Ss 833 BGB and 834 BGB; ss 836 BGB; 837 BGB- 838 BGB.

vicarious liability¹⁷³ which are dealt with in separate paragraphs, three general grounds for liability for unlawful causation of damage are constituted in the BGB.

In terms of the first and, in practice, the most important general rule of delict, a person is liable for damage that he caused through his fault, and for unlawful injury to the life, body, health, freedom, property, or other right of another.¹⁷⁴ The second general rule creates delictual liability for unlawful causation of damage through conduct contrary to a statutory ruling that is aimed at the protection of other legal subjects (*Schutzgesetz*).¹⁷⁵ This last rule creates delictual liability for any intentional causation of damage *contra bonos mores*.¹⁷⁶

From the statutory requirements for liability (*Grundtatbestände*) that are a requisite for these three general delictual grounds of liability, certain general conditions for liability (*Deliktsvoraussetzungen*) manifest themselves. Firstly there must be conduct, which, in principle

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- 173 Being the liability of employers for delicts by their employees, (s 831 BGB) and of caretakers of minors, insane and physically disabled (s 832 BGB). See Cohn *Manual I* 159-160; Markesinis *Torts* 676-686; Horn *et al Introduction* 157-160; Medicus *Schuldrecht II* 375-378; Fikentscher *Schuldrecht* 770-778; Palandt *BGB* 996-1001; Zweigert & Kotz *Introduction* 629-645; Larenz *Lehrbuch II* 571-576; Esser-Weyers *Schuldrecht II* 494-502.
- 174 S 823 I BGB. See in general Cohn *Manual I* 155-157; Markesinis *Torts* 35 *et seq*; Horn *et al Introduction* 147-155; Medicus *Schuldrecht II* 344-363; Fikentscher *Schuldrecht* 8 725-736; Palandt *BGB* 946-982; Esser-Weyers *Schuldrecht II* 457-469; Zweigert & Kotz *Introduction* 599-602. *Sonstige recht* is qualified. Only absolute rights such as ownership are recognized. Rights recognized as *sonstiges Rechte* are, amongst others, the right to an established business (*Gewerbebetrieb*) (see RGZ 58 24 at 29; BGH NJW 1959 479; Markesinis *Torts* 61-62; Medicus *Bürgerliches Recht* 364-368; Von Caemmerer *Schriften* 490; 565-566; Palandt *BGB* 949-951; Larenz *Lehrbuch II* 558-562; Zweigert & Kotz *Introduction* 600-601; intellectual property such as patents, trade marks and copyright, (Markesinis *Torts* 59; Palandt *BGB* 949); limited proprietary rights and possession under certain circumstances (Medicus *Bürgerliches Recht* 361-362; *Schuldrecht II* 355-357; Fikentscher *Schuldrecht* 8 734-736; Palandt *BGB* 949); and the general law of the personality (BGH NJW 1961 2059; Markesinis *Torts* 63-66; Medicus *Bürgerliches Recht* 368-369; *Schuldrecht II* 360-361; Fikentscher *Schuldrecht* 8 734; Larenz *Lehrbuch II* 548-558; Palandt *BGB* 951).
- 175 S 823 II BGB. This article is interpreted in such a fashion that only persons who fall within the class that the legislature intended to protect and the damage foreseen in the Act, are affected. See BGH NJW 1980 1792 BGHZ 29 100; Markesinis *Torts* 890-894; Cohn *Manual I* 157; Medicus *Bürgerliches Recht* 372-374; *Schuldrecht II* 363-368; Fikentscher *Schuldrecht* 8 761-766; Zweigert & Kotz *Introduction* 602-603; Larenz *Lehrbuch II* 545-548; Esser-Weyers *Schuldrecht II* 487-488.
- 176 S 826 BGB. Unlawfulness consists of conduct which is *contra bonos mores*, that is which is against the community conception of what is proper (*Sittenwidrigkeit*). See RGZ 48 114 at 124 125; BGH NJW 1957 587 at 588; BGHZ 17 327 at 332; Markesinis *Torts* 894-898; Medicus *Schuldrecht II* 371-373; Fikentscher *Schuldrecht* 8 766-769; Palandt *BGB* 985-992.

can consist of an act or an omission.¹⁷⁷ This conduct must cause damage to another. Under damage is understood patrimonial damage,¹⁷⁸ which flows from the injury to one of the protected rights or interests¹⁷⁹ and non-patrimonial damage which flows from personal bodily injury, injury to the freedom of the personality or some other injury to the personality.¹⁸⁰ Apart from a factual causal relationship between conduct and damage, a certain juridical causality is also required. This causal relationship, is, according to the German courts, the adequate causation relationship.¹⁸¹ Fault, which can consist of intent¹⁸² or negligence¹⁸³ is required.¹⁸⁴

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- 177 See Cohn *Manual II* 156; Fikentscher *Schuldrecht* 713; Medicus *Schuldrecht II* 337; Palandt *BGB* 985-986; Larenz *Lehrbuch II* 523-524; Esser-Weyers *Schuldrecht II* 470-471.
- 178 S 253 BGB determines that non-patrimonial damages can only be recovered in cases where the law specifically provides for this.
- 179 Because only certain specific interests are protected by s 823 I BGB, and because a general right to patrimonium is not recognized as a *sonstige recht* (see BGHZ 41 127; BGH NJW 1980 1582; Medicus *Schuldrecht II* 358; Larenz *Lehrbuch II* 526; Von Caemmerer *Schriften* 289; Palandt *BGB* 951), pure economic loss flowing from an injury to one of the protected interests cannot be recovered in terms of this section. (BGH NJW 1964 720; BGHZ 29 65; BGH NJW 1976 1740; BGH NJW 1977 2208; Markesinis *Torts* 48-50; 266; Markesinis 1993 *LQR* 5-12; Horn *et al Introduction* 149; Fikentscher *Schuldrecht* 723; Zweigert & Kotz *Introduction* 600). Ss 823 II and 826 II BGB do not limit or describe the interests that can be injured; therefore damages for pure economic loss can be recovered in delict. See Markesinis *Torts* 48.
- 180 S 847 I BGB determines that non-patrimonial loss may only be recovered in a case of injury to the body, health, and freedom. See in regard to non-patrimonial loss Larenz *Lehrbuch I* 474-479; *Lehrbuch II* 601-604; Lange *Handbuch* 256-273; Palandt *BGB* 1039-1040.
- 181 See RGZ 105 264; BGH Vers R 1952 128; RGZ 133 126; BGH NJW 1952 1010; BGHZ 3 261 at 267; BGH NJW 1972 904; Markesinis *Torts* 95-108; Horn *et al Introduction* 151-152; Larenz *Lehrbuch II* 539; Esser-Weyers *Schuldrecht II* 470.
- 182 Which is defined as a direction of the will coupled to the knowledge that the conduct is unlawful. See BGH NJW 1951 597; Larenz *Lehrbuch I* 279; *Lehrbuch II* 528; Medicus *Schuldrecht I* 140-141; *Schuldrecht II* 342; Fikentscher *Schuldrecht* 322-325; Palandt *BGB* 317.
- 183 Which is defined in s 276 BGB as the failure to comply with the duty of care required by the community (*Verkehr*). The required care is determined by the objective standard of the *bonus paterfamilias*. See BGH JW 1928 1049 BGH VersR 1967 808; BGH NJW 1980 2465; Markesinis *Torts* 72-74; Larenz *Lehrbuch I* 282-293; *Lehrbuch II* 528; Medicus *Schuldrecht I* 141-145; *Schuldrecht II* 342; Esser-Weyers *Schuldrecht II* 475; Fikentscher *Schuldrecht* 8 310-312; Palandt *BGB* 332 *et seq*; Zweigert & Kotz *Introduction* 608-609.
- 184 Except in a case of s 826 BGB which expressly requires intent.

The last general requirement is that the conduct must be unlawful. The concept of unlawfulness (*Rechtswidrigkeit*) is not described in the BGB, but it has always been clear that an injury to the interests or rights which are protected in the delict articles of the BGB and which is contrary to the provisions of the law, will be unlawful. From the provisions of the law in relation to delictual liability, a general legal duty has been derived which requires each legal subject to arrange his affairs in such a fashion that he does not injure the protected interests of other legal subjects (*Allgemeine Verkehrs (sicherungs) pflicht*). Conduct contrary to this duty is unlawful. This general duty has gradually crystallized into a certain number of particular *Verkehrspflichten* which rest on legal subjects in certain situations or in certain circumstances.¹⁸⁵ It is generally accepted that the *allgemeine Verkehrspflicht* does not compel each person to take positive action to prevent injury to another. An omission is therefore only unlawful if it is contrary to a legal duty (*Rechtspflicht*), which, in the circumstances, rested upon the wrongdoer. A *Verkehrspflicht* can compel a legal subject to take positive steps to prevent injury to another, for example where he has created a danger or risk for others through his own conduct or where he has entered into a certain relationship with other legal subjects.¹⁸⁶ It appears however, that there are two contrary considerations in regard to the assessment of the unlawfulness of particular conduct. According to the traditional, and currently still acceptable view, the unlawfulness of conduct is only determined with reference to the result caused. In terms hereof, each injury to a protected interest, which runs contrary to a general duty or in the case of an omission, a particular legal duty, is unlawful in the absence of a ground of justification.¹⁸⁷ In contrast thereto, the second view states that unlawfulness is not determined only by reference to the consequences of the injury to the interests or right, but furthermore also requires that the conduct of the wrongdoer must be contrary to a prescribed norm of conduct (*allgemeine Sorgfaltspflicht*). In the determination of this norm of conduct, it is not only a weighing of interests or policy considerations that plays a role, but also the norms of conduct in relation to the reasonable conduct in the prevention of damage, which traditionally resorted under the requirement of fault, more particularly

185 Larenz *Lehrbuch II* 537-545; Medicus *Bürgerliches Recht* 387; Esser-Weyers *Schuldrecht II* 471; Fikentscher *Schuldrecht* 740-741; Von Caemmerer *Schriften* 478-489; Palandt *BGB* 348.

186 This is also applicable to indirect injury to an interest (*mittelbare Verletzung*). See in this regard RGJW 1931 3446; RGZ 85 185; RGZ 155 161 BGH NJW 1986 576; BGHZ 71 86 93; Cohn *Manual I* 156-157; Markesinis *Torts* 74-75; Medicus *Bürgerliches Recht* 387 399; *Schuldrecht II* 337-338; Esser-Weyers *Schuldrecht II* 473; Fikentscher *Schuldrecht* 8 715 747-749; Larenz *Lehrbuch II* 541-545; Von Caemmerer *Schriften* 481-489; Dietz *Anspruchskonkurrenz* 282.

187 RGZ 50 60; RGZ 103 187; BGHZ 74 9 at 14; Cohn *Manual I* 155; Medicus *Schuldrecht II* 336; Larenz *Lehrbuch II* 537; Fikentscher *Schuldrecht* 295 792; Von Caemmerer *Schriften* 547-548; Esser-Weyers *Schuldrecht II* 471-472.

negligence.¹⁸⁸

A full discussion of the concurrence of delictual and contractual actions is outside the scope of this thesis. Briefly, in regard to the concurrence of actions, it is generally accepted that not every breach of contract will resort under one of the general delictual grounds of liability, because breach of contract does not comply with all the delictual *Grundtatbestände*. It is, however, generally recognized that, in certain circumstances, breach of contract can comply with the *Grundtatbestände* of the general liability grounds.¹⁸⁹

6.5.1.2 Defects in consent

6.5.1.2.1 Introduction.

A contract comes into being through two or more corresponding (in terms of content) declarations of will.¹⁹⁰

"Ein vertrag kommt zustande durch zwei oder mehrere sich inhaltlich dekkende, aufeinander Bezug nehmende Willenserklärungen, die von einem Handlungswillen, Erklärungsbewusstsein und Rechtsbindungswillen getragen sind."¹⁹¹

It is immediately clear that a modified declaration theory is used.

Under German law the manifestation of the will (*Willenserklärung*) can be defective on different grounds.¹⁹² German law distinguishes between a defect in the formation of the will (*Willensbildung*) in case of an error of motive (*Motivirrtum*),¹⁹³ fraud (*arglistige Täuschung*), and threat (*widerrechtliche Drohung*), and a defect in the declaration of the will (*ein Mangel in der*

188 BGHZ 24 21; BGH NJW 1954 913; BGH NJW 1957 785; Markesinis *Torts* 72-74; Medicus *Schuldrecht II* 336-337; Von Caemmerer *Schriften* 548-549; Larenz *Lehrbuch II* 538-540; Fikentscher *Schuldrecht* 295-296; Esser-Weyers *Schuldrecht II* 472.

189 See Esser-Schmidt *Schuldrecht I* 18; Markesinis *Torts* 49; Dietz *Anspruchskonkurrenz* 18-19; Georgiades *Anspruchskonkurrenz* 81; Markesinis *Contract* 43-45; Eichler 1963 *AcP* 401; Arens 1970 *AcP* 392; Van Aswegen *Sameloop* 239-240.

190 Gabler *Bankrecht* 19-20.

191 Fikentscher *Schuldrecht* 8 65.

192 S 119 BGB; Palandt *BGB* 83-87; Münchener Kommentar *BGB* 800-856.

193 Palandt *BGB* 86.

Erklärungshandlung) which arises, for example, when the representor says something different from that which he intended to say; this constitutes an *Erklärungsirrtum* (error in declaration).¹⁹⁴ The mistaken party can rescind the contract, regardless of the behaviour of the other party.¹⁹⁵ However, the other party has a claim for the harm (*Vertrauensschaden*) he has suffered if he has justifiably relied on the promise now rescinded.¹⁹⁶

The contract can also be vitiated in a case of the so-called fundamental error, *Grundlage Irrtum*, when the error affects the essence of the contract.¹⁹⁷

Relating to fraud and threat,¹⁹⁸ German law assumes that the deceived or threatened party was incapable of making a free choice because his will had been completely negated. Thus the victim is deprived of any will and on that basis he can annul the contract. Furthermore the deceived or threatened party has a claim for damages. In this respect he can require to be placed in the same position he would have been in if the contract had never been concluded. This is called *Ersatz des Vertrauensschadens*.¹⁹⁹

6.5.1.2.2 Mistake²⁰⁰

Basically German law distinguishes between an error in the transaction (*Erklärungsirrtum*), which affects the contract²⁰¹ and an error of motive (*Motivirrtum*) which does not affect the contract.²⁰² The distinction between these two categories is rather subtle. When the contractor has formed his intention quite correctly, but has made a mistake in declaring it, there is a material error, while in case of an error of motive, the intention itself is incorrectly formed.

194 S 119 I BGB.

195 Zweigert & Kötz *Introduction* 414; Markesinis (ed) *Contract* 198.

196 S 122 BGB; Gabler *Bankrecht* 22-24; Zweigert & Kötz *Introduction* 415; Horn *et al Introduction* 82; Markesinis *Contract* 206; Münchener Kommentar *BGB* 862-866.

197 Palandt *BGB* 83-87.

198 S 123 BGB; Palandt *BGB* 89-94; Münchener Kommentar *BGB* 868.

199 See s 123 BGB; Horn *et al Introduction* 80-81.

200 See Zweigert & Kotz *Introduction* 372-380.

201 Fikentscher *Schuldrecht* 8 428.

202 S 119 BGB.

However, the question whether the error is one in the transaction or one of motive is of no great importance under German law, because in terms of s 119 II BGB a contracting party may also rescind the contract for error in motive if it concerns qualities of the person or the thing which, according to standard business practice, are regarded as essential. Therefore, the circumstances which fall within the scope of s 119 BGB and which may allow a party to set the contract aside because of mistake, include situations of slips of the tongue or the pen, and the use of ambiguous terms or expressions, as well as misunderstandings about the essential elements of the contract.²⁰³

Apart from s 119 BGB a contract can be annulled because of a fundamental error when both parties share the same misconception about the subject matter of the contract. In cases of this so-called fundamental error (*Grundlagenirrtum*), the error concerns a particular feature of the contract which according to good faith and normal commercial practice, is contemplated as the necessary foundation of the contract. In the absence of a specific statutory provision, this concept is based on the broad principle of good faith (*Treu und Glauben*).²⁰⁴ The courts have regarded it as unreasonable if the contract is upheld when both parties are mistaken about the underlying assumption of the contract (*Geschäftsgrundlage*) which in fact does not exist. The discretion that the courts have to determine whether or not an error is fundamental, is a broad one. As already mentioned, the party in error can rescind the contract irrespective of how it was evoked. As a rule the behaviour of the other party is irrelevant except in as far as his claim for damages after the rescission of the contract is concerned, if he has justifiably relied on the promise now rescinded. However, throughout German contract law gradually more attention is being paid to the behaviour of the contracting parties in accepting a duty of disclosure which can take precedence over the duty to make one's own investigations.²⁰⁵

In contracts of sale, German law in particular imposes on the vendor a duty to inform the other party about the qualities of the subject matter of the contract in case of material and juridical defects,²⁰⁶ in which situations may resemble cases of error. It is the general opinion in case law and jurisdiction that these rules relating to material and juridical defects prevail over the rules concerning error.

The underlying principle for the duty of disclosure is the protection of the reasonable

203 Palandt *BGB* 85-87; Münchener Kommentar *BGB* 800-856.

204 S 242 BGB.

205 Eg, BGH NJW 1974 1975; A G Köln NJW 1978 2603; BGH NJW 1978 2546; BGH NJW 1979 1707.

206 Ss 434 BGB and 459 BGB.

expectations and the justifiable reliance of the contracting parties in the context of a reasonable allocation of risk.²⁰⁷

6.5.1.2.3 Fraud or duress

In German law the relationship between being mistaken and being deceived is emphasized.²⁰⁸ In the case of fraud, however, the accent is specifically laid on the objectionable behaviour of the other party.²⁰⁹

In terms of s 123 BGB, fraud under German law requires a deliberate deception which induces the misled party to enter into the contract.²¹⁰ It is assumed that the free will of the deceived party has been fully negated and thus that his private autonomy, which is a basic element of contract law, is at stake. This gives him the right to invalidate the contract. It would appear that what is necessary is that the party who invokes the fraud has acted on purpose. Failure to speak constitutes fraud only when there is a duty to speak according to the principle of good faith and taking into account all the circumstances of the individual case.²¹¹

To illustrate, the Bundesgerichtshof held a party liable for fraud in a case where the vendor of land had concealed a notice by the local authority and in another case where the vendor of a building did not disclose the fact that an extension to the building had been built illegally.²¹²

When the deceit is practiced by someone other than the contracting party, rescission is granted only when the contracting party himself was aware or should have been aware of the deception or when the third party's behaviour is attributable to him.²¹³

207 See, generally, in this particular regard, Lauer *Informationspflichten*; Breidenbach *Informationspflichten*.

208 Zweigert & Kötz *Introduction* 424-430.

209 Deceit may be a tort in terms of s 826, or the contract induced by deceit may be rescinded under contract law in terms of s 123 BGB.

210 Zweigert & Kötz *Introduction* 424; Markesinis (ed) *Contract* 207; Gabler *Bankrecht* 23-24.

211 Zweigert & Kötz *Introduction* 425; Markesinis *Contract* 209.

212 Respectively BGH WM 1976 401 and BGH NJW 1979 2243. See, also, BGH NJW 1971 1795; BGH NJW 1977 1055; BGH NJW 1979 1707.

213 Horn *et al Introduction* 81; s 123 BGB; s 875 ABGB; s 28(2) OR; Palandt *BGB* 89.

In the case of threat (*widerrechtliche Drohung*) the threatened party acts as a result of illegitimate pressure and therefore can annul the contract.²¹⁴

There is neither a general rule which allows the person acting as a result of economic pressure to rescind the contract, nor a general concept of undue influence. However under s 138 BGB a contract is void if a fiduciary relationship exists and one party abuses another's poverty, dependency, irresponsibility or inexperience, which resembles cases of economic duress and undue influence.²¹⁵

Recently the Bundesgerichtshof extended the scope of s 138 BGB in a case where a brewery lent money to a couple in order to furnish their cafe. The terms of the loan were very onerous. The couple were obliged to sell only the brewery's products for a period of 10 years and they did not receive any protection against the brewery's supplying another cafe in the area where they operated. Moreover, after the expiration of the contract they had to hand over all the customers without any compensation whilst another clause prevented them from subsequently operating in the same line of business. Thus the couple were bound hand and foot. It was held that the contract was void in terms of s 138 BGB.²¹⁶

6.5.1.3 The duty of disclosure

6.5.1.3.1 General principles

6.5.1.3.1.1 Disclosure of facts (*Auskunfts-pflicht*)²¹⁷

In all business spheres, information and advice are being sought. The reason for this is the speed

214 Zweigert & Kötz *Introduction* 428-430; Markesinis (ed) *Contract* 209-211; Hartkamp *et al* (eds) *European Code* 146.

215 Kempermann *Vertrauensverhältnissen* 104-119; Hartkamp *et al* (eds) *European Code* 146.

216 BGH NJW-RR 1987 628.

217 One should be careful when discussing duties of disclosure in German law because duties to inform (*Auskunft*) and duties to advise (*Rat*) are closely connected. The material difference between advice and information lies therein that with advice one is dealing with a subjective utterance and in the case of information, with an objective utterance. Information relates to facts. See Dirichs *Haftung* 3. With advisory duties, the crux is the assessment of facts and reaching of a conclusion in regard thereto. See Vortmann *Aufklärungs- und Beratungspflichten* 2; Canaris *Bankvertragsrecht* 101; OLG Karlsruhe WM 1988 411 at 412.

of development and daily increasing specialisation, to the extent that human general knowledge can no longer cope.²¹⁸

It has been stated that the underlying principle in German law for a duty of disclosure is the protection of reasonable expectations and the justifiable reliance of the contracting parties in the context of a reasonable allocation of risk.²¹⁹

The BGB does not prescribe a general duty of disclosure of facts.²²⁰ Such a duty may, however, arise from contract or a particular Act or *Gesetz*.²²¹

In addition, a duty of disclosure of facts can arise as a result of the concept of good faith in terms of s 242 BGB²²² when the following requirements are present:

- There must be a particular existing²²³ relationship between the parties, such as a contractual relationship, a legal or *gesetzliches* relationship or a delictual relationship.
- The person in need of information must be, excusably, unable to obtain the information

218 See Dirichs *Haftung* 1.

219 Breidenbach *Informationspflichten*.

220 See, also, Markesinis (ed) *Contract* 209 who states that there is no general duty of disclosure and advice; each party must enquire as to advantages and disadvantages of a transaction. An important exception mentioned by Markesinis is the case where the facts are obviously of great importance (*von erheblicher Bedeutung*); see Vortmann *Aufklärungs- und Beratungspflichten* 9; Nobbe *Bankrecht* 17; BGH ZIP 1993 1089) to the other party, and provided good faith and common practice require that these facts be disclosed.

221 Brox *Schuldrecht* 73. Examples of Acts conferring a duty is s 681 BGB (mandate); s 713 BGB (member of companies); s 1379 BGB (spouses); s 2027 BGB (trustee of deceased estate).

222 Fikentscher *Schuldrecht* 8 128 cautions:

"Die grundsätzliche, ins ethische führende Bedeutung des s 242 besteht in folgendem: Schulverhältnisse sollen nicht nur irgendwie und überhaupt erfüllt werden, sondern in bestimmter, nämlich anständiger und verkehrüblicher Weise."

Freely translated, the statement means that obligations must be fulfilled in a socially responsible manner. The *boni mores* therefore determine which relationships attract disclosure and advisory duties. See, also, Nobbe *Bankrecht* 17; BGH ZIP 1993 1089.

223 See Fikentscher *Schuldrecht* 8 128.

without the cooperation of the other party.

- The other party must be in a position, without difficulty, to disclose the facts.

Should a party fail in the duty to so disclose, the debtor may escape liability and, in a case of incorrect disclosure, may even claim damages.²²⁴

In Germany, contract law has in recent years taken more and more note of the duty of bankers to inform, advise and explain. New, additional duties which create obligations for the banks are being developed. These include duties relating to research, supervision and notification. This move has its legal origins in the duty to clarify and advise. It is therefore reasonable to expect an expansion of the existing list of duties in regard to disclosure depending on the facts of the case, in future.²²⁵

In summary, a party who was or (having regard especially to any professional qualification) ought to have been aware of a fact which he knew to be of determining importance for the other contracting party is bound to inform the latter of that fact, provided that the latter was unable to discover it for himself or provided that, because of the nature of the contract, the character of the parties, or the incorrectness of the information provided by the other party, he could justifiably rely on that other to provide the information.²²⁶

6.5.1.3.1.2 Advice (*Aufklärungs- und Beratungspflichten*)²²⁷

Under the duty to explain or advise falls the duty to inform the other contractant about recognized circumstances requiring consideration and decision (*Entscheidungserhebliche Umstände*).²²⁸ The duty to explain stretches, however, only to such particulars as are unknown to the other contractant, and does not exist where both parties could easily inform themselves from general

224 Brox *Schuldrecht* 74.

225 Vortman *Aufklärungs- und Beratungspflichten* 1.

226 Ghestin in Harris & Tallon (eds) *Contract Law* 166.

227 These duties are referred to as *Aufklärungs- und Beratungspflichten*. Both duties are pre-contractual *Nebenleistungspflichten*, accessory duties of performance, that serve to inform the contracting party about circumstances that may lead to the derailment (*Vereitelung*) of the contract. See Vortmann *Aufklärungs- und Beratungspflichten* 3; Canaris *Bankvertragsrecht* 9.

228 Nobbe *Bankrecht* 16-17.

sources of information.²²⁹

The duty to explain or advise relates to communications to which the contractant has aligned his earlier behaviour. Together with explanation and advice the crux of the matter lies in the assessment of facts and the conclusions that might be drawn therefrom.²³⁰ In contrast thereto the duty to disclose, relates to the communication of certain facts.

The duty to explain is therefore owing when information is required which is of determining importance (*bedeutsam*) for a contractual decision. A duty to disclose relates however, to those facts, upon which the information receiver wishes to base his future relationship.²³¹

The duty to explain and the duty to advise are to be considered the same. Both duties are pre-contractual²³² additional duties that serve to inform the contracting party of circumstances which may lead to the frustration of the purpose of the contract. The violation of these duties can be by way of omission or commission. In isolated cases the border between misrepresentation and non-disclosure is quite indistinguishable.²³³

Other duties such as the duty to comment or warn that have developed out of the duty to explain and the duty to advise, are special duties such as the duty of care or the duty to ward off danger. Their origins stem from the need, to protect the other contracting party and to ensure the achievement of the object of the contract.²³⁴

As a result of the circumstances existing at the time, a contracting party must be informed against those circumstances of which he is unaware and of which the other party has knowledge, in order to prevent him from suffering damage. This duty to warn is readily recognizable in those cases in which the one party has a duty towards the other party, owing to the relationship between the

229 See Emmerich *Leistungsstörungen* 44.

230 Canaris *Bankvertragsrecht* 74-75; OLG Karlsruhe WM 1988 411 at 412; Vortmann *Aufklärungs- und Beratungspflichten* 2.

231 Vortman *Aufklärungs und Beratungspflichten* 3.

232 Canaris *Bankvertragsrecht* 9-10 sees these duties not as contractual, but as of a *gesetzlicher Natur*, existing independent of any particular type of banking contract such as loan or discounting. These duties are rather to be seen as part of the banker-customer relationship or *Geschäftsverbindung*.

233 Vortmann *Aufklärungs- und Beratungspflichten* 3.

234 Eg, notification to pay in the case of non-payment of a bill. See BGH ZIP 1989 563.

parties, which duty he can comply with easily and without further ado. Also, in the case of the duty to warn on the one hand and the duty to explain and advise on the other, the borderlines between them can sometimes be indistinct.²³⁵

A banker is, in principle, legally obliged to advise a customer truthfully and explain all the circumstances that are relevant to the customer's business decision.²³⁶ However, from this definition it should not be concluded that a general duty of explanation and advice exists,²³⁷ not even from the fact that a long relationship has been in existence between banker and client or where the bank has taken a *Hausbankfunktion*.²³⁸

A duty of explanation therefore only exists when the contracting party is reasonably entitled thereto, in accordance with the dictates of good faith (*Treu und Glauben*)²³⁹ and the legal convictions of the community, the *Verkehrsauffassung*.²⁴⁰

The liability of a bank based on its failure to comply with its duty to explain, advise or disclose,

235 Vortmann *Aufklärungs- und Beratungspflichten* 4.

236 RG WarnR 1916 227 456; BGH WM 1987 1329 at 1331.

237 BGH ZIP 1981 962; BGH ZIP 1983 1060.

238 BGH WM 1990 584; OLG Köln 1990 1616 at 1617 states the following in regard to the explanatory duties to a customer of long standing who undertakes suretyship for another customer:

"Auch in diesem Fall muss der Bürge bzw. der Kunde des Kreditinstitutes annehmen und wissen, dass der Hauptschuldner ohne weitere Sicherungen nicht mehr kreditwürdig ist und das Geldinstitut insoweit in einem Interessenwiderstreit steht.

Hierüber muss die Bank den Bürgen nicht besonders aufklären, für ihn ist vielmehr offensichtlich, dass die Bank in diesem Fall zumindest auch ihm, dem Bürgen, unter Umständen entgegengesetzte, eigene Interessen mit der Hereinnahme von Sicherheiten verfolgt."

The surety must not expect, without further investigation, that the principal debtor is creditworthy, and must realise that he, the surety, stands in a situation of conflict of interest with the bank. The bank does not have to explain this to the surety. For a contrary opinion, pleading for a heavier duty on the banker in this regard, see Köndgen *Gewährung* 47.

239 S 242 BGB.

240 RGZ 111 233; BGH NJW 1973 752 at 753; Schmeltz *Verbrauchercredit* 153; Vortmann *Aufklärungs- und Beratungspflichten* 7.

furthermore, remains limited to a few exceptions.²⁴¹ The exceptional circumstances in which these exist are where the bank itself creates, or contributes to, an economic risk²⁴² or where the bank actively encourages the surety to sign, and when the bank has, in relation to the special risks of the business, a concrete *Wissenvorsprung*,²⁴³ or where the bank has exceeded its role as financier in the business of the client and can be seen as a partner,²⁴⁴ or where the bank has a serious conflict of interest with the customer.²⁴⁵

6.5.1.3.2 The bankers duty of disclosure

6.5.1.3.2.1 Disclosure to customers

The bank does not have any general duty of disclosure to the customer, notwithstanding the preamble to the previous AGB-Banken.²⁴⁶ The customer generally has no legal claim to disclosure.²⁴⁷ A duty of disclosure may arise out of contract, or, extraordinarily, may arise from *Treu und Glauben*²⁴⁸ or as a result of *guten Sitten*,²⁴⁹ but in accepting a legal duty of disclosure on these grounds, extreme restraint (*äusserste Zurückhaltung*) has to be used, as the banks have made their disavowance of such a duty clear in the 1986 AGB-Banken²⁵⁰ and the customer must

241 Bundschuh *Bankrecht* 84-85; Nobbe *Bankrecht* 20.

242 Nobbe *Bankrecht* 28.

243 Vortmann *Aufklärungs- und Beratungspflichten* 7; Nobbe *Bankrecht* 21; BGH ZIP 1992 166; BGH ZIP 1991 1956.

244 Nobbe *Bankrecht* 26; BGH ZIP 1988 562; BGH ZIP 1992 166; BGH ZIP 1992 163.

245 Nobbe *Bankrecht* 30-31; Reinking & Niessen 1991 ZIP 78 at 85; BGH ZIP 1992 990; BGH ZIP 1992 913.

246 The preamble to the 1986 AGB-Banken stated that the banker-customer relationship is a fiduciary relationship. The customer may expect the bank to carry out its instructions with the necessary care (*Sorgfalt*) of *eines ordentlichen Kaufmanns*, and the bank must protect the customer's interest in the best possible manner. See, also, Sandkühler *Bankrecht* 22. This is not contained in the AGB-Banken of 1993. There are, of course, certain statutory duties of disclosure. See s 402 BGB; s 666 BGB; s 840 ZPO.

247 Canaris *Bankvertragsrecht* 58.

248 S 242 BGB.

249 S 826 BGB; OLG Hamm WM 1987 1297 at 1298.

250 Note also the last sentence of s 10 AGB-Banken of 1986:

"[D]ie Bank übernimmt ferner keine Haftung aus einer etwaigen Unterlassung von Auskünften und Raterteilungen."¹

be aware of the fact that such disclosure is not generally prescribed.²⁵¹

Where the customer does ask for information, the bank should act as an *ordentliche Kaufmann* and should disclose those facts known to the bank, as far as this is material to the dispositions of its customer.²⁵²

In principle, a banker is legally obliged to advise a customer truthfully and explain all circumstances that are relevant to the customer's business decision.²⁵³

6.5.1.3.2.2 Disclosure about customers (*Die Bankauskunft*)²⁵⁴

The question of status reports by banks is covered in s 2 of the new AGB-Banken of 1993. This section states that a bank may disclose information regarding the customer only if it is legally required to do so or if the customer has consented thereto or if the bank is authorized to disclose banking affairs. The general conditions differentiate between business customers and private customers, the latter being often less inclined to disclose information about their wealth. The

251 Canaris *Bankvertragsrecht* 58-59.

252 Sandkühler *Bankrecht* 23; Gabler *Bankrecht* 504-505; Nobbe *Bankrecht* 17.

253 RG WarnR 1916 227 456; BGH WM 1987 1329 at 1331.

254 S 10 AGB-Banken of 1986 states:

"Bankauskünfte sind allgemein gehaltene Feststellungen und Bemerkungen über die wirtschaftlichen Verhältnisse des Kunden, seine Kreditwürdigkeit und Zahlungsfähigkeit."

In contrast to duties to advise, assess, or warnings, bank disclosure relates to the disclosure of facts, regarding the economic relations of the customer, and his creditworthiness. See Sandkühler *Bankrecht* 22; Vortman *Aufklärungs- und Beratungspflichten* 3.

S 2(2) AGB-Banken of 1993 reads:

"Eine Bankauskunft enthält allgemein gehaltene Feststellungen und Bemerkungen über die wirtschaftlichen Verhältnisse des Kunden, seine Kreditwürdigkeit und Zahlungsfähigkeit; betragsmassige Angaben über Kontostände, Sparguthaben, Depot- oder sonstige der Bank anvertraute Vermögenswerte sowie Angaben über die Höhe von Kreditansprüchen werden nicht gemacht."

Normally the bank does not give account balances or credit limits.

In regard to status reports generally, see Ebeling 1955 *WM* 1366 *et seq*; Gaede 1972 *NJW* 926 *et seq*; Schraepfer 1972 *NJW* 1836 *et seq*.

bank will not give any information about a private customer without his express consent.²⁵⁵

A person in regard to whose affairs a bank makes a statement or disclosure, may have a damages claim against the bank.²⁵⁶ The rule is that the bank, if it discloses facts about a customer, should state the objective truth.²⁵⁷ The bank is obliged to give the information with the care or *Sorgfalt eines ordentlichen Kaufmanns* truthfully and fully.²⁵⁸

The courts take the attitude that the bank should rather refuse to make statements about its customer, if it is of the opinion that disclosure may be misleading, even if negative conclusions are drawn from its failure to disclose.²⁵⁹

If a bank makes a false statement to a third party about the customer, the bank may be held liable in delict to the third party.²⁶⁰

The bank should normally also ensure that it does not exceed its duty of secrecy. It is submitted that the bank should always insist on the customer's express consent to the making of disclosure of its affairs to third parties.²⁶¹ Bank references are, of course, given only to another bank requesting the information.²⁶²

255 See Cranston (ed) *European Banking Law* 74; Fischer & Klanten *Bankrecht* 160-161; Schwintowski & Schäfer *Bankrecht* 63.

256 Canaris *Bankvertragsrecht* 72-73

257 Gabler *Bankrecht* 506; Fischer & Klanten *Bankrecht* 161; OLG Oldenburg WM 1987 836.

258 Fischer & Klanten *Bankrecht* 161-162. No figures are usually given — only information of general creditworthiness. The information needs to sketch only the big picture. The reader is expected to read carefully and between the lines as well. See Fischer & Klanten *Bankrecht* 162. The bank also need not do an intensive investigation into the customer's affairs. The bank need only disclose the facts available to it at the time of the request. See Schwintowski & Schäfer *Bankrecht* 64.

259 Gabler *Bankrecht* 506-507.

260 Canaris *Bankvertragsrecht* 71-72; Horn *et al Introduction* 80; Markesinis *Torts* 285; 896; Bundschuh *Bankrecht* 5; Nobbe *Bankrecht* 46; Fischer & Klanten *Bankrecht* 167; BGH WM 1972 583 at 584; BGH WM 1989 1409.

261 See s 2 of the new AGB-Banken of 1993; Gabler *Bankrecht* 507; Lanio *AGB-Banken* 155; Bundschuh *Bankrecht* 1; Dirichs *Haftung* 7.

262 Nobbe *Bankrecht* 45; Fischer & Klanten *Bankrecht* 164.

Although the suretyship is a contract between the surety and the creditor, German law recognizes a contractual relationship between surety and principal debtor on the grounds of agency.²⁶³ As *Beauftrager*, the surety may require the principal debtor to inform him of the extent of his liability and it is assumed that in this respect the principal debtor has released the bank from its duty of secrecy.²⁶⁴

6.5.1.3.3 Disclosure of facts to a surety

Suretyship, as a particular contract, is regulated by statute.²⁶⁵ As seen above where the general principles of suretyship were discussed, suretyship is an accessory obligation, and has a security character whereby it is understood that the liability is a subsidiary one.²⁶⁶

An extremely important aspect of the character of German suretyship, is the fact that suretyship is a contract (*einseitig verpflichtender Vertrag*) creating liability for the surety only. It is entered into between surety and creditor; the co-operation of the principal debtor is not required.²⁶⁷ Only the surety attracts liability, not the creditor.²⁶⁸ This onerous view of suretyship underlies the reason why the German law of disclosure to a bank's surety is restricted.

The creditor is generally not compelled to advise the surety about the risks and patrimonial relationships of the principal debtor. It is for the surety to inform himself in this regard.²⁶⁹ Only in exceptional circumstances may an advisory duty arise on the grounds of good faith, for example where the bank has itself had an influence on the decision of the surety to bind himself. If such an exceptional duty exists,²⁷⁰ the bank must inquire whether the surety has assessed the

263 *Beauftrager*. See s 662 BGB; Palandt *BGB* 782-784.

264 Gabler *Bankrecht* 513.

265 See ss 765 BGB - 777 BGB; Palandt *BGB* 862-877.

266 Gabler *Bankrecht* 590; Müller *Schuldrecht* 308; Palandt *BGB* 862; Fischer & Klanten *Bankrecht* 231; RGZ 59 11; BGH NJW 1998 2972.

267 Gabler *Bankrecht* 590; Müller *Schuldrecht* 313; Fischer & Klanten *Bankrecht* 239.

268 Gabler *Bankrecht* 590; Fikentscher *Schuldrecht* 8 621.

269 Gabler *Bankrecht* 596; Bundschuh *Bankrecht* 84; Fischer & Klanten *Bankrecht* 239; BGHZ 125 206. In very restricted cases, a duty to advise may arise, such as where the principle debtor is about to go bankrupt, or where the surety has been misled about the risks by the creditor. See BGH ZIP 1987 764; BGH ZIP 1987 757; BGH ZIP 1989 629.

270 Vortmann *Aufklärungs-und Beratungspflichten* 7.

relationships of the principal debtor correctly.

Under no circumstances may the creditor give false information to the surety in regard to the financial relationships of the principal debtor. If he does, he may face a claim in terms of s 123 BGB (*arglistiger Täuschung*).²⁷¹

In principle, the creditor need not take the interests of the surety into account when taking a suretyship, or further suretyships. However, good faith should be observed also in this regard, and the creditor may not, at will, neglect or ignore the interests or position of the surety.²⁷²

In principle, the bank does not have a general duty to explain the extent of the risks that the surety is undertaking.²⁷³ This principle is valid in respect of the consideration of both the legal effect of the suretyship as well as its financial effect.²⁷⁴ Flowing from this principle, the fact that the principal debtor has exceeded his credit limit needs no explanation.²⁷⁵ The fact that the bank is also the banker of the surety, places no duty of explanation on the bank. The bank may assume that the surety has informed himself of all material aspects necessary for taking the decision.²⁷⁶ Any information lacking falls within the surety's own sphere of risk.²⁷⁷

This strict division of risk is due to the design of suretyship as a one-sided contract,²⁷⁸ which confers little protection on the surety.²⁷⁹ The law does allow an exception to the above ruling only when, through its own conduct, the bank as creditor has caused the surety to be mistaken as to

271 Gabler *Bankrecht* 596; Markesinis *Tort* 285; 896; Horn *et al Introduction* 80; Markesinis *Contract* 207.

272 Gabler *Bankrecht* 596.

273 BGH WM 1983 1850; BGH WM 1986 11; BGH ZIP 1987 764; BGH ZIP 1987 1519; OLG Celle WM 1988 1815; OLG München WM 1989 601.

274 BGH WM 1987 853; BGH WM 1987 1481.

275 OLG Köln WM 1990 1616; Vortman *Aufklärungs- und Beratungspflichten* 82.

276 BGH WM 1986 11; BGH NJW 1989 1605.

277 Vortmann *Aufklärungs- und Beratungspflichten* 82.

278 Gabler *Bankrecht* 596; OLG Köln NW-RR 1990 755 at 756; Scholz & Lwowski *Kreditsicherheiten* 348 and 365.

279 Vortmann *Aufklärungs- und Beratungspflichten* 81.

an increased risk or unexpected risk.²⁸⁰ Under no circumstances may the bank mislead the surety about the facts of the matter or attempt to trivialize the type, scope or risk of the surety's liability and thereby influence his decision.²⁸¹

The cause of the mistake can be a positive statement or a failure to speak by the bank.²⁸² A duty to act positively or to speak arises only in exceptional circumstances in the banker-surety relationship. If such a duty does exist, a bank must comply with the duty and cannot hide behind its duty of secrecy towards the customer.²⁸³ This duty may even require the bank to obtain from the customer its release from its duty of secrecy.²⁸⁴

Failure to disclose relevant information in the course of a business transaction may be actionable under s 826 BGB especially where the defendant's conduct constitutes an abuse of his dominant economic position.²⁸⁵

If a surety assumes an obligation, the amount of which exceeds by far his present and potential future income situation and assets, such a contract can be void under s 138 BGB, if additional circumstances levy a considerable burden on the surety and lead to an intolerable imbalance between the parties to the contract. In particular, such burdens can be caused if the creditor exploits the surety's inexperience in business matters or if he exploits a mental predicament, or in some way exerts undue influence on the surety's freedom of decision.²⁸⁶

The creditor has no duty to advise the surety continuously about the standing of the principal

280 BGH WM 1986 11; BGH WM 1987 853; Vortmann *Aufklärungs- und Beratungspflichten* 84. An *Aufklärungspflicht* may arise where the bank has exceeded its role as financier and could be seen as the partner of the debtor. See BGH NJW 1988 1583; BGH WM 1990 920; BGH ZIP 1992 163; BGH ZIP 1992 990. The duty may also arise where a serious conflict of interest between the bank and its customer has arisen. See BGH ZIP 1988 562; BGH ZIP 1991 90; BGH WM 1990 920; BGH ZIP 1992 2146; Nobbe *Bankrecht* 26-30.

281 BGH NJW 1994 1341.

282 BGH ZIP 1987 1519.

283 OLG Hamburg ZIP 1988 1538; Vortmann *Aufklärungs- und Beratungspflichten* 86-87.

284 OLG Hamm ZIP 1982 1061; OLG Hamburg ZIP 1988 1538; Vortmann *Aufklärungs- und Beratungspflichten* 87.

285 BGH NJW 1982 2815.

286 BGH NJW 1994 1341.

debt.²⁸⁷ During the existence of the suretyship, the bank need not take into account the patrimonial interests of the surety. It is the surety's duty to inform himself of continuing contractual risks.²⁸⁸

6.6 CONCLUSION

German Law also has several theories on what constitutes a "banker-customer relationship". The relationship between banker and customer is not limited to one type of transaction, but is mostly a relationship which endures for a period and which can consist of several types of business transaction.²⁸⁹ The legal regime of this relationship is constituted by the principles of general contract law as found in the German Civil Code and Commercial Code. These codes do not contain special provisions on banking transactions. Instead, the general provisions on contracts, for example on credit contracts, agency contracts, purchase contracts, commission contracts and others, as well as the general principles of good faith, and the rules relating to the interpretation of contracts, are applicable. In addition, the rules and principles on pre-contractual duties and on tort liability under the German Civil Code come into play. This private law of banking transactions is modified and completed by special legislation on the protection of customers and investors. The most important laws in this regard are the law on General Conditions of Contracts of 1976,²⁹⁰ the Law on Consumer Credits of 1990,²⁹¹ and the Securities Trading Act of 1994.²⁹²

The banker-customer relationship can be described as a bundle of different contracts. The various contracts between bank and customer normally have some similarities and common features. Invariably, the bank must act in good faith, must be reasonable, and not act contradictorily when handling the customer's affairs.²⁹³

The banking industry uses uniform standard conditions of contract in their contracts with customers and other banks. The AGB-Banken of 1993 is subject to the AGB-Gesetz. Section 9

287 Gabler *Bankrecht* 596.

288 Fischer & Klanten *Bankrecht* 239-240; OLG Köln WM 1995 1268.

289 See par 6.2.1 *supra*.

290 Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen (AGB-Gesetz).

291 Verbraucherkreditgesetz.

292 Wertpapierhandelsgesetz. (WpHG). See par 6.2.1 *supra*.

293 See par 6.2.2 *supra*.

AGB-Gesetz states that clauses in general conditions of contract are void if they place the other party in a disadvantageous legal position that violates the standards of fairness. Under its various contractual and pre-contractual relations with its customer, the bank must exercise due diligence and care when handling the customer's affairs. It must provide proper information and disclosure, and must observe strict standards of fairness.²⁹⁴

As a rule, the bank must keep the customer's affairs confidential; in particular, it must not give information about his assets with the bank or about his plans for certain financial transactions, unless the customer has given his consent. The duty does not have an express statutory basis, but is derived from the contractual relationship between the bank and the customer, which implies a general fiduciary duty. Various statutes override the secrecy obligation. The bank may also be justified in disclosing information where there is an overriding public duty to do so, or where there is an overriding interest of the bank to do so.²⁹⁵

The bank must do its best to avoid any conflict between the interest of its customer and its own interest. The establishment of Chinese Walls to avoid any conflict between the interests of the bank and the interest of its customer has become a particularly important element of conflict management and is one of the primary organisational obligations imposed by s 34 of the Securities Trading Act of 1994.²⁹⁶

As far as investment banking is concerned, banks must give proper information and advice to their customers as investors when they render financial services to them.²⁹⁷

The BGB provides for a system of securities for creditors. It provides for only one type of personal security (*Personalsicherheit*): the contract of suretyship. The surety agrees to be liable to the creditor, to stand in (*einzustehen*) for the compliance with the obligation of the third party. This undertaking must be in writing unless the surety is a merchant. The surety is basically liable only to the extent that the principal debt for which he has stood surety actually exists; he can use against the creditor any defences available to the third party. Thus, the liability of the surety is made accessory (*akzessorisch*) to the main debt, and the liability of the surety is a subsidiary

294 See par 6.2.3 *supra*.

295 See par 6.2.4.2 *supra*.

296 See par 6.2.4.3 *supra*.

297 See par 6.2.4.4 *supra*.

one.²⁹⁸

The European Union has issued a number of directives and recommendations on consumer protection. The most important initiative in this field is the Directive on Consumer Credits that has been made part of the German national consumer credit legislation. Under this legislation, banks are obliged to conclude credit contracts with private customers, in writing, and to include in the contract certain precisely prescribed information about the most important conditions of the credit, in order to give the borrower a full picture of his rights and duties, and in particular, about the economic burden of the credit. Another important piece of legislation on consumer protection is the German Law on General Conditions of Contract (AGB-Gesetz), which is aimed at protecting every customer against the restriction of his or her contractual freedom that would result from unilateral formulation of contractual conditions. The Wertpapierhandelsgesetz²⁹⁹ lays the foundation for a German capital-market law or securities law as a new body of law that is close to banking law, but not entirely a part of it. The new law provides for a federal authority for the supervision of the trade in securities and it establishes a number of duties for all enterprises active in the field of financial services. These enterprises must exercise due diligence when serving the customer. They must organize their business in a way that enables them to render the necessary information and advice, and to avoid conflict of interest with their customers. They furthermore must gather the necessary information about the customer, his knowledge, experience, and investment expectations. On the basis of this information, the enterprise rendering the financial service can give the customer the information and advice appropriate to him and recommend those investments that suit his needs and expectations.³⁰⁰

In German law the institutions known as breach of contract and delict are arranged in separate paragraphs of the BGB. Breach of contract is usually treated under the general rules relating to improper compliance with an obligation. An obligation (*Schuldverhältnis*) is described as a relationship between a debtor and creditor, with a duty of performance (*Schuld*, or *Leistungspflicht*) and a corresponding right to performance (*Forderung*), as content.³⁰¹

Section 242 BGB creates a general duty to perform according to the dictates of good faith (*Treu*

298 See par 6.3 *supra*.

299 WpHG of 1994.

300 See par 6.4 *supra*.

301 See par 6.5.1.1 *supra*.

und Glauben). This principle has been used in various ways by the courts to develop a control mechanism for the whole law of contract.³⁰²

Under German law the manifestation of the will (*Willenserklärung*) can be defective on different grounds. German law distinguishes between a defect in the formation of the will (*Willensbildung*) in the case of an error of motive (*Motivirrtum*), fraud (*arglistige Täuschung*), and threat (*widerrechtliche Drohung*), and a defect in the declaration of the will (*ein Mangel in der Erklärungshandlung*) which arises, for example, when the representor says something different from that which he intended to say; this constitutes an *Erklärungsirrtum*. The mistaken party can rescind the contract, regardless of the behaviour of the other party. However, the other party has a claim for the harm (*Vertrauensschaden*) he has suffered if he has justifiably relied on the promise now rescinded.³⁰³

The German principles of disclosure and advice are heavily influenced by the concept of good faith (*Treu und Glauben*). A bank must therefore contract in a manner required by good faith and fair dealing, taking into account the general commercial practice.³⁰⁴

Various statutes, the AGB-Banken of 1993, the legal convictions of the community (*Verkehrsauffassung*), and good faith, all play a role in determining a duty of disclosure and advice.³⁰⁵ Perhaps the best summary as to the existence or not of a banker's duty of disclosure would be the following:

A party who was or (having regard especially to any professional qualification) ought to have been aware of a fact which he knew to be of determining importance for the other contracting party is bound to inform the latter of that fact, provided that he was unable to discover it for himself or that, because of the nature of the contract, the character of the parties, or the incorrectness of the information provided by the other party, he could justifiably rely on that other to provide the information.³⁰⁶

302 *Ibid.*

303 See par 6.5.1.2.1 *supra*.

304 S 242 BGB. See, also, par 6.5.1.3.1.1 *supra*.

305 See pars 6.5.1.3.1.1 and 6.5.1.3.2 *supra*.

306 See Ghestin in Harris & Tallon (eds) *Contract Law* 166.

CHAPTER 7: THE BANKER'S DUTIES OF DISCLOSURE AND ADVICE TO CUSTOMERS AND SURETIES: THE NETHERLANDS

7.1 A COMPARATIVE NOTE

7.1.1 Introduction

As discussed in the chapter on German Law¹, it was common until recently to divide the European legal systems into five groups, so-called "legal families". On the continent many authors distinguished:

- the French legal family;
- the German legal family;
- the Nordic legal family;
- the Socialist legal family; and
- the Anglo-American legal family.

The British Isles and Ireland were described as countries belonging to the Anglo-American legal family.²

The Netherlands fall within the French family³ and a brief comparative note is in order at this point.

1 Chapter 6 sub par 6.1.1.

2 See, for instance, Zweigert & Kötz *Introduction* 63-73.

3 Hartkamp *et al* (eds) *European Code* 102; Zweigert & Kötz *Introduction* 101-103. Malström 1969 *Scandinavian Studies in Law* 127 at 148 classifies the Netherlands, with France, as part of the Latin Group of a Central European Group.

7.1.2 The French group

After the French Revolution a committee was established to prepare the codification of several fields of law, which codifications were to be introduced into the whole territory of the French Republic. Until that time a strong Roman-law orientated system of law had been in force in the southern part of modern France (*pays de droit écrit*), whereas in the northern part many different systems of customary laws existed that were less influenced by Roman law (*pays de droit coutumier*).⁴ The committee prepared three important codes in the field of civil law, which were later enacted: a civil code (Code Civil of 1804), a commercial code (Code Commercial of 1807) and a code of civil procedure (Code de procedure civile of 1804). The Civil Code was divided into three books:

- (1) law of persons and family;
- (2) law of property;
- (3) law of obligations including the law of inheritance and matrimonial property.

These codes came into force at the time the French Republic, under the leadership of Napoleon, covered an important part of Western Europe. Therefore, these codes were immediately enforced in the territories of Belgium, Luxembourg, the southern part of the Netherlands as well as parts of Germany. In other countries of Western Europe, under the influence of France, similar codes were introduced, for example the Civil Code for the Kingdom of the Netherlands which was enacted during the reign of King Louis-Napoleon, a brother of the French Emperor.⁵

After the decline of the French Empire in 1814, the codes of the Napoleonic area stayed in force in France, and partly also in countries which had formerly belonged to France, or were under French influence. The reason for this was that the value of having the most important fields of law centrally codified instead of the state of affairs that existed before in most European countries, that is different local laws, was generally accepted.⁶

7.1.3 The Netherlands

Since, during this period, the southern provinces of the Netherlands were part of the French

4 Zweigert & Kötz *Introduction* 75-76.

5 Zweigert & Kötz *Introduction* 102.

6 Hartkamp *et al* (eds) *European Code* 99.

Empire Napoleonic legislation came into force in 1804 in these provinces. The northern provinces of the country constituted the Kingdom of Holland from 1806 to 1810 under King Louis-Napoleon. Codes following the French model were introduced in this kingdom. A Civil Code⁷ came into force in 1809. In 1810 the whole territory of the modern Netherlands became part of the French Empire and in 1812 the French codes came into force in the whole country. These codes remained provisionally in force with minor modifications in the Kingdom of the Netherlands until separate codifications were enacted. The new Dutch codes were introduced on 1 October 1838 into the field of private law.⁸ The structure of the Civil Code differed from the French Code Civil, although many of the provisions were mere translations of the French original. Only in some matters did the codes follow its own, more traditional Dutch solutions, for example in the field of matrimonial property law and the area of law regarding the transfer of ownership. After an unsuccessful attempt in the nineteenth century to recodify private law, a project was started in 1947 to do this. In that year Professor Meijers was entrusted with the official task of making a draft of a new Civil Code. In 1970 the first book of this new code (on the law of persons and the family) came into force, followed by a second book in 1976 on the law of legal entities. In 1991 book 8 on the law of transport was put into force. Finally the core of the new code (book 3: general part of patrimonial law; book 5: law of property; book 6: law of obligations; parts of book 7: specific contracts) came into force on 1 January 1992. Book 4 (law of succession and contracts) came into force on 1 January 1992. The other parts of book 7 will follow in the near future. Many of the provisions of this code still show the descendance from the French tradition, but on other points the influences of other traditions are evident. The code was prepared after thorough comparative research and the Swiss, Italian and German codes, in particular, influenced the solutions chosen by the legislator in the Netherlands. Even Anglo-American theories influenced certain of the Code's topics. Like the Italian Civil Code the new code of the Netherlands integrates civil and commercial law. When all parts of the new code are in force the commercial code will be abolished.⁹

7 Wetboek Napoleon voor het Koninkrijk Holland of 1809. See Zweigert & Kötz *Introduction* 102.

8 BW, Wetboek van Koophandel, Wetboek van Burgerlijke Rechtsvordering.

9 See, in general, Hartkamp *et al* (eds) *European Code 102*; Hondius (ed) *Dutch Law; Hebly Evidence*; Warendorf *Companies*; Zweigert & Kötz *Introduction* 102-103.

7.2 THE BANKER-CUSTOMER RELATIONSHIP

7.2.1 A combination of contracts

Under banking law is usually understood the total of the juridical aspects of the operations of banks, particularly general banks.¹⁰ Apart from general banks, the Dutch banking system also has co-operative banks, savings and Post banks, hypothecation banks, finance companies and loan companies, investment banks and participation companies, as well as, of course, the central bank, that is the Nederlandsche Bank.¹¹

Dutch law does not specifically provide for an all-encompassing "banking contract" which would cover the entire relationship between bank and customer. Some authors in the Netherlands¹² believe that a so-called "relation agreement" comes into existence when a customer engages the services of a bank for the first time. However this view is not generally held.¹³ The activities that Dutch banks perform are extremely varied and includes the granting of credit, money lending, money and capital market transactions, *depothandel*, mandate, *rekening courant*, negotiable instruments, *giraal betalingsverkeer*, credit cards, documentary letters of credit, foreign exchange transactions, term transactions, swaps, securities and various other activities as can be expected from a developed country.¹⁴

Most people look at the relationship in a pragmatic way: a combination of qualified and unqualified contracts, governed by the general rules of contract law, and the General Banking Conditions.¹⁵

10 Schwintowski & Schäfer *Bankrecht* 3; Schönle *Bank- und Börsenrecht* 2.

11 See Kessenich-Hoogendam *Aansprakelijkheid* 2-3. The central Bank regulates the Banking Industry in terms of the Banking Act of 1948. See Rank *Geld* 25.

12 See Van Ravenhorst *Bankovereenkomst* 56-62; Van Ravenhorst 1990 *WPNR* 5947; who is of the opinion that the banker-customer relationship is a factual one to which the objective law gives effect.

13 See, for instance, Rank *Geld* 221; Van Delden *Handelsrecht* 711-712.

14 Bosman *Bankwezen*; Van den Berge *Betalingsverkeer*; Rank *Geld* 23-25.

15 Nieuwe Algemene Bankvoorwaarden. For discussions see Rank *Geld* 220-221; Wessels 1996 *WPNR* 6222 335; Molenaar 1988 *TVVS* 99.

7.2.2 Qualified and unqualified agreements

Under Dutch law a distinction is made between qualified (*benoemde*) agreements and unqualified (*onbenoemde*) agreements. Special statutory provisions apply to a specific type of qualified agreement, in addition to the general rules of the law of contract which apply to all agreements whether qualified or not.¹⁶

Certain aspects of the relationship between bank and customer in the Netherlands can be seen as separate qualified agreements. For instance, a loan or credit granted by the bank to a customer and a savings deposit made by a customer with his bank can both be qualified as a loan agreement (*verbruikleen*).¹⁷

When a customer gives instructions to his bank to make certain payments this can be qualified as a mandate (*opdracht*) under Dutch law.¹⁸ Giving securities to be looked after by the bank constitutes a custody agreement (*bewaargeving*).¹⁹

An essential relationship is the bank account agreement (*bankrekening overeenkomst*). This agreement has elements of a mandate (*ie* a positive balance) and borrowing (*ie* maintaining an overdraft). In addition the bank account is a *rekening-courant*, (current account), in which mutual claims of the bank and the customer are set off against each other. The Dutch Civil Code contains a specific provision for continuous set-off in a current- account arrangement.²⁰

Usually, the entire relationship between the bank and a customer will consist of one or more qualified agreements combined with various unqualified elements. The relationship between banker and customer is determined from case to case by the type of activity that the bank is performing for the customer.²¹

16 Art 6.2 BW, eg, requires that debtor and creditor are obliged to treat one another according to the dictates of reasonableness and fairness.

17 Art 7A.1791 BW.

18 Art 7.400 BW.

19 Art 7.600 BW.

20 Art 6.140 BW; Rank *Geld* 222; De Rooy 1980 *WPNR* 5520 376 at 377.

21 Van Delden *Handelsrecht* 711-712; Asser-Rutten *Verbindtenissenrecht* 42 *et seq*; Rank *Geld* 221; Hondius 1990 *WPNR* 5982 771-772.

In addition to the provisions applying to certain qualified agreements, the general rules of the law of contract apply to the relationship between bank and customer. An essential rule of Dutch contract law is that the contents of an agreement are not exclusively determined by what the parties have expressly agreed, but also by custom and by the principle of "reasonableness and fairness".²² The contents of an agreement can be interpreted, supplemented²³ and even, under certain circumstances, be set aside²⁴ by the principle of reasonableness and fairness. Another important aspect of Dutch contract law is the law on general conditions.²⁵ These enactments have had and will continue to have an impact on the General Banking Conditions (*Algemene Bankvoorwaarden*) of Dutch banks.

7.1.3 General banking conditions (*Algemene Bankvoorwaarden*)²⁶

The *Algemene Bankvoorwaarden* (ABV) apply to virtually all retail banking transactions in the Netherlands. The present text of the ABV, which has been in force since 1 February 1996, is the result of consultations between the Association of Dutch Banks (*Nederlandse Vereniging van Banken*) and representative consumer and business organisations. The ABV apply to general banks, savings banks and cooperative banks in their dealings with both private and business customers.²⁷ In addition to the ABV, banks use specific conditions for certain banking products, such as eurocheques, foreign currency accounts, custody of securities, and so forth.²⁸

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- 22 Art 6.248 BW states that an agreement has the legal consequences which may flow, not only from contract, but also from statute, custom, or the dictates of reasonableness and fairness. Implied terms therefore play an important part in the bank's contracts. See Zimmermann & Whittaker (eds) *Good Faith* 54-55.
- 23 *Aanvullende werking van de redelijkheid en billijkheid*. See HR 1976-09-24 NJ 1978 245; Rb Zuthpen 1983-07-07 NJ 1985 679; HR 1981-03-13 NJ 1981 635.
- 24 *Beperkende werking van de redelijkheid en billijkheid*. See HR 1981-01-16 NJ 1981 312; HR 1982-05-07 NJ 1983 525.
- 25 *Algemene Voorwaarden*, Arts 6.231 to 6.247 BW. See, in general, on the Dutch general conditions, Hondius in Brownsword *et al* (eds) *Welfarism* 253; Hondius *Standaardvoorwaarden*.
- 26 Hereinafter shortened to ABV. The ABV is annexed to Tjittes & Blom *Aansprakelijkheid* 201.
- 27 See Wessels 1996 *WPNR* 6222 335 at 336; Molenaar 1988 *TVVS* 99 at 100.
- 28 See Cranston (ed) *European Banking Law* 110.

In the ABV,²⁹ banks have undertaken to exercise "due care" in rendering their services.³⁰ However, this obligation has been made subject to the proviso that a bank is not obliged to make use of information of which it has knowledge, but which is not in the public domain. According to the ABV this type of information includes price-sensitive information.³¹

The duty of care should be seen as complementing the general rule of contract law that agreements should be performed in accordance with "reasonableness and fairness".³² It is, among other things, the basis on which a customer may expect the bank to keep information about him confidential. The ABV state that in exercising this due care the banks will, to the extent possible, take into account the interests of the customer.³³

7.2.4 The multi-functional bank

Traditionally, banks in the Netherlands have been involved in a wide range of financial services. The services of these "general" banks include brokerage, investment advice and the arranging of new issues.³⁴ All general banks are Admitted Institutions of Amsterdam Exchanges NV and, as such, are allowed to conduct business on the Amsterdam (AEX) Stock Exchange. It is quite common, for instance, for a Dutch bank to have its credit department and its brokerage or new issues department within one legal entity. As a result, a bank may sometimes be confronted with a conflict of interest between its affairs and those of its customers, for instance, a customer of the brokerage department seeking certain information on a company which is a client of the credit department. In such a case the banks must choose between a customer's interest in receiving certain information and the bank's interest in withholding information in order to prevent insider dealing. To a certain extent, the setting up of "Chinese walls" within the banks might solve this

29 Art 2 ABV.

30 The applicability of the duty of due care to the broad field of "rendering services" is new in the 1996 ABV. The previous ABV which came into force on 1 January 1988 referred to due care in executing orders from customers and in performing obligations under any agreements and transactions with customers. See Cranston (ed) *European Banking Law* 110.

31 Art 2 ABV. See, on price-sensitive information and Chinese Walls, Van Dijk 1997 *TVVS* 235-240.

32 Art 6.248 BW.

33 Cranston (ed) *European Banking Law* 111.

34 See, in general, Bol *Bankwezen*; Eizenga *Spaarbanken*; Bosman *Bankwezen*; Van den Berge *Betalingsverkeer*.

dilemma.³⁵

Dutch banks have for some time now built "Chinese walls".³⁶ Their use is closely connected with the prevention of insider dealing. The most important pieces of legislation aimed at preventing the use of insider information are the recently amended and extended provisions of Articles 46 *et seq* of the Securities Transactions Supervision Act of 1995.³⁷ The principal provision states that a person having insider information may not conclude or produce transactions in securities listed, or shortly to be listed, on a recognised stock exchange in or outside the Netherlands. There are a limited number of statutory exceptions to this prohibition, including a so-called "Chinese walls exception". In addition, the Act allows for further exemptions to be granted by ministerial decree. Furthermore, the Securities Transactions Supervision Act of 1995 contains provisions regarding the disclosure of insider information as well as certain transactions in securities, and requires issuing institutions to set internal regulations in accordance with ministerial guidelines. Several other regulations also contain rules regarding insider dealing, including the General Regulations and the Further Regulations for Admitted Institutions with which Admitted Institutions of Amsterdam Exchanges NV must comply.³⁸

Under these rules, banks, as Admitted Institutions, are under an obligation to provide for adequate arrangements to avoid the passing of price-sensitive information from one department to another.³⁹

In view of the stock-exchange rules, the Association of Dutch Banks introduced a code of conduct in 1991 in respect of the separated handling of price-sensitive information. The code of conduct, which took effect on 1 April 1991, recommended certain action in setting up Chinese Walls. The code of conduct requires the banks to make a physical or, alternatively, a clear procedural division between its credit, issues and brokerage departments. Furthermore, the banks must inform their customers that Chinese Walls are in place and that as a result of the Chinese

35 See Van Dijk 1997 *TVVS* 235-240.

36 *Ibid.*

37 Wet toezicht effectenverkeer of 1995.

38 Neate *Bank Confidentiality* 381; Art 7(e) General Regulations and Art 5 Further Regulations for Admitted Institutions. The Listing Rules for the *AEX* Stock Exchange also required listed companies to adopt internal regulations for the prevention of insider trading but this requirement has been repealed in view of the new Securities Transactions Supervision Act of 1995. See, also, Cranston (ed) *European Banking Law* 116.

39 Cranston (ed) *European Banking Law* 116.

Walls, certain price-sensitive information will not be conveyed to the customers and will not be used by banks in rendering services.⁴⁰ Under the Code of Conduct banks must appoint an officer to enforce compliance.⁴¹ The banks' employees must be made subject to various obligations in order to comply with the Chinese walls and to ensure their effect.⁴²

The use of Chinese walls will help banks to avoid insider trading. However, at least until the introduction of the "Chinese Walls exception" mentioned above, it was considered doubtful whether their use could always prevent banks from incurring criminal liability.⁴³ The new rules have not yet been tested.⁴⁴

For Chinese walls to be effective in terms of a bank's position *vis-à-vis* its customers, a contractual arrangement would be necessary. The proviso discussed above to the duty of due care as included in Article 2 of the General Banking Conditions aims to achieve this.⁴⁵

7.2.5 Bank confidentiality

There is no explicit statutory provision which imposes an obligation of secrecy on banks in the Netherlands.⁴⁶ In Dutch civil law, such an obligation is nevertheless assumed to exist. The Dutch Criminal Code⁴⁷ does contain secrecy provisions, but these do not apply to banks. Exceptions to the civil-law confidentiality obligation of banks apply when banks have to testify in proceedings

40 Cranston (ed) *European Banking Law* 116; Neate *Bank Confidentiality* 283.

41 This is similar to the German enactment, s 33 WpHG, requiring a Compliance Organisation. See Fischer-Klanten *Bankrecht* 342.

42 See Van Dijk 1997 *TVVS* 235 at 236; Neate *Bank Confidentiality* 383.

43 Neate *Bank Confidentiality* 384.

44 See Van Dijk 1997 *TVVS* 235 at 236; Mok 1996 *TVVS* 343 *et seq.* About abuse of *voorwetenschap* in general, see Groenhuijsen *Voorwetenschap*. Various sets of rules exist in the Netherlands for the prevention of insider trading. See Neate *Bank Confidentiality* 379-383.

45 See Van Dijk 1997 *TVVS* 235 at 238.

46 There are certain statutes that deal with aspects of bank secrecy, such as s 10 of the Constitution of the Netherlands which lays down the principle of protection against disclosure of personal data; ss 272 and 273 of the Criminal Code in regard to the disclosure of certain data; s 64 of the Banking Act of 1948 providing for the confidential treatment of data of the Central Bank; s 31 of the Securities Transactions Supervision Act of 1995 in regard to provisions in respect of data available to the Securities Board.

47 S 273 of the Criminal Code.

or give information to the tax inspector.⁴⁸ Also, on the basis of the legislation on the prevention of money-laundering, banks have a statutory duty to report "unusual transactions".⁴⁹

Neither any Act nor the ABV explicitly⁵⁰ provides for confidentiality by banks, but an obligation of secrecy is generally assumed to exist. The bank's obligation to keep the information of its customers confidential follows from the general principle that the contents of an agreement are also determined by customs and "reasonableness and fairness".⁵¹

The duty of due care contained in the ABV is believed to be an additional basis for banks to assume an obligation of secrecy. The complaints committee for the Banking Business has ruled several times on the basis of the ABV that a bank has a basic obligation of secrecy.⁵²

A civil-law obligation of secrecy is also recognised in the Dutch law of delict. A person can be held liable for damages resulting from a breach of a generally required duty of care (*die in het maatschappelijk verkeer betaamt*).⁵³ Breach by banks of their obligation of secrecy could under certain circumstances, be considered a breach of this duty of care and therefore tortious.⁵⁴

The Act Concerning the Registration of Personal Data⁵⁵ provides for an obligation of confidentiality in respect of registered personal information, that is a collection of personal

48 See, in regard to the tax collector, s 47 of the Algemene Wet inzake Rijksbelastingen of 1959; HR 1974-12-10 NJ 1975 178 (*Re Stad Rotterdam*). The duty of confidentiality of banks may be set aside on the basis of the rules of evidence in civil matters. See ss 176 *et seq* Code of Civil Procedure. It would appear as if a duty of confidentiality, whether imposed by statute or by contract could be set aside depending on whether the fundamental need that justice be done outweighs the requirement that secrecy be maintained. See HR 1989-12-22 RvdW 1990 13 and Bartelings 1991 *TWVS* 91/3 at 59.

49 Disclosure of Unusual Transactions Act of 1993.

50 The phrases "to exercise due care in providing services" and "to the best ability take into consideration the interests of the customer" contained in Art 2 of the ABV are considered to be indications of a duty to maintain customer data confidential. See Neate *Bank Confidentiality* 360.

51 Neate *Bank Confidentiality* 360; Art 6.2 BW; Art 6.248 BW.

52 See Case nos 8626, 8716, 8745, 8765 and A9160 of the Complaints Committee for the Banking Business, quoted in Cranston (ed) *European Banking Law* 112.

53 Art 6.162 BW.

54 Cranston (ed) *European Banking Law* 112.

55 Wet persoonsregistraties of 1 July 1989.

information concerning various persons managed by automated means or, for ease of consultation, systematically compiled. Article 11 of the Act Concerning the Registration of Personal Data states that registered personal information can only be disclosed to third parties if such disclosure is in accordance with the purpose of the registration or required pursuant to a statutory provision, or when the registree has given his consent. The Dutch Association of Banks has adopted a Privacy Code on the basis of this Act.⁵⁶

Under article 272 of the Dutch Criminal Code, disclosure of a secret by a person who knows, or should know, that he has a duty of secrecy pursuant to his office, or pursuant to a statutory provision, is a criminal offence. This obligation of secrecy under criminal law has not been accepted by the courts in respect of banks.⁵⁷ In HR 1974-12-18 NJ 1975 441, a bank had provided a Dutch civil-law notary with information on the amount of credit outstanding to one of its customers. The Court of Appeal decided that this did not constitute a criminal offence within the meaning of Article 272 of the Criminal Code.

There are exceptions to the civil-law obligations of secrecy. A person who is called to testify in civil or criminal proceedings in the Netherlands is, in principle, obliged to appear in court.⁵⁸ Violation of this duty to appear and testify is a criminal offence, unless the witness has a valid excuse. Such valid excuse exists if the witness has a statutory right to be excused. Directors or employees of a bank have no such statutory right.⁵⁹ Under civil and criminal law, a statutory "right to be excused" exists for, among others, those who are bound to secrecy pursuant to their profession or office (for instance, solicitors, doctors and clergy). Case law on this point shows that courts in the Netherlands have so far denied bankers this right. Legal authors seem to hold the same view. Therefore, a banker will have to breach his obligation of secrecy if he is called to testify in civil or criminal court proceedings.⁶⁰

Various other exceptions to the bank's obligation of secrecy exist under both civil and criminal

56 Privacy Code of the Dutch Banking Association of 16 May 1995. See Neate *Bank Confidentiality* 364.

57 HR 1974-12-18 NJ 1975 441.

58 Art 191 of the Code of Civil Procedure; Art 218 of the Code of Criminal Proceedings.

59 Neate *Bank Confidentiality* 372.

60 *Ibid.* See, also, Cranston (ed) *European Banking Law* 113.

law.⁶¹ An important exception is the right of inspection by the tax authorities. Pursuant to the General Act on state taxes,⁶² the tax inspector may require a bank to give him access in order to find facts for the determination of taxes to be imposed on a certain customer of the bank. The tax inspector may also ask the bank to give any further information which may be relevant for the imposition of taxes on the given customer. Since 1984, a code of practice issued by the Ministry of Finance, provides for guidelines to be followed by banks when the tax inspector uses his right of inspection. It should be noted that the tax inspector may seek access in two ways firstly by giving the name of the customer and secondly, by giving the bank account number.

Another exception is the bank's duty on the basis of the Consumer Credit Act of 1990⁶³ to register the granting of consumer credits with the Central Office for Credit Registration. Finally, the courts have held that under certain circumstances the bank may have a duty to provide a third party who is granting security for the obligations of the customer to the bank, with information about the financial position of that customer.⁶⁴

The duty of secrecy may also be breached in terms of the provisions of the prevention of money-laundering statutes.⁶⁵ The Netherlands has implemented the Money Laundering Directive⁶⁶ and the recommendations of the Financial Action Task Force on money-laundering, through two pieces of legislation: the Disclosure of Unusual Transactions Act of 1993⁶⁷ and the Act on Identification when Providing Financial Services.⁶⁸

61 Exceptions include the customer's consent, where disclosure is made in the interests of the bank, where disclosure is made within the banking group, and where disclosure is required by law or a duty to the public requires disclosure. See, in general, Neate *Bank Confidentiality* 364-377.

62 Algemene Wet inzake Rijksbelastingen of 28 August 1959, as amended.

63 Wet van 4 juli 1990, *Staatsblad* 395, houdende regels met betrekking tot het consumentenkrediet.

64 HR 1990-06-01 NJ 1991 759; HR 1994-06-03 RvdW 1994 126.

65 Sint Truiden 1991 *Bb* 137-139.

66 EC Directive (Prevention of the Use of the Financial System for the Purpose of Money Laundering 91/308/EEC:[1991] OJ L166/77. See, also, Sint Truiden 1991 *Bb* 173-174.

67 Wet melding ongebruikelijke transacties van 16 desember1993.

68 Wet identificatie bij financiële dienstverlening van 12 desember 1993.

7.2.6 Liability of banks for investment advice and other lender liability aspects

7.2.6.1 Investment advice

Liability for incorrect advice can arise under two heads;

- (1) liability for breach of contract (*wanprestatie*); and
- (2) liability for tort (*onrechtmatige daad*).

Contractual liability may arise when a bank, in rendering advice, breaches a specific contract with a client for the rendering of advisory services.⁶⁹ It is more likely however, that there will not be a specific contract. The bank may then be liable for a breach of its duty under the ABV and the general rules of the law of contract to exercise due care in its relation to its customer.⁷⁰

The bank's incorrect advice may also constitute a delict. Under the Dutch law of delict, it is among other things, delictual to act in violation of a "generally required duty of care" (*zorgvuldigheid die in het maatschappelijk verkeer betaamt*) or, in other words, to be negligent.⁷¹ This negligence may, in addition to breach of contract, be a basis on which a bank may be sued for giving incorrect advice.

It is difficult to indicate when exactly, under Dutch law, a bank will be liable for incorrect investment advice. It will depend on the circumstances of the case.⁷² A relevant circumstance might be the customer's expertise or experience in respect of a contemplated action or transaction.⁷³ An inexperienced customer will require more care from the bank than an experienced customer. The duty of care may force the bank not only to warn a customer against the risks of a transaction, but even to refuse to carry out a transaction for its customer. This

69 Art 6.81 BW.

70 Art 6.2 and Art 6.248 BW; Asser Hartkamp II *Verbintenissenrecht* 307-309; Hofmann-Abas *Verbintenissenrecht* 192-194.

71 Art 6.162 BW.

72 In order to determine reasonableness and fairness, a Dutch court must take into account the relationship between the parties, the justified interests of each party and the circumstances of each case. See Pres Rb 's Gravehage 1958-03-03 NJ 1958 386; HR 1984-05-04 NJ 1984 670.

73 See, for instance, HR 1990-06-01 NJ 1991 759; HR 1994-06-03 RvdW 1994 126.

applies in particular to high-risk transactions such as dealings in options.⁷⁴

However, the bank does not have a general obligation to prevent a customer from carrying out his own risky investment policy or to warn him about the risks of his investment policy.⁷⁵

Under Dutch law a party to a contract is permitted, in principle, to exclude liability for breach of contract and/or for tort in all circumstances except wilfulness or gross negligence. Exclusion by a party of liability for breach of contract or tort by its employees is permitted in all circumstances, even if an employee's act was wilful or grossly negligent.⁷⁶

The ABV contain several limitations on the liability of banks.⁷⁷ These limitations are less far reaching than an exclusion of liability, with the exception of wilfulness or gross negligence, as referred to above.

Invoking a contractual limitation or exclusion of liability may, under certain circumstances, be considered to violate the principle of reasonableness and fairness. Under certain circumstances, it might be unreasonable for a bank to invoke the exclusion in the ABV, even though the contractual exclusion itself is valid under Dutch law. In such case the bank will be liable notwithstanding the contractual exclusion.⁷⁸

74 HR 1997-05-23 RvdW 1997 128.

75 HR 1997-01-24 NJ 1997 260. This *lacuna* does not mean that a bank can hide behind a Chinese Wall in order not to warn a customer of a danger that it is aware of. The possibility of liability for lack of reasonableness and fairness exists. See Van Dijk 1997 *TVVS* 235 at 239; Kessenich-Hoogendam *Aansprakelijkheid* 72; Botter 1996 *TVVS* 130; Timmerman & Honee *Dubbelrol* 70; HR 1967-05-19 NJ 1967 261 at 262 (*Saladin v Hollandse Bank Unie*).

76 HR 1967-05-19 NJ 1967 261. (*Saladin v HBU*).

77 Arts 3, 27 and 31 ABV.

78 The landmark case on the exclusion of liability by a bank is the *Saladin v HBU* decision of the Supreme Court. (See HR 1967-05-19 NJ 1967 261). In this case the Supreme Court had to consider a bank's liability for incorrect investment advice and the effect of the bank's contractual exclusion of liability. The bank (HBU) had, on its own initiative, advised Mr Saladin, who had no expertise in financial matters, to purchase certain securities. The transaction was recommended by the bank as very advantageous and very safe. Mr Saladin purchased the securities, but discovered soon afterwards that the transaction was very unsafe and that his investment was virtually worthless. He sued the bank on the basis of breach of contract and tort and claimed damages as a result of the transaction. In the proceedings, the question whether the bank was liable in tort never needed to be resolved. The bank had excluded all liability for the transaction in a letter of confirmation to Mr Saladin. The central question of the proceedings was therefore whether the bank could reasonably invoke the contractual exclusion of liability even if

The position of a bank in its capacity as lead manager of an issue of securities has come under scrutiny in recent years. A lead banker has a duty to verify the contents of a prospectus⁷⁹ in respect of bond issues⁸⁰.

7.2.6.2 Other aspects of banker liability

7.2.6.2.1 Bases of liability

7.2.6.2.1.1 Breach of contract (*Wanprestatie*)

*Wanprestatie*⁸¹ or breach of contract, occurs where a bank fails to comply with its obligations⁸²

the bank had committed a tort.

The Supreme Court decided that the answer to the question of liability depended on "various circumstances". One of these circumstances might be the position of the parties in society and their relation to each other. The Supreme Court does not decide on factual matters. It could therefore only decide whether the Court of Appeal had given a reasonable decision in denying Mr Saladin's claim on the basis of the bank's contractual exclusion of liability. The Supreme Court did find that the decision of the Court of Appeal in this case was reasonable. Mr Saladin therefore lost his case in the final instance. If the bank had not excluded its liability, the matter would probably have been decided in Mr Saladin's favour.

79 Arts 6.194-196 BW deals specifically with misleading publicity.

80 In the important *Co-op* case, (See HR 1994-12-02 NJ 1996 246) the Hoge Raad ruled on the responsibility of a lead manager for — and liability in respect of — a prospectus, based on tort. The legal framework for prospectus liability under Dutch law is formed by a special category of tort dealing with the providing of misleading information. (Art 6.194 BW). In essence, a person commits a tort by publishing or making available misleading information in relation to goods or services offered by that individual, on his behalf or another person's behalf, in the course of a business or profession.

In this case the court held that a bank which acts as a lead underwriter in the offering of securities is in principle responsible for the contents of the prospectus. The mere fact that certain statements in the prospectus do not originate from that bank, but from others such as auditors, does not discharge the lead manager from its responsibilities. ABN-AMRO's claim that it was not under an obligation to verify the financial information supplied to it by the Co-op's auditors was rejected, notwithstanding the fact that the prospectuses contained an auditor statement. The Court stated further that a lead manager should not be considered as having (co-) determined the contents of a prospectus if the prospectus states in clear and unambiguous terms that certain statements in the text are not prepared by it and that it does not accept responsibility for the accuracy of statements prepared by other persons. The responsibility statement included in the Co-op prospectuses did not meet such requirements.

81 Art 6.162 BW *et seq.*

82 Asser-Hartkamp I *Verbintenissenrecht* 250-251; Pels Rijken 1980 *TP* 1101 at 1104

to the other contracting party, and thereby causes the other party damage. The other contracting party, obviously, need not be a customer of the bank to create this liability.

Agreements between bank and customer can, of course, be oral or in writing. It often happens that the original relationship between banker and client is contained in a written contract, but that later oral amendments can be agreed to, often with dire consequences.⁸³

In the case of the so-called *benoemde overeenkomst*, the law can add certain consequences to the agreement, through the requirement of reasonableness and fairness which is applicable to all contracts.⁸⁴

The general principles of the law of obligations and contract are applicable to the agreement. In addition, general conditions⁸⁵ could be applicable. The Dutch Courts have found that it is not against good faith for a bank to rely upon these "background" conditions.⁸⁶

A banker owes his customer a duty of care⁸⁷ and has reasonably to take into account the interests of his customer. The banker has to deal with the customer as a reasonable banker would. This duty to act with care has been incorporated into law in terms of Art 2 ABV,⁸⁸ but exists even in cases where a particular banker is not a member of the association.

83 Kessenich-Hoogendam *Aansprakelijkheid* 7.

84 Art 6.2 BW.

85 See Art 6.231 BW *et seq* in regard to general conditions in contracts.

86 HR 1986-07-22 NJ 1986 767; HR 1987-01-16 RvdW 1987 27; in regard to general or standard terms see Hondius *Standaardvoorwaarden*.

87 "Een bank is in haar doen en laten verplicht de nodige zorgvuldigheid jegens haar cliënt in acht te nemen en naar de beste vermogen-voor zover redelijkerwijze van haar te verlangen-met diens belangen rekening te houden. Zij moet zich jegens hem gedragen als een redelijk handelende bank."

Kessenich-Hoogendam *Aansprakelijkheid* 8; See, also, Asser-Kleijn *Bijzondere Overeenkomsten* 128; HR 1974-01-11 NJ 1974 179; HR 1980-02-15 NJ 1980 327.

88 Art 2 of the ABV reads as follows:

"The bank shall exercise due care in providing services. It will thereby to the best of its ability take into consideration the interests of the customer, provided however that it is not required to use information which is available to it but which is not in the public domain, including information which may affect quoted prices of securities."

The guideline which the bank should bear in mind is the economic interests of the customer. The bank should strive to serve the customer's economic interests to the best of its ability. In order to do this the banker should be informed to the highest level about the affairs of the customer. Should a client suffer damage through the failure of the bank to take into account information that the bank did not possess or that a reasonable bank would not have known, the bank would not be liable.

Should any advice from the bank be given on any ground other than the economic interests of the customer, then such advice could lead to liability of the bank.⁸⁹ Furthermore, the banker has a duty of care towards co-creditors,⁹⁰ and sureties.⁹¹

This duty of care towards the customer brings in its train an onus on the banker to behave in such a fashion that the economic interest of its customer is paramount.⁹²

7.2.6.2.1.2 Delictual liability

The banker's liability for delictual⁹³ actions may be owing to a customer or to a third party, such as a creditor of the customer. Delictual liability arises when a bank infringes a right of the customer or third party, acts contrary to a legal duty, acts contrary to good faith or does not act⁹⁴ with the required *zorgvuldigheid* (care)⁹⁵ (according to the dictates of the *maatschappelijk verkeer* (social standards))⁹⁶ towards a customer or third party, and the customer or third party, as the case may be, suffers damage as a result thereof. The bank can legally be held liable for

89 Kessenich-Hoogendam *Aansprakelijkheid* 9.

90 Kessenich Hoogendam *Aansprakelijkheid* 19.

91 See Asser-Kleijn *Bijzondere Overeenkomsten* 128; HR 1967-05-19 NJ 1967 261 (*Saladin v Hollandse Bank Unie*).

92 Kessenich-Hoogendam *Aansprakelijkheid* 9.

93 Art 6.162 *et seq* BW.

94 "Act" can mean *handelen en nalaten*. See Asser-Hartkamp III *Verbintenissenrecht* 26; Schut *Onrechtmatige Daad* 107-109.

95 Schut *Onrechtmatige Daad* 46-73; Asser-Hartkamp III *Verbintenissenrecht* 31-50; Nieuwenhuis *Hoofdstukken* 132-136.

96 HR 1919-01-31 NJ 1919 161 (*Lindenbaum v Cohen*); Asser-Hartkamp III *Verbintenissenrecht* 30-31.

such damage.⁹⁷ The banker's conduct in this regard should be judged without taking into account a possible breach of a contractual duty.⁹⁸

In recent years it has often happened that a claim by a customer is of a dual nature, being based on breach of contract in the first place and then as subsidiary to that, based on delict, and often it is not clear on which of the two legal bases the bank is to be held liable.⁹⁹ There are, of course, differences in the two bases of liability. For example, when one is dealing with delictual liability, the transgressor may be held vicariously liable for the actions of its personnel,¹⁰⁰ whilst with contractual liability the transgressor is liable for the actions of those involved in carrying out the terms of the contract on his behalf, the so-called *Erfüllungsgehilfe* (persons performing the contract on his behalf), even though these people are not strictly subservient to the contractant.¹⁰¹ In this sense the liability based on contract is wider than that flowing from delict, but in another sense it is narrower: in a case of contract the transgressor is liable for the actions of others involved in the execution of the contract; with delictual liability there must be some functional connection between the completion of the contract and the delict,¹⁰² or put differently, that the master-servant relationship gave rise to the delict.¹⁰³ It is not necessary for the staff member to commit the delict in the execution of his orders.¹⁰⁴

Differences between contract and delict can also be found in the differing effect of a bank's exemption clauses and in the difference in the burden of proof.¹⁰⁵

97 HR 1919-01-31 NJ 1919 161 (*Lindenbaum v Cohen*); Asser-Hartkamp III *Verbintenissenrecht* 30-31.

98 Kessenich-Hoogendam *Aansprakelijkheid* 9; HR 1920-03-26 NJ 1920 476.

99 Kessenich-Hoogendam *Aansprakelijkheid* 10.

100 Art 6.170BW.

101 Kessenich-Hoogendam *Aansprakelijkheid* 10.

102 Kessenich-Hoogendam *Aansprakelijkheid* 10; Schut *Verantwoordelijkheid* 286.

103 Kessenich-Hoogendam *Aansprakelijkheid* 10; Hofmann-Drion-Wiersma *Verbintenissenrecht* 258.

104 Kessenich-Hoogendam *Aansprakelijkheid* 10.

105 See Hofmann-Van Opstall *Verbintenissenrecht* 70; Asser-Rutten *Verbintenissenrecht* 151; Den Tonkelaar *Resultaatsverbintenissen* 53. The difference between delict and contract, as far as the determination of lawfulness is concerned, is becoming smaller.

As the topic of concurrence of actions is too specialised to be covered fully in this thesis, one can say in summary, that it is trite law that not every breach of contract can be considered as a delict, but that only an action which is unlawful, independently of the breach of an obligation, simultaneously meets the requirements for both delict as well as breach of contract.¹⁰⁶

In addition to the above grounds, *negotiorum gestio* or *zaakwaarneming* can be a further basis of liability.¹⁰⁷

7.2.6.2.2 Specific aspects of banker liability

7.2.6.2.2.1 Introduction

Most claims against banks relate to credit granted by the bank to a customer. The customer as well as each third party involved in the credit relationship between the bank and its customer, are potential plaintiffs who could sue the bank for damages flowing from the credit relationship and actions of the bank which may be unlawful.¹⁰⁸ Statutory measures do exist in the extension of credit,¹⁰⁹ but generally the agreement to extend credit is based on contract and obligations flowing therefrom, although general conditions may be applicable.¹¹⁰

7.2.6.2.2.2 Duty of care towards customer and co-creditor

Normally, a bank may be liable to its customer as a result of a breach of the contract between them, where applicable. In addition, an agreement whereby the bank extends credit to the customer, compels the bank to act with care towards a customer-debtor, as well as towards a co-

106 See HR 1926-06-11 NJ 1926 1049; HR 1955-12-09 NJ 1956 157; HR 1959-03-06 NJ 1959 349; RB Maastricht 1979-11-11 NJ 1980 655; HR 1983-12-02 NJ 1984 367; Asser-Hartkamp II *Verbintenissenrecht* 445; III *Verbintenissenrecht* 10 and 94; Schut *Onrechtmatige Daad* 19; Niewenhuis *Hoofdstukken* 131; Van Dunné *Dialektiek* 207; Kessenich-Hoogendam *Beroepsfouten* 6; Pels Rijken 1980 *TP* 1101 at 1105; Kortmann 1986 *TPR* 827 at 828; Wiersma 1960 *Handelingen NJV I* 224 at 238; Stolker *Aansprakelijkheid* 19.

107 Art 6.198 BW.

108 See, in connection with the banker's liability, Molenaar 1984 *TVVS* 29 *et seq*; Croon & Van Everdingen 1986 *TPR* 1139.

109 The risk of a devaluation lies upon the bank. See HR 1931-01-02 NJ 1931 274 (*Mark is Mark*); HR 1957-01-18 NJ 1959 110 (*Rupiah*).

110 Arts 6.231 to 6.247 BW.

creditor. This is true at the time of entering into the credit agreement, expanding the credit ceiling, limiting the credit and the termination of the agreement.¹¹¹

7.2.6.2.2.3 Duty of care in granting and expanding credit

Theoretically, banks have to act responsibly (*nie lichtvaardig*) in granting or expanding credit, or may face damages claims from its debtor. In practice however, this will not occur often.

What is more likely is a claim from another creditor. Should the bank irresponsibly extend or expand credit, the appearance of creditworthiness is established. Creditors may be enticed into granting credit which may prove to be irrecoverable.¹¹²

Should the bank extend credit without taking into account the interests of other creditors, whose interests the bank must respect, the bank may be held liable in delict. The accent here would lie in the manner in which and the measure to which the bank acquires, and eventually realises security.¹¹³ Banks normally require security when lending out money, whether it is a pledge,

111 Kessenich-Hoogendam *Aansprakelijkheid* 19.

112 Kessenich-Hoogendam *Aansprakelijkheid* 20.

113 See HR 1957-06-28 NJ 1957 514. This is the famous *Erba* case. In this case the Italian firm Erba delivered textile goods, to the Dutch company X, and was not paid. X went into liquidation and it appeared that Erba would not even recover their goods, as these were to be transferred to the Amsterdam Bank in terms of a cession which was given as security for a loan by the Bank to X. Erba instituted an action against the bank in which it claimed, *inter alia*, that the bank had acted illegally against Erba by allowing X to maintain the sham of creditworthiness against third parties, including Erba. As a result of this misrepresentation or sham Erba was moved to deliver the goods to X, whilst in fact Erba had no chance of recovery. The bank had secured for itself a number of security interests, leaving no assets available for other creditors. The Rb Amsterdam granted Erba's claim, but on appeal their claim was dismissed. The Hoge Raad decided, in principle, that a claim in delict may lie where the bank created the fictional appearance of creditworthiness, allied to the fact that the bank acted in its own interests and consciously harmed the other creditors. The Hoge Raad summed up the situation as follows:

"[E]en eigendomsoverdracht tot zekerheid op zichzelf niet onrechtmatig is en ook de door het Hof genoemde omstandigheden ieder voor zich behoeven daarin geen verandering behoeven te brengen, maar dit niet wegneemt dat de wijze waarop en de mate waarin een credietgever zich goederen tot zekerheid doet overdragen, gelet op de verdere omstandigheden van het geval — ook omstandigheden als door het Hof vermeld — beschouwd in onderling verband en samenhang, kunnen meebrengen dat de credietgever, zo hij al niet de gegeven crediettransactie zelve had behoren na te laten, dan toch daarna bij de uitvoering daarvan met de belangen van derden in zekere mate zal moeten rekening houden of doen houden en zo hij dit nalaat, zal hij onder omstandigheden op grond daarvan uit onrechtmatige daad jegens hen aansprakelijk kunnen zijn."

hypothec, notarial bond, suretyship or cession.¹¹⁴ It would appear as if the granting of credit to a company in difficulty constitutes a tort when the loan cannot be serviced from the added value produced by the activity financed with the loan proceeds. If the debtor does not produce sufficient added value, the credit will only create an appearance of creditworthiness and in the long run the deficit will only widen. In that case, the other creditors alone bear the burden of the enterprise risk, while the bank which has taken all the security can escape the *concursum creditorum* via secured transactions. The credit decision would have been wrongful, not because it was accompanied by excessive security interests, but because it was fundamentally unhealthy in economic terms.¹¹⁵

The agreement extending credit to the debtor may be for a fixed term or for an undetermined period. When no period has been determined, the credit relationship can theoretically be ended by notice by the bank or the debtor. Should a bank, however, suspend credit, it would have to consider various factors in order to comply with the requirement that the agreement must be executed in good faith.¹¹⁶ Generally, the bank would have to consider what reasonable notice is. Reasonable notice would depend on the facts of each case. The period of notice would at least

Accordingly the court considered:

"Met name zou een bank, die een door haar aan een koopman verstrekt omvangrijk crediet wegens diens ongunstige financiële toestand heeft opgezegd en die vervolgens het crediet tot een ongeveer even groot bedrag opnieuw verleent, nadat op haar wens de schuldenaar zijn activa volledig of nagenoeg volledig aan haar tot zekerheid in eigendom heeft overgedragen of anderszins verbonden, de in de toekomst te verwerven goederen inbegrepen, — zo, dat de koopman aan nieuwe schuldeisers, die hem na het sluiten van bedoelde crediettransactie met de bank voor hun leveranties nog crediet geven, praktisch geen verhaal meer biedt, terwijl hij naar buiten den schijn van credietwaardigheid behoudt - dan onrechtmatig zou handelen, indien komt vast te staan dat in het gegeven geval de bank, in verband met het nader overeengekomene omtrent de omvang van crediet en zekerheidsstelling en het verloop van zaken nadien, heeft geweten, althans kunnen voorzien dat bij stopzetting van dit nieuwe crediet de nieuwe leveranciers, indien zij dan nog niet betaald waren, zouden worden benadeeld wegens gebrek aan verhaal en de Bank desniettemin heeft nagelaten zorg te dragen dat de debiteur tevoren in de gelegenheid was of alsnog werd gesteld deze leveranciers te betalen of de goederen terug te geven, tenzij de bank zelf dit alsnog doet."

A general fiduciary transfer of property as security, in itself, does not constitute a tort. See Cranston (ed) *Risk* 210.

114 HR 1983-07-01 RvdW 1983 138; Kessenich-Hoogendam *Aansprakelijkheid* 20.

115 See Cranston (ed) *Risk* 210-211; Croon & Van Everdingen 1986 *TPR* 1172.

116 Art 3.11 BW.

have to be long enough to assist the debtor in avoiding unnecessary, preventable trouble. The imposition of a heavier burden on the debtor without its being necessary to protect the legitimate interests of the bank, would be senseless. In the case of a conflict of interests, a weighing of these interests would have to take place, to determine the period of notice. Only in exceptional cases, could the credit be suspended summarily.¹¹⁷

A reasonable notice period would not be required:

- where the debtor's interests are not adversely affected,¹¹⁸
- where the bank has contracted with the debtor upon such terms. In principle the bank may call in the credit immediately in these circumstances. The bank must, however, notwithstanding an agreement to this effect, keep the requirements of good faith in mind.¹¹⁹
- where the bank's material interests require no notice, that is in exceptional cases.¹²⁰

The bank would definitely be acting contrary to good faith if it refused to carry out a payment instruction prior to the termination date or if notice had not been given. In these circumstances the bank would be liable to pay damages.¹²¹ The debtor could, in fact, obtain an interdict against the bank in terms of which the bank would be ordered to effect the payment.¹²²

The bank not only owes a customer a duty of care in terminating credit, but may also owe such duty to another creditor of the customer if the legitimate interests of the creditor are known to the bank or should be known to the bank.¹²³

It often happens that a creditor has given security to the bank, for example by way of pledge or a bond. The question as to the legality or illegality of a bank's actions in regard to the third party will often be determined by the bank's approach to the security. One of the most important

117 Hof 's Gravenhage 1928-11-23 W 11982; Hof 's Gravenhage 1983-12-07 RvdW/KG 1984 27.

118 Kessenich-Hoogendam *Aansprakelijkheid* 21.

119 Kessenich-Hoogendam *Aansprakelijkheid* 22.

120 Hof 's Gravenhage 1928-11-23 W 11982.

121 Rb Rotterdam 1927-04-6 W 11982.

122 Hof 's Gravenhage 1983-12-07 RvdW/KG 1984 27.

123 Kessenich-Hoogendam *Aansprakelijkheid* 24; HR 1986-05-09 NJ 1986 792.

decisions in this regard by the Hoge Raad is the *Erba*¹²⁴ case, referred to above.¹²⁵

In determining the question whether a bank has acted unreasonably in limiting or suspending the credit or, eventually upon execution of its securities, there has to be a weighing of interests. Not only are the interests of the two main parties important, but the general interests of society also play a role. The public interest in a well-functioning banking system requires that the conduct of a bank in regard to credit granted by itself and suretyships or security obtained in terms thereof can, only in limited cases, be attacked by the interests of a co-creditor. It must not be forgotten that the banking industry is risky and that it may be contrary to public policy which prevails in a well-functioning banking system to make the system more difficult unless there are well deserving interests to be protected.¹²⁶

7.2.6.2.2.4 The bank's dealing with security for credit

In lending, a bank would normally take some form of security. This security can be by way of pledge, hypothec or notarial bond. Often a bank would take a cession, or would require personal security in the form of suretyship.¹²⁷

A bank often inserts a clause in its agreement to the effect that it may call for additional security at some future date. Notwithstanding such a clause, the bank cannot exercise this right to call for additional security, unreasonably. The bank will have to carry out the credit agreement in good faith.¹²⁸ The bank will have to take into account the justifiable interests of the debtor in as far as is reasonably required of the bank.¹²⁹ As an example, reference can be made to the case of *Kley v NMB*.¹³⁰

In this matter Kley sued the Bank in order to have certain debits struck out against her account. The bank claimed in reconvention that Kley should furnish certain further security as originally

124 HR 1957-06-28 NJ 1957 514.

125 Sub par 7.2.6.2.2.2.

126 Kessenich-Hoogendam *Aansprakelijkheid* 25.

127 Stein *Zekerheidsrechten* 26.

128 Art 3.11 BW.

129 Kessenich-Hoogendam *Aansprakelijkheid* 27.

130 HR 1983-08-10 NJ 1984 61 (*Kley v NMB*).

agreed upon. Kley did not deny these facts, but defended the claim in reconvention. Kley's case succeeded. The court's reasoning was that the bank had never asked Kley for additional security when Kley had owed a much larger amount than that which was outstanding at the stage of the court case. Furthermore NMB had terminated the credit relationship, and the request for additional security at that stage could have seriously jeopardised Kley's application for credit at another bank.

The decision in this case entails the limiting of the bank in the execution of its agreed rights, by the covenant of good faith. Good faith also influences the manner in which the bank realises its security. If the manner in which the bank realises its security leads to an unequal or unfair treatment of the debtor it may be contrary to good faith. A debtor may even, upon application, apply for the stay of the realisation of the security and claim that the *status quo* should remain. The bank may in certain circumstances even be held liable for damages.¹³¹

In another case,¹³² the bank was removing certain office equipment from the building of the debtor in order to execute upon its security. The debtor applied for an interdict to stop the bank from doing so, because the debtor's interests and his prospects would be seriously jeopardised, as the debtor was involved in certain serious discussions in regard to the take-over of the debtor firm by another. The debtor's claim was granted. The court ordered the bank not only to refrain from removing the inventory from the building for a period of ten days but, in fact, ordered the bank to return and reinstall the already removed inventory.

The bank cannot merely take securities and then trust that its claims will be sufficiently recovered. The duty of care owed by one to the other in the social and commercial world entails the bank's also taking into account the interests of other creditors.¹³³ If the bank is unreasonable towards a creditor, the bank may be liable to the co-creditor for damage that the latter has suffered through the bank's actions.¹³⁴

7.2.6.2.2.5 Banker and surety

A bank often obtains personal security in the form of suretyship. Briefly, the surety must comply

131 See Rb Middelburg 1983-06-15 RvdW/KG 1983 214.

132 Rb Zutpen 1983-03-21 RvdW/KG 1983 161.

133 Kessenich-Hoogendam *Aansprakelijkheid* 28.

134 See the *Erba* case HR 1957-06-28 NJ 1957 514 discussed above at par 7.2.6.2.2.3.

with the debtor's obligations should the debtor be in default, in other words, its liability is accessory.¹³⁵

Naturally, the exact content of the obligation of the surety is determined by agreement. The agreement between the bank and surety must, however, be carried out in good faith.¹³⁶ In one case¹³⁷ the two directors, sole shareholders of a company, signed personal suretyships and passed mortgage bonds over their homes as security for the debts of the company to the bank. In a period during which, to the banks knowledge, the business of the company was doing badly, the bank acquired a claim of another party against the company. At a later stage, at the request of the sureties, the bank advised them of their outstanding obligations, but without advising them of the ceded claim. The company went into liquidation and the bank refused to release the sureties from their obligation in terms of the ceded debt and refused to cancel the bonds, unless they paid the amounts owing in terms of the ceded claim as well.

The court found the bank's conduct to be contrary to the requirements of good faith and ordered that the bonds be cancelled.

In addition to the limiting effect of good faith and reasonableness and fairness, duties to inform, advise and investigate may have an influence on the banker-surety relationship, as we will see in the discussion on duties of disclosure *infra*.

7.2.7 Forms of security

A distinction is made between security in the form of rights *in rem* (*beperkte rechten*)¹³⁸ and contractual security. The main difference between the two types of security lies in the creditor's position in case of the debtor's bankruptcy. This position is much stronger if the creditor holds security in the form of a right *in rem*: in principle, the encumbered goods do not form part of the bankrupt's estate and the creditor is entitled independently to enforce his security right in order to settle his claims.¹³⁹

135 Suretyship is regulated by Arts 7.850 BW *et seq*; see Asser-Kleyn *Bijzondere Overeenkomsten* 96 *et seq*; Stein *Zekerheidsrechten* 175 *et seq*.

136 Art 3.11 BW.

137 Rb Arnhem 1982-01-26 NJ 1983 107.

138 Art 3.8 BW.

139 Cranston (ed) *European Banking Law* 120.

The rights *in rem* which are most frequently used by bankers are the rights of pledge and mortgage. A right of mortgage can be created on registered goods (eg real property, ships and aircraft). A valid mortgage requires a notarial deed which must be filed with¹⁴⁰ the competent public register.

A right of pledge can be created over all goods which do not require a mortgage and can, in principle, take two forms: the traditional pledge (*vuistpand*) and the non-traditional pledge (*bezitloos pand*). A traditional pledge requires that the pledgor transfer his power over the object of the pledge to the pledgee or a third party, which pledge is created simply by a notarial or a private deed. However, a non-traditional pledge created by private deed is only valid upon filing of the deed in the competent register. The range of objects over which a pledge can be created is wide: it can be used to encumber movables, but may also be created over registered claims and shares in book-entry form. It can therefore be particularly helpful to banks. In this context two remarks should be added. First, unlike a lot of other jurisdictions, Dutch law does not recognise the concept of a "floating charge". In addition, more than 95 per cent of the securities listed on the AEX Stock Exchange are transferred by way of giro transfer pursuant to the Act on Securities Transactions by Giro.¹⁴¹ This Act provides for specific rules for the creation of a pledge over securities within the giro system.¹⁴²

Apart from the right *in rem*, security can be obtained through contractual arrangements. These include the subordination of claims, suretyship (*borgtocht*) and guarantee (*garantie*). Contracts of suretyship and guarantee are usually entered into by third parties' securing the obligations of the debtor. Unlike the guarantee, for which there are no specific statutory provisions, the contract of suretyship is regulated by the Civil Code.¹⁴³ One essential feature of the security is its accessory nature:¹⁴⁴ accessory, that is, to the relation between the original debtor and the creditor. This feature is generally unacceptable to banks and they will therefore usually demand a guarantee which imposes direct and independent obligations on the guarantor in their favour. To avoid any chance of the suretyship provisions in the Civil Code being applicable, the guarantee should state particularly that the arrangements are not to be considered to create rights of

140 Cranston (ed) *European Banking Law* 120.

141 Wet giraal effectenverkeer of 1977.

142 Arts 20 *et seq* of the Act on Securities Transactions by Giro of 1977.

143 Art 7.850 BW. See, also, Asser-Kleijn *Bijzondere Overeenkomsten* 96 *et seq*; Stein *Zekerheidsrechten* 175 *et seq*.

144 See Van Brakel *Leerboek* 391; Pitlo-Bolweg *Verbintenissenrecht* 541.

suretyship.

7.2.8 Consumer protection

In recent decades, consumers' rights have been the object of increasing attention. This has resulted in a variety of new legislation. This section will focus on two sets of legislation which are of particular importance to bankers and their customers: the provisions on general conditions in the Civil Code¹⁴⁵ and the Consumer Credit Act of 1990.

The Civil Code contains specific provisions with respect to general conditions. In Article 6.231 BW, general conditions are defined as written statements which are intended to be used in a number of agreements. The provisions which reflect the essence of the agreement do not qualify as general conditions. It is understood that such essential provisions are those without which it is not possible to reach an agreement; for example, in a sale and purchase agreement the price and quantity of the goods are considered to be essential.

A provision in general conditions may be annulled if:¹⁴⁶

- such provision places an unreasonable burden on the other party;¹⁴⁷ or
- the user of the general conditions has not offered the other party a reasonable opportunity to take cognisance of the conditions.¹⁴⁸

The provisions on general conditions are intended primarily to protect individuals. The Civil Code therefore provides that, if used in respect of individuals who do not act in the course of a profession or trade, certain conditions are *per se* unreasonably burdensome (usually referred to as the "black list"). Other provisions are considered to be *prima facie* unreasonably onerous (the "grey list").¹⁴⁹ As the aim of the legislation is to protect individuals against the abuse of general conditions it is evident that certain parties cannot invoke the protection of the statutory

145 Arts 6.231 BW to 6.247 BW.

146 Art 6.233 BW.

147 Art 6.233 (a) BW.

148 Art 6.233 (b) BW.

149 Arts 6.236-237 BW.

provisions (for example, large companies) as is fully described in the Civil Code.¹⁵⁰

The ABV qualify as general conditions under the Civil Code. Therefore, the banks have to comply with the statutory provisions, relating to standard terms and conditions, when drafting and updating the ABV.

The Consumer Credit Act of 1990,¹⁵¹ which, *inter alia*, implements the EC (Consumer Credit) Directive,¹⁵² sets out the rules for professionals granting credit to consumers. A few of the detailed provisions of the Act will be highlighted.

The applicability of the Act is both restricted and broad. On one hand, the Act protects individuals who do not act in the course of a profession or trade and only applies to credit transactions up to an amount of Dfl 50,000. On the other hand, the Act covers a wide range of credit transactions including traditional loans, purchase by instalments, mail-order credits and credit-card transactions, as well as certain overdraft arrangements. However, the applicability of the Act is subject to the condition that the consumer obtains (part of) the credit for a period of at least three months.

The Act provides for a number of rules designed to protect the consumer: the giver of credit is obliged to make available to the consumer, without charge and in writing, the conditions on the basis of which he is prepared to grant the credit. Furthermore, the giver must obtain written information as to the creditworthiness of the consumer prior to entering into a transaction for credit exceeding Dfl 2,000. In relation hereto he may obtain information from the Central Office for Credit Registration. Also, a credit transaction can only be entered into in writing. The Act contains rules as to the contents of the agreement.

The Act provides that certain onerous provisions in a credit agreement are null and void; others can be annulled at the request of the consumer. Finally, the Act imposes restrictions on the security which may be obtained by the giver of credit.

It follows from the above description that the Act provides elaborate protection for consumers

150 Art 6.235 (b) BW.

151 Wet van 4 juli 1990, *Staatsblad* 395, houdende regels met betrekking tot het consumentenkrediet.

152 EC Directive (Consumer Credit) 87/102/EEC: [1987] OJ L42/48, as amended on 22 February 1990, to EC Directive (Consumer Credit) 90/88/EEC: [1990] OJ L61/14.

obtaining credit. This is of particular importance as the Act covers almost all consumer credit transactions: more than 90 per cent of such transactions relate to credit of less than Dfl 50,000.¹⁵³

7.3 THE BANKER'S DUTY OF DISCLOSURE AND RELATED ASPECTS

7.3.1 Contract law: defects in consent

7.3.1.1 Introduction

Under Dutch law error (*dwalig*), threat (*bedreiging*), fraud (*bedrog*), and abuse of circumstances (*misbruik van omstandigheden*) are considered vices of consent or defects of will (*wilsgebreken*). Threat, fraud and abuse of circumstances are to be found in Book 3 of the new Dutch Civil Code¹⁵⁴ and are generally applicable to all juridical acts, whereas error is treated in Art 6.228 of the new Dutch Civil Code and primarily concerns contracts.

In case of a defect of consent there is a *consensus ad idem* between the contracting parties and the agreement has been expressed correctly, but the underlying will has been formed in a defective way. On this ground a party can rescind the contract and under certain circumstances can claim for damages.¹⁵⁵ In regard to threat, fraud and abuse of circumstances, the unlawful behaviour of the other party which induced the victim to enter into the contract, is emphasised. Moreover in cases of mistake and misrepresentation, both in the case law and under the new legislation, the stress has shifted from the error of judgment of the mistaken party to the misstatement or omission by the other party in which context the interaction between the duty to inform and the duty to make one's own investigations is of great importance.¹⁵⁶

The Civil Code provides for common mistake — when both parties share the same misconception about the subject matter of the contract. Therefore both parties are in error.¹⁵⁷

153 Cranston (ed) *European Banking Law* 125.

154 Art 3.44 BW.

155 To claim damages under Dutch law, it is usually required that liability should arise in delict. See Art 6.162 BW. Liability may, however, also be based on good faith/reasonableness and fairness as set out in Arts 6.2 BW and 6.248 BW.

156 Hartkamp *et al* (eds) *European Code* 147-148.

157 Art 6.228 BW.

7.3.1.2 Error.¹⁵⁸

Error or *dwaling*, like the other defects of consent, plays a role in the formation of the contract and concerns the intention of the contracting parties to create legal relations. The concept of *dwaling* under Dutch law has been developed from a traditional defect of consent where the main emphasis is on the misunderstanding of the mistaken party, to a legal concept with the accent on the false pre-contractual statement of fact made by the other party, or his failure to disclose information. Formerly *dwaling* was controlled primarily by the notion of the *zelfstandigheid der zaak*, that is to say, the subject matter of the contract. After the decisions in the leading cases on this subject,¹⁵⁹ *dwaling* is now placed within the legal context of the duty to make true statements of fact in the course of precontractual negotiations, the duty to disclose information and the duty of the representee to make his own inquiries before concluding the contract.¹⁶⁰

Thus, in the case of *Baris v Riezenkamp*¹⁶¹ a purchaser bought the equipment for the production of auxiliary motors after a misrepresentation by the vendor concerning the calculation of the cost price. The purchaser was allowed to rescind the contract because the Hoge Raad assumed that generally a party could justifiably rely on the correctness of a representation by the other party which turned out to be false, and which had induced him to enter into the contract.¹⁶²

In the case of *Van der Beek v Van Dartel*,¹⁶³ a duty to disclose relevant information was accepted where the vendor of a house had "forgotten" to tell the purchaser that the local authority had the intention to claim the occupation of the house unless — within two months — a reasonable proposal for the occupation of the house was received. The Hoge Raad held that there is a duty of disclosure which prevails over the duty to make one's own investigations.¹⁶⁴ However under

158 Asser-Hartkamp II *Verbintenissenrecht* 173-198; Van Rossum *Dwaling* 9-53; Hondius *Consumentenrecht* 21-23.

159 1957-11-15 NJ 1958 67 (*Baris v Riezenkamp*) and 1973-11-30 NJ 1974 97 (*Van der Beek v Van Dartel*).

160 Hartkamp *et al* (eds) *European Code* 148.

161 HR 1957-11-15 NJ 1958 67.

162 See, also, HR 1966-01-21 NJ 1966 183 (*Booy v Wisman*).

163 HR 1973-11-30 NJ 1974 97 (*Van der Beek v Van Dartel*).

164 Other cases include HR 1979-12-7 NJ 1980 290 (*Van Hensbergen v Gemeente 's-Gravenhage*); HR 1990-06-01 NJ 1991 759 (*Van Lanschot v Berthe Bink*); HR 1990-12-21 NJ 1991 251 (*Van Geest v Nederlos*).

Dutch law, the perception of *dwaling* as a defect of consent has not been discarded, although the emphasis has shifted.¹⁶⁵

The concept of *dwaling* is contained in Art 6.228 BW. Although the nature of *dwaling* has changed from that in the original Dutch Civil Code, it remains a defect in consent. Whilst the emphasis is now placed on the precontractual statement of fact made by the representor or his failure to disclose, some room for common mistake remains. For an action based on *dwaling* to be successful it is necessary that the false precontractual statement of fact or the failure to disclose be of such importance that without this behaviour, the party in error would not — or at least not on the same terms — have entered into the contract. In case of common mistake the error of both parties must similarly be of substantial importance.¹⁶⁶

Furthermore in Art 6.228 (2) BW some restrictive conditions referring to *dwaling* are laid down. The error cannot be based on future circumstances, and sometimes the error is not excusable because the mistaken party has a predominant duty to make his own inquiries before entering into the contract, especially when he is an expert or a professional party. Thus, the concept of *dwaling* under the Civil Code is treated within the context of justified allocation of risk.¹⁶⁷

7.3.1.3 Fraud, threat, and abuse of circumstances¹⁶⁸

Under Dutch law, fraud and error are closely connected. While it is the fraud which causes the error, it is not the fraud itself that constitutes the defect of will, but the misconception of the deceived party which is effected by the fraud. Fraud exists if a representee is induced by another party to enter into the contract by that party's deliberately providing him with false information, intentionally concealing any fact he was obliged to expose, or by any other trick. In respect of fraud, as contrasted with error, the intention to mislead the representee is of critical importance. General recommendations, notwithstanding the fact that they may not be true, cannot constitute fraud.¹⁶⁹

165 Hartkamp *et al* (eds) *European Code* 148-149.

166 See Van Rossum *Dwaling* 303-331.

167 Hartkamp *et al* (eds) *European Code* 149.

168 Asser-Hartkamp II *Verbintenissenrecht* 199-204; 205-209; 209-216; Van Rossum *Dwaling* 55-74.

169 Hartkamp *et al* (eds) *European Code* 147.

Threat occurs where one party induces another party to conclude a contract, by unlawfully coercing him or a third party with threats of harm to his person or his property (for example by blackmail). The threat must be of such a nature that a reasonable person would be influenced. For the rescission of a juristic act, it is necessary that the threat must have an unlawful character.¹⁷⁰

The Civil Code recognizes a fourth defect of consent, namely the abuse of circumstances.¹⁷¹ A person who acts under special circumstances, such as a state of necessity or dependency, inexperience or mental crisis, can rescind the contract if the other party induces him to enter into the contract although the other party knows or ought to have known of the special circumstances or should have prevented him from concluding the contract. In most of the cases involving the abuse of circumstances the other party acts as a result of a mental or economic dominance.¹⁷²

As an example, in the case of *Van Elmbt v Feierabend*¹⁷³ an elderly widow sold her house of which she was very fond, to a man whom she trusted to be the person who would help her out of her financial problems and whom she trusted blindly. The man knew that possession of her house was of crucial importance to the widow. The Hoge Raad held that the contract was void in view of her state of mind and her dependency.¹⁷⁴

When the threat, fraud or abuse of circumstances is exercised by a third party, the juristic act can only be annulled when the other party has been aware of it. Under Dutch law economic duress is applied restrictively.¹⁷⁵

7.3.2 Duties of disclosure

7.3.2.1 Introduction

In civil-law systems, a softening of the mechanism of offer and acceptance as the exclusive test

170 *Ibid.*

171 Art 3.13 BW. See Asser-Hartkamp II *Verbintenissenrecht* 199-204; Rijken *Exoneratieclausules* 88.

172 Hartkamp *et al* (eds) *European Code* 150.

173 HR 1964-05-29 NJ 1965 104.

174 See, also, HR 1992- 03-27 NJ 1992 377 (*Van Meurs v Ciba-Geigy BV*).

175 Eg, the case of *Brandwijk v Brandwijk* HR 1979-11-02 NJ 1980 429; HR 1987-05-01 NJ 1987 989 (*Wirtz v A S C*); HR 1990-06-01 RvdW 1990 117 (*Donkelaar v Unigro*).

for the formation of contract has taken place and the duty to perform and enforce a contract in good faith has developed towards an overall duty to act in good faith once a legally relevant relationship has come into existence. This also means that the negotiating parties can be bound by this duty.¹⁷⁶ As a consequence of this overall duty to act in good faith, a duty of disclosure can arise — at least in certain specific situations — to provide the other party with the highly relevant information necessary for the conclusion of a contract by informed consent.¹⁷⁷

As a background to duties of disclosure, it should always be borne in mind that in Dutch law the concept of good faith has a limiting influence in the sphere of contract law (*beperkende werking van de goede trouw*).¹⁷⁸ In addition Art 6.2 BW requires that debtor and creditor act towards one another according to the dictates of reasonableness and fairness, and Art 6.248 BW states that a contract has not only the legal consequences agreed upon, but also those which, according to the nature of the agreement, flow from statute, usage, or the dictates of reasonableness and fairness.¹⁷⁹

176 Van Erp in Hartkamp *et al* (eds) *European Code* 119 states that there is some circular reasoning to be detected here. The very moment that the step is taken that contracting parties, by the fact of their contract negotiations, enter into a legally relevant relationship, good faith is their basic norm of behaviour. See HR 1957-11-15 NJ 1958 67 (*Baris v Riezenkamp*). On the other hand, their relationship can be said to be legally relevant, because good faith governs their pre-contractual dealings. See HR 1982-06-18 NJ 1983 723 (*Plas v Valburg*).

177 Van Erp in Hartkamp *et al* (eds) *European Code* 119.

178 See Art 3.11 BW; See, for a more in-depth discussion on the limiting effect of good faith Van Dam & Fick 1991 *TRW* 113 at 113-137.

179 The concept of reasonableness and fairness has a limiting as well as a supplementary role in contract law. It is supplementary in the sense that, where a legal relationship between debtor and creditor leaves a gap (*leemte*) various additional rights and duties may flow based on reasonableness and fairness. See Hondius *et al* *Verbintenissenrecht* note 5; HR 1976-09-24 NJ 1978 245; Rb Zuthpen 1983-07-07 NJ 1985 679; HR 1981-03-13 NJ 1981 635. Reasonableness and fairness therefore can play a supplementary role in, eg, duties to consult (HR 1923-02-23 NJ 1923 802; Hof Amsterdam 1979-05-10 NJ 1980 369), duties to account (Hof 's Gravenhage 1960-12-02 NJ 1961 498; Rb Alkmaar 1966-05-12 NJ 1967 167), duties of disclosure (HR 1923-02-23 NJ 1923 802; HR 1964-03-13 NJ 1964 188; HR 1974-01-11 NJ 1974 179; HR 1987-11-06 NJ 1988 212; HR 1988-06-17 NJ 1988 958; Hof Arnhem 1975-05-27 NJ 1976 291), duties to make information available (Rb Alkmaar 1966-05-12 NJ 1967 167; Pres Rb Amsterdam 1979-04-26 NJ 1979 623), duties to pay a monetary compensation (Rb Alkmaar 1965-03-25 BR 1965 558; Rb 's Hertogenbosch 1971-10-15 NJ 1973 118), and duties to contract, (HR 1956-12-21 NJ 1959 180; Hof Arnhem 1988-12-12 NJ 1989 444).

In its limiting role, reasonableness and fairness may also limit rights and duties flowing from the statute, usage or legal act. In this sense, the Dutch refer to the *beperkende werking van redelijkheid en billijkheid*. (See HR 1990-04-20 NJ 1990 526.) In this role, reasonableness and fairness can be determining in cases, eg, of abuse of law (HR 1990-

In the eighties, several cases in Holland came before the Court wherein duties to disclose, inform and to investigate were accepted.¹⁸⁰ There is a developed and developing appreciation of the duties of disclosure and information and these duties appear to have an absorbing effect on the doctrines of the law of obligations.¹⁸¹ Reference to this absorbing effect on a few contractual concepts shall be made in sub-chapters 7.3.2.2 to 7.3.2.5.

7.3.2.2 Disclosure principles and mistake

For a successful reliance on mistake it is not sufficient, in Dutch law, for the mistaken party merely to have been mistaken, even when his mistaken conception of the facts relates to material aspects. In principle, the mistaken party carries the risk that he has not been properly informed. The other party who is not aware, and need not be aware, of a mistake can accept the facts as presented to him. In other words he can accept the outward appearance as presented (*opgewekt vertrouwen*).¹⁸² This party's interest weighs heavier than the interest of the mistaken party when it comes to rescission of the contract. The question whether a party may rely on the appearance created must be answered in terms of a subtle network of rules relating to the relationship (*onderlinge verhoudings*) of advisory, informational, and investigative, duties.¹⁸³ Foremost is the mistaken party's own responsibility. In Art 6.228 (2) BW it has been stated as follows:

"De vernietiging kan niet worden gegrond op een dwaling die in verband met de aard van de overeenkomst, de in het verkeer geldende opvattingen of de omstandigheden van het geval voor rekening van de dwalende behoort de blyven."

This can imply an information gathering or investigative duty for the mistaken party. This is not always so, because there can also be cases wherein the matters are different from what was originally thought, and where informational and investigative duties would not have brought

01-05 NJ 1990 728; HR 1990-04-20 NJ 1990 526; Hof Leeuwarden 1987-04-29 NJ 1988 364), in ameliorating compulsory law (*dwingende wetbepalingen*) (HR 1983-07-01 NJ 1984 149; HR 1989-01-20 NJ 1989 322), and a broad range of obligations in Dutch law.

180 See *Vranken Plichten* 3.

181 The growth in the duty to inform has been referred to as a *manifestasie van de indringing van de etiek in het recht*. See Henriquez 1976 *NJB* 625.

182 HR 1957-11-15 NJ 1958 67 (*Baris v Riezenkamp*); HR 1984-01-27 NJ 1984 545 at 6; HR 1981-03-27 NJ 1981 492 (*El Araichi v Roemo*).

183 *Vranken Plichten* 5.

these matters to light timeously. In principle, the risk hereof remains with the mistaken party.¹⁸⁴ There are two situations in which this statement is not true: firstly where wrong information was given to the mistaken party by the other party,¹⁸⁵ and secondly where the other party kept quiet when he had a duty to speak. In this sub-chapter, I shall limit my discussion to this second duty. Most cases of mistake seem to belong or relate to the situation where one party had a duty to speak. In substance, this duty revolves around the relationship between disclosure and investigative duties. The premise is the mistaken party's own investigational duty. Often this premise is disregarded because of a duty the other party has to inform the mistaken party, or to advise him. The determination of the existence of these duties is difficult. Vranken¹⁸⁶ asks the question whether one is compelled to alleviate the stupidity, inexperience, or lack of knowledge of the mistaken party, or whether one must lose one's own advantage or where one wishes to take a certain risk, whether one must show the other party or inform the other party thereof, with the possibility that he may decide to take the risk himself. Vranken¹⁸⁷ is of the opinion that apart from cases of abuse of prior knowledge,¹⁸⁸ the answer to the above questions should be in the negative. An advantage obtained through specific knowledge or through an intelligent taking of risk, need not be abandoned by informing the other about one's presumptions or interpretation of the facts and developments. Not only facts, but also relevant changes in facts which take place during negotiations, are normally the subject of disclosure.¹⁸⁹

In summary, it may be said that the question whether a party may accept the appearance of facts presented to him by the other, or the question whether a party has a duty to inform, depends on

184 HR 1959-06-19 NJ 1960 59 (*Kantharos v van Stevensweert*).

185 See Drion *Dwaling* 305; HR 1937-02-25 NJ 1937 1058 (*Schouten v Schouten*).

186 Vranken *Plichten* 11.

187 *Ibid.*

188 In share transactions, abuse of prior knowledge entails criminal sanctions. See Henriques 1976 *NBJ* 625 at 633; Groenhuijsen *Voorwetenschap*; Wet toezicht effectenverkeer of 1995.

189 HR 1979-12-07 NJ 1980 290 (*Van Henzenbergen v Gemeente 's Gravenhage*); In HR 1973-11-30 NJ 1974 97 (*Van der Beek v Van Dartel*) the Court held as follows:

"dat wanneer een partij vóór de totstandkoming van een overeenkomst aan de wederpartij bepaalde inlichtingen had behoren te geven ten einde te voorkomen dat de wederpartij zich omtrent het betreffende punt een onjuiste voorstelling zou maken, de goede trouw er zich in het algemeen tegen zal verzetten dat eerstbedoelde partij ter afwering van een beroep op dwaling aanvoert dat de wederpartij het ontstaan van de dwaling mede aan zichzelf heeft te wijten."

the particular circumstances of the case.¹⁹⁰ There is no general formula. As a rule of thumb, however, it may be said that no advice needs to be given in regard to expectations, guesses and the interpretations of facts and circumstances. Only existing facts and circumstances or developments may in principle be taken into consideration.¹⁹¹ Henriques¹⁹² suggests that the following guidelines should be followed:

- A duty to speak exists where a party knows certain facts, or knows or should realise that these facts are relevant to the other party who may not know these facts, notwithstanding the fact that the other party could have obtained these facts from another source.¹⁹³
- To the extent that a party acts more as an expert, he has a greater duty to speak. In contrast, where a party deals with an expert, his own duty to inform may diminish.¹⁹⁴
- The more confidential the relationship, the greater the duty.
- The more complicated a transaction or the object of the transaction becomes, the greater the duty to speak.
- A duty to speak may often be in conflict with a duty to remain silent. This can often lead to problems in the banker-surety-customer relationship. The question that remains is, namely: To what extent may the bank inform a prospective surety as to the weakness of its customer? It is suggested that the banker should insist upon the customer's consent to do this.

190 It still revolves around the question "wat partijen over en weer uit elkaars gedragingen en verklaringen kunnen en mogen afleiden" (what parties can deduce from one another's statements and conduct), where the social and cultural circle of the parties and their financial, social economical and intellectual capacities are relevant. See HR 1977-03-11 NJ 1977 521 (*Kribbebijter*); HR 1981-03-13 NJ 1981 635 (*Haviltex*); HR 1983-11-18 NJ 1984 345 (*Shu v Lam*).

191 *Vranken Plichten* 15.

192 Henriques 1976 *NJB* 625 at 631-632.

193 HR 1973-11-30 NJ 1974 97 (*Van der Beek v Van Dartel*).

194 Rb Dordrecht 1973-02-19 NJ 1974 539.

7.3.2.3 Disclosure and abuse of circumstances

In regard to abuse of circumstances,¹⁹⁵ whether or not it finds its origin in mental or economic duress, the protection of reliance is paramount. The party who may reasonably rely is protected.¹⁹⁶ As with any other form of reliance protection, duties to disclose and inform, and investigative duties also play a similar role in determining when a party may reasonably rely. This is not unusual because the different doctrines often overlap.¹⁹⁷ One who, for example, signs a document that he does not understand or whose content he cannot perceive, can act not only on the grounds of mistake, but also on the grounds of a lack of consent or an abuse of circumstances.¹⁹⁸ This osmosis goes even further and also encompasses cases of breach of contract.¹⁹⁹

7.3.2.4 Disclosure and standard terms²⁰⁰

According to current Dutch law, duties to disclose, inform and investigate can be applicable to standard terms. Two aspects are important in this regard. The first aspect relates to the question whether standard terms are applicable to the agreement and the second relates to the question whether one or more conditions are legal (substantive testing). In the case law it is generally expected that general conditions do apply to an agreement.²⁰¹

Hondius²⁰² suggests the following formula according to which:

"degeen die een kontraktsdokument ondertekent aan de daarin vervatte(verwijzing naar) standaardvoorwaarden is gebonden, indien en voor zover hij bij de ondertekening op toerekenbare wijze bij de wederpartij het vertrouwen heeft opgewekt dat hij gebonden

195 Prohibited in Art 3.13 BW . See HR 1957-01-11 NJ 1959 37; HR 1964-05- 29 NJ 1965 104.

196 Vranken *Plichten* 62.

197 *Ibid.*

198 *Ibid.*

199 HR 1985-11-15 NJ 1986 213 (*Stavenuiter v Oosterbaan*); HR 1965-12-10 NJ 1967 80 (*Vleugels v De Drie Hoefijzers*).

200 Regulated by statute, see Art 6.231BW .

201 Hondius *Standaardvoorwaarden* 391 *et seq*; Nieuwenhuis *Beginselen* 138.

202 Hondius *Standaardvoorwaarden* 408-409.

wilde zijn. Het antwoord op de vraag of het vertrouwen geacht mag worden te zijn opgewekt, hangt af van de waardering van omstandigheden als de mate van akkoordverklaring, de gebruikelijkheid van de betreffende klausules in het licht van de kontekst en de mogelijkheid van de wederpartij om zich van de kondities bewust te zijn. In bijzondere gevallen zullen ook andere omstandigheden een rol spelen."

This formula is considered to be applicable to unsigned contracts,²⁰³ with reference to general conditions by way of notes,²⁰⁴ and in general also in other situations.²⁰⁵

However, disclosure duties play a much lesser role in regard to the substantive control of general conditions than elsewhere in the law of contract, mainly by virtue of the extensive attention the subject receives in the Civil Code.²⁰⁶

7.3.2.5 Disclosure in pre-contractual relationships

In Dutch law, in many respects, disclosure duties are no different in regard to contracts which do not come to fruition than they are to contracts where negotiations are crowned by an agreement. There may be some length of time between the first contact between the parties and the conclusion of the contract. Events occurring in this interim period may be relevant. Drion²⁰⁷ demonstrates that the pre-contractual phase is important in determining whether an agreement was reached and what was agreed upon. Consequences of the agreement, flowing from the dictates of good faith, can be determined by pre-contractual events. Finally, the conduct of the parties in the pre-contractual phase can point to the voidability or voidness of the contract due to lack of consent or aspects relating to general terms according to the Civil Code.²⁰⁸

Recently, there have been developments in terms of which pre-contractual relationships are

203 *Ibid*, at 422.

204 *Ibid*, at 434.

205 *Ibid*, at 436-438.

206 Art 6.231 BW-6.247BW. These duties may play a role in testing clauses in the grey list or the general norm, or testing clauses in commercial contracts. See Vranken *Plichten* 75-86.

207 Drion *Precontractuele Verhoudingen* 231.

208 Art 6.231 BW.

becoming an independent basis for liability.²⁰⁹ It appears as if duties to disclose and inform play a large role in the concept.²¹⁰

The leading Dutch case in regard to discontinued negotiations is *Plas v Valburg*.²¹¹ In this case the Court held that, in principle, a party is free to break off negotiations without having to compensate another for costs incurred. There may, however, be circumstances in which the negotiations may only be broken off against payment of the other side's incurred costs. Furthermore, in certain circumstances negotiations may have reached such a stage that the covenant of good faith dictates that a party is no longer free to break off relations, because, owing to the advanced state of the negotiations, the parties may rely on this for a contract to flow from their negotiations.²¹² It is no longer necessary to seek liability in other fields such as delict, tacit terms, unlawful enrichment, misrepresentation and so forth, but purely on the basis of good faith.²¹³

7.3.2.6 The limiting effect of good faith on contracts

7.3.2.6.1 Three groups of situations and the role of disclosure

Not only has the principle contained in Art 3.11 BW²¹⁴ saturated the whole law of contract and obligations and created new doctrines, but it has also itself grown into a doctrine of some import: the exercise of certain rights can be in conflict with good faith. In order to determine the role of disclosure duties in regard to this doctrine, one may distinguish between three groups of cases. In the following sub-chapters, I shall investigate (1) the limiting effect of good faith as a contribution to a more comprehensive substantive testing, (2) the limiting effect as a standard of conduct in the execution of contracts, and (3) the limiting effect in relation to third parties.

209 Drion *Precontractuele Verhoudingen* 231 *et seq*; Vranken *Plichten* 87; Hartkamp *et al* (eds) *European Code* 119.

210 Vranken *Plichten* 88.

211 HR 1982-06-18 NJ 1983 723 (*Plas v Valburg*).

212 See, also, Zimmermann & Whittaker (eds) *Good Faith* 246; HR 1996-06-14 NJ 1997 481 (*De Ruiterij v MBO*); HR 1996-10-04 NJ 1997 65 (*Combinatie v De Staat*); HR 1982-06-18 NJ 1983 723 (*Plas v Valburg*).

213 Vranken *Plichten* 95. And, it is submitted, in terms of the concept of reasonableness and fairness.

214 This is the article imposing a duty of good faith upon all contracting parties.

7.3.2.6.2 Good faith: a more intensive substantive test

It often happens in Dutch law that agreements between parties that succeed the test of legality, fail the test of good faith. The law contains limited assistance in testing for legality. Vranken speaks in this regard of a *verlegenheidsoplossing*.²¹⁵ If one looks more closely at the case law, it becomes apparent that this solution was previously used to combat the abuse of exclusion clauses, especially when these were contained in general conditions.

Later it grew into an instrument that would do more justice to situations where there was the possibility of any inequality of bargaining power or where there was a particular relationship between the parties, especially when it related to living (*wonen*) conditions and to working and living (*leven*) conditions.²¹⁶

The checklist of circumstances which have to be weighed, when pronouncing upon legality, has spread, colouring the whole fabric of the law of contract and is decisive in regard to every doctrine.²¹⁷ Of even more importance is the way *rechtsvinding* operates in this context: no general norms are applicable, but rather viewpoints, rules of thumb, or sub-norms, to which, in each concrete case one or more principle may be applicable.²¹⁸ The legal-political aspect of the decision can be made more visible in this fashion.

A good example of the limiting effect of good faith between the parties who stand in a particular relationship to one another is found in the case of the *Katwijkse boedelscheiding*.²¹⁹ The husband in this case claimed compliance with a divorce settlement in terms of which the former marital home was to be transferred or awarded to the wife against payment of Dfl 35,000. In the particular case his claim was refused as being in conflict with good faith when it appeared that the woman could not get finance in order to comply with the order. No such condition was contained in the contract. The Hoge Raad, however, took the particular relationship between the parties as former spouses and the duty of the wife to take care of the three children born of the marriage, into account.

215 Vranken *Plichten* 143.

216 See HR 1967-05-19 NJ 1967 261 (*Saladin v Hollandse Bank Unie*).

217 Vranken *Plichten* 143: The case of *Saladin v Hollandse Bank Unie* HR 19 May 1967 NJ 1967 261 is a good example of the use of a checklist of elements which need to be considered in making a good faith finding.

218 Vranken *Plichten* 143; Hartkamp *et al* (eds) *European Code* 185-186.

219 HR 1981-01-16 NJ 1981 312 (*Katwijkse boedelscheiding*).

Further examples are found where there is the question of inequality of bargaining power. In these cases, in particular, disclosure and informational duties have been playing a growing role since the beginning of the 1980's.²²⁰

7.3.2.6.3 Good faith: norm of conduct in exercising rights

Good faith has a limiting effect as a standard of conduct in the execution of contractual rights, in various circumstances such as breach of contract, voidness, voidability, undue payment suspensive conditions, and so forth. For the purposes of this thesis, I shall limit this short discussion to its effect on suretyship.

On the fringes of the cases which will be discussed hereunder in regard to the limiting effect of good faith in relation to third parties, lie the cases of disclosure duties and duties of warning in regard to suretyship. One example from the cases,²²¹ is the case of *Los v Autofinancier*.²²² Autofinancier repossessed a motor vehicle on the grounds of non-payment. Los was the surety and co-principal debtor. Four years after signing the suretyship, Los was summonsed by Autofinancier. Los's defence boiled down to the fact that good faith required that Auto Financier should have informed him of the non-payment by the principal debtor, so that, for example, he could have complied with the arrear payments and could have arranged for a subrogation in order to make his loss as small as possible. The Hoge Raad decided that there can be circumstances where a creditor is compelled to warn the surety when the hire-purchase purchaser does not comply with his obligations or threatens not to comply with his obligations. This is not always the case, but it will depend on the circumstances of each case whether this duty exists.²²³

The circumstances of each case is the determining factor in establishing a duty of disclosure, and the following factors play an important role, namely the nature of the agreement, the relationship of the parties, and the detriment that the one party may suffer: the surety has taken a heavy load upon himself without being involved in the execution of the principal agreement. In this sense the surety is a debtor and the creditor knows well what role he plays in the legal relationship. This

220 Hartkamp 1981 *WPNR* 5559.

221 HR 1964-03-13 NJ 1964 188 (*Los v Autofinancier*).

222 HR 1964-03-13 NJ 1964 188.

223 See, also, HR 1961-01-13 NJ 1961 364 (*Bolderman v Velthoven*); HR 1980-02-15 NJ 1980 327 (*NPRC v Atlas en Milchsack*).

creates disclosure and warning duties for the creditor in regard to the interests of the surety.²²⁴

7.3.2.6.4 Good faith: third parties

The area of application of this category is very limited because the Dutch system of the law of obligations is still dominated by the dichotomy of contract and delict.²²⁵ In this system, third parties are normally forced to fall back on a delictual claim.²²⁶ As far as third parties and contractual good faith are concerned, the most common example is where the third party has relied on the existence or termination of a legal relationship between others. In the case of *Guliker v AGO*²²⁷ the bank granted credit to Guliker on the basis of the text of a policy in terms of which storm damage and fire damage were covered. Later it appeared that the insurance only covered storm damage. The court held that the bank was entitled to rely on the text of the policy and need not have investigated whether the text was correct or not. The same may be relied upon in regard to a deed of cession or a three-party agreement: contrary agreements cannot be laid at the door of the third party, in principle.²²⁸

Once more we have a situation where reliance is protected in the event of its being justified on the grounds of the conduct of the original contracting parties. As far as the role of disclosure duties is concerned, the same factors as discussed previously²²⁹ are important and have to be weighed, namely the nature and content of the legal relationship, the relationship and social positions of the parties and the way in which the agreement was formed.²³⁰

224 See, also, Asser-Kleijn *Bijzondere Overeenkomsten* 128; HR 1974-01-11 NJ 1974 179 (*Van der Velde v Amro Bank*); Hof 's Gravenhage 1984-09-20 NJ 1985 877; Hof Arnhem 1987-03-17 NJ 1988 1046; HR 1988-06-17 NJ 1988 958 (*Van Beuningen v de Bary*); HR 1989-01-16 RvdW 1989 18 (*De Vor v Amro*).

225 *Vranken Plichten* 149.

226 In terms of Art 6.162 BW.

227 HR 1982-07-08 NJ 1983 456 (*Guliker v AGO*).

228 Art 3.36 BW.

229 See HR 1967-05-19 NJ 1967 261 (*Saladin v Hollandse Bank Unie*) and par 7.3.2.6.3 *supra*.

230 See Asser-Hartkamp II *Verbintenissenrecht* nr 130; Nieskens-van der Putt *Derdenbescherming* 24.

7.3.2.7 Current developments in Dutch law

Duties to disclose and inform, and investigative duties are irrevocably bound up with recent developments in Dutch law. Some say that the development of these duties themselves is the most recent development.²³¹ There is a growing protection of reliance and an amelioration of the exclusivity of contract. Stated otherwise, there is the origin of other forms of liability, the closing of the gap between the tests for lawfulness for contract (reasonableness and fairness, good faith) and delict (social carefulness or *maatschappelijke zorgvuldigheid*), changes in the law of obligations, as seen in the greater stress placed on differentiation, notwithstanding the enlargement of scale in commerce.²³²

The rise of these duties dates from the early 1980's. It therefore does not appear in the Civil Code as yet, apart from the traditional rules of mistake. It remains *rechtersrecht*, judge-made law, *par excellence*.²³³ The limits of the duties are, however, not yet clear enough for codification.²³⁴

The place, function and meaning of these duties may be determined from various angles. Vranken²³⁵ identifies at least four perspectives, namely procedural, substantive, protection of reliance and methodical.

7.4 CONCLUSION

Dutch law does not specifically provide for an all-encompassing "banking contract" which would cover the entire relationship between bank and customer. Most people look at the relationship in a pragmatic way: a combination of qualified and unqualified contracts, governed by the general rules of contract law, and the General Banking Conditions.²³⁶

231 Vranken *Plichten* 201.

232 Vranken *Plichten* 201.

233 See, eg, Hof 's Hertogenbosch 1992-05-26 NJ 1993 90 (*Valkenswaard v De Stichting Woninggarantie*) in which case the court held that the creditor must reasonably take into account the interests of the surety. Amongst other things, the surety is owed a duty to be informed.

234 For a general discussion see Valkhoff *Orwetenschap*; Wilms *RW* 1980-1981 489 at 490-520.

235 Vranken *Plichten* 202.

236 Nieuwe Algemene Bankvoorwaarden. For discussions see Rank *Geld* 220-221; Wessels 1996 *WPNR* 6222 335; Molenaar 1988 *TVVS* 99; pars 7.2.2 and 7.2.3 *supra*.

Usually, the entire relationship between the bank and a customer will consist of one or more qualified agreements combined with various unqualified elements. The relationship between banker and customer is determined from case to case by the type of activity that the bank is performing for the customer. In addition to the provisions applying to certain qualified agreements, the general rules of the law of contract apply to the relationship between bank and customer. An essential rule of Dutch contract law is that the contents of an agreement are not exclusively determined by what the parties have expressly agreed, but also by custom and by the principle of "reasonableness and fairness". The contents of an agreement can be interpreted, supplemented and even, under certain circumstances, be set aside by the principle of reasonableness and fairness. Another important aspect of Dutch contract law is the law on general conditions.²³⁷ These enactments have had and will continue to have an impact on the General Banking Conditions of Dutch banks. The Algemene Bankvoorwaarden (ABV) apply to virtually all retail banking transactions in the Netherlands. The present text of the ABV is the result of consultations between the Association of Dutch Banks and representative consumer and business organisations. The ABV apply to general banks, savings banks and cooperative banks in their dealings with both private and business customers. In the ABV banks have undertaken to exercise "due care" in rendering their services.²³⁸

Dutch banks may sometimes be confronted with a conflict of interest between its affairs and those of its customers, The Association of Dutch Banks introduced a code of conduct in 1991 in respect of the separated handling of price-sensitive information. The code of conduct recommended certain action in setting up Chinese Walls. The code of conduct requires the banks to make a physical or, alternatively, a clear procedural division between its credit, issues and brokerage departments. Furthermore, the banks must inform their customers that Chinese Walls are in place and that as a result of the Chinese Walls, certain price-sensitive information will not be conveyed to the customers and will not be used by banks in rendering services.²³⁹

There is no explicit statutory provision which imposes an obligation of secrecy on banks in the Netherlands. In Dutch civil law, such an obligation is nevertheless assumed to exist. Various exceptions to the bank's obligation of secrecy exist under both civil and criminal law.²⁴⁰

237 Algemene Voorwaarden, Arts 6.231 to 6.247 BW. See par 7.2.2 n25 *supra*.

238 See par 7.2.3 *supra*.

239 See par 7.2.4 *supra*.

240 See par 7.2.5 *supra*. Exceptions include the customer's consent, where disclosure is made in the interests of the bank, where disclosure is made within the banking group, and where disclosure is required by law or a duty to the public requires disclosure. See, in

Liability for incorrect advice can arise under two heads;

- (1) liability for breach of contract (*wanprestatie*); and
- (2) liability for tort (*onrechtmatige daad*).

Contractual liability may arise when a bank, in rendering advice, breaches a specific contract with a client for the rendering of advisory services. It is more likely however, that there will not be a specific contract. The bank may then be liable for a breach of its duty under the ABV and the general rules of the law of contract to exercise due care in its relation to its customer. The bank's incorrect advice may also constitute a delict. Under the Dutch law of delict, it is, among other things, delictual to act in violation of a "generally required duty of care" (*zorgvuldigheid die in het maatschappelijk verkeer betaamt*) or, in other words, to be negligent. This negligence may, in addition to breach of contract, be a basis on which a bank may be sued for giving incorrect advice.²⁴¹

Normally, a bank may be liable to its customer as a result of a breach of the contract between them, where applicable. In addition, an agreement whereby the bank extends credit to the customer, compels the bank to act with care towards a customer-debtor, as well as towards a co-creditor. Banks have to act responsibly (*nie lichtvaardig*) in granting or expanding credit, or may face damages claims from its debtor. In practice however, this will not occur often. What is more likely is a claim from another creditor. Should the bank irresponsibly extend or expand credit, the appearance of creditworthiness is established. Creditors may be enticed into granting credit which may prove to be irrecoverable. Should the bank extend credit without taking into account the interests of other creditors, whose interests the bank must respect, the bank may be held liable in delict.²⁴²

In recent decades, consumers' rights have been the object of increasing attention. This has resulted in a variety of new legislation. The Civil Code contains specific provisions with respect to general conditions. A provision in general conditions may be annulled if such provision places an unreasonable burden on the other party or the user of the general conditions has not offered the other party a reasonable opportunity to take cognisance of the conditions. The ABV qualify as general conditions under the Civil Code. Therefore, the banks have to comply with the statutory provisions, relating to standard terms and conditions, when drafting and updating the

general, Neate *Bank Confidentiality* 364-377.

241 See par 7.2.6.1 *supra*.

242 See pars 7.2.6.2.2.2 and 7.2.6.2.2.3 *supra*.

ABV. The Consumer Credit Act of 1990,²⁴³ which, *inter alia*, implements the EC (Consumer Credit) Directive,²⁴⁴ sets out the rules for professionals granting credit to consumers.²⁴⁵

Under Dutch law error (*dwaling*), threat (*bedreiging*), fraud (*bedrog*), and abuse of circumstances (*misbruik van omstandigheden*) are considered vices of consent or defects of will (*wilsgebreken*). In the case of a defect of consent there is a *consensus ad idem* between the contracting parties and the agreement has been expressed correctly, but the underlying will has been formed in a defective way. On this ground a party can rescind the contract and under certain circumstances can claim for damages.²⁴⁶

In civil-law systems, a softening of the mechanism of offer and acceptance, as the exclusive test for the formation of contract has taken place and the duty to perform and enforce a contract in good faith has developed towards an overall duty to act in good faith once a legally relevant relationship has come into existence. This also means that the negotiating parties can be bound by this duty. As a consequence of this overall duty to act in good faith, a duty of disclosure can arise — at least in certain specific situations — to provide the other party with the highly relevant information necessary for the conclusion of a contract by informed consent.

As a background to duties of disclosure, it should always be borne in mind that in Dutch law the concept of good faith has a limiting influence in the sphere of contract law (*beperkende werking van de goede trouw*). In addition Art 6.2 BW requires that debtor and creditor act towards one another according to the dictates of reasonableness and fairness, and Art 6.248 BW states that a contract has not only the legal consequences agreed upon, but also those which, according to the nature of the agreement, flow from statute, usage, or the dictates of reasonableness and fairness.²⁴⁷

Duties to disclose, inform and warn are playing an ever-growing role in contract law in Western Europe, as we have also seen in the discussion of the banker's duty of disclosure in German law above, and it is a development that South African Banks can ignore only at their own peril.

243 Wet van 4 juli 1990, *Staatsblad* 395, houdende regels met betrekking tot het consumentenkrediet.

244 EC Directive (Consumer Credit) 87/102/EEC: [1987] OJ L42/48, as amended on 22 February 1990, to EC Directive (Consumer Credit) 90/88/EEC: [1990] OJ L61/14.

245 On consumer protection see par 7.2.8 *supra*.

246 See par 7.3.1.1 *supra*.

247 See par 7.3.1.1 *supra* and particularly the authorities quoted in n 179.

It would appear as if the Continental systems are more generous in recognizing a duty of disclosure, provided that the mistaken party is unable to discover the information for himself.

The Hoge Raad has developed a style in its grounds of judgment on the subject of good faith which can be regarded as a model of its kind.²⁴⁸ It compels the courts to take into account a comprehensive "checklist" of elements,²⁴⁹ and to include in their grounds of judgment the reason why, in the light of these elements, the principle of good faith requires a certain interpretation, or why the principle of good faith conditions, in a certain manner, the rights and obligations of the parties. It therefore provides some rules of thumb, which may be over-ruled, but only for convincing reasons.²⁵⁰

It is suggested that, as duties of disclosure can arise from good faith, these guidelines or checklists would be a determining factor in finding the existence of a duty or not.²⁵¹

Anthropological perceptions have changed, and with them the interpretation of the notion of good faith. The notion of good faith is no longer understood as conveying the simple idea that one should keep one's word, but rather as a combination of a number of elements or principles to be balanced against one another. The most important of these principles or elements can be summarised as follows:

- taking responsibility for the expectations one has created;
- due respect for the right of self-determination;
- maintaining a degree of proportionality between the advantages and the disadvantages which any action can cause the parties involved;
- determining the rights and duties of the parties, taking into account their reciprocity;

248 The first clear example was the case of HR 1967-05-19 NJ 1967 261 (*Saladin v Hollandse Bank Unie*), where the Hoge Raad stipulated the following elements: the degree of negligence, related to the nature and seriousness of the interests involved, the nature and remaining contents of the contract, the social position of, and mutual relationship between, the parties, the manner in which the clause was made and the level of awareness by the parties of its purpose. Similar checklists have been used in cases concerning many other types of clauses, as well as cases concerning misunderstanding, mistake, interpretation of terms and clauses and so forth. See Storme in Hartkamp *et al* (eds) *European Code* 185n42. In regard to good faith see par 7.3.2.1 *supra*.

249 See par 7.3.2.6.3 *supra*.

250 See Hartkamp *et al* (eds) *European Code* 185-186; Zimmermann & Whittaker (eds) *Good Faith* 194.

251 See par 7.3.2.6.2 *supra*.

- a fair allocation of risks.²⁵²

252 Hartkamp *et al* (eds) *European Code* 185.

CHAPTER 8: THE BANKER'S DUTIES OF DISCLOSURE AND ADVICE TO CUSTOMERS AND SURETIES: SOUTH AFRICA

8.1. BANKER-CUSTOMER RELATIONSHIP

8.1.1 The cheque account

In *Selangor United Rubber Estates Ltd v Cradock (a Bankrupt) and Others (no 3)*¹ Ungood-Thomas J stated:

"Banking law is not a separate body of law, though, like innumerable other activities, it has statutory provisions dealing exclusively with it, and being a distinctive and important activity, textbooks dealing separately with it."

Malan and Pretorius² state that banking law is not an autonomous branch of the law, but a modern development which uses the concepts and techniques of the general law of obligations, and in consequence, the relationship between bank and customer is classified and explained in terms of these general principles.

The relationship is based upon contract,³ and involves a debtor and creditor relationship.⁴ In

1 [1968] 2 All ER 1073 at 1118.

2 Malan & Pretorius *Bills of Exchange* 333.

3 See *Standard Bank SA Ltd v Oeanate Investments (Pty) Ltd* 1995 (4) SA 510 (C) at 530; *ABSA Bank Bpk h/a Volkskas Bank v Retief* 1999 (3) SA 322 (NC) at 339; *Strydom NO v ABSA Bank Bpk* 2001 (3) SA 185 (T) at 192.

4 In *London Joint Stock Bank Ltd v MacMillan & Arthur* 1918 AC 777 at 789 Lord Finlay LC stated:

"The relation between banker and customer is that of debtor and creditor, with a superadded obligation on the part of the banker to honour the customer's cheques if the account is in credit."

See, also, *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110 at 118; *Hart v Sangster* [1957] 2 All ER 708; *Selangor United Rubber Estates Ltd v Cradock (a*

*Standard Bank of SA Ltd v ABSA Bank Ltd and Another*⁵ the Court summed up the question of ownership of the money as follows:

"...as a customer deposits money, such money becomes the property of the bank subject to obligation by the bank to honour validly drawn cheques by the customer."⁶

Stassen⁷ is of the opinion that the description of the relationship as set out in the case of *Rousseau NO v Standard Bank of SA Ltd*⁸ is purely functional and suggests that the contract between banker and customer be classified. He concludes that the legal relationship consists of, on the one hand, *mandatum*, and on the other hand, *mutuum*. As the relationship contains elements of several different kinds of contracts it has often been referred to as a relationship *sui generis*.⁹

Bankrupt) and Others (no 3) [1968] 2 All ER 1073 at 1118 (England). The English approach is also followed in South Africa. In *Rousseau NO v Standard Bank of SA Ltd* 1976 (4) SA 104 (C) at 106, Watermeyer J summed up as follows:

"The legal relationship between a banker and its customer whose account is in credit, is that of debtor and creditor. The customer is a creditor who has a claim against the bank in the sense that he has a right to have it make payments to him, or to his order, on cheques drawn by him up to the amount by which his account is in credit.

When a customer draws a cheque on his bank in favour of a third party (ie. the payee) this is an instruction to the bank to make payment to the payee. This the bank could do by taking the money out of its own funds and handing it either to the payee personally or to a collecting banker on the payee's behalf, but in practice where a payee hands a cheque to his banker for collection a balance is struck from time to time between the two banks..."

See, also, *Estate Ismail v Barclays Bank (DC & O)* 1957 (4) SA 17 (T) at 26; *Kearney v Standard Bank of SA Ltd* 1961 (2) SA 647 (T) at 652; Malan & Pretorius *Bills of Exchange* 333; Joubert (ed) 19 *LAWSA* par 154.

5 1995 (2) SA 740 (T) at 746.

6 See, also, *Estate Ismail v Barclays Bank (DC & O)* 1957 (4) SA 17 (T) at 26; *Kearney NO v Standard Bank of South Africa Ltd* 1961 (2) SA 647 (T) at 650; *S v Kearney* 1964 (2) SA 495 (A) at 502-503; *Western Bank Ltd v Registrar of Financial Institutions and Another* 1975 (4) SA 37 (T) at 43-44; *Rousseau NO v Standard Bank of SA Ltd* 1976 (4) SA 104 (C) at 106; *GS George Consultants and Investments (Pty) Ltd v Datasys (Pty) Ltd* 1988 (3) SA 726 (W) at 735.

7 Stassen 1980 *MB* 77 at 79.

8 1976 (4) SA 104 (C) at 106, quoted *supra* at n4.

9 In *GS George Consultants and Investments (Pty) Ltd v Datasys (Pty) Ltd* 1988 (3) SA 726 (W) at 736 the Court states:

Another, and more preferable, view is that the contract between the customer and banker is that of a *mandatum*.¹⁰ The state of the customer's account, that is, whether he is the banker's creditor or debtor, does not determine the nature of the contract between them, but may be seen as indicative of the manner in which the contract is to be performed.¹¹

It must be borne in mind that the above description of the banker-customer relationship is rather narrow, when the multi-functionality of banks is taken into account.¹² In *Standard Bank of SA Ltd v ABSA Bank Ltd and Another*¹³ the Court cautions as follows:

"...the relationship which exists between a banker and its customer is a collection of a number of complex juristic relationships which tend to vary from customer to customer, depending on the specific agreement which has been entered into between the customer and the bank. Naturally such relationship would exhibit in varying degrees certain features which have been recognised both in our common law as well as in various judicial *dicta*. However, in any given case, in my view, the proper course to take is not

"That the contract is *sui generis* need not be doubted. Nevertheless, that conclusion does not exclude the proposition that the contract is fundamentally one of *mutuum* with numerous superadded features, including the banker's duty of secrecy."

See, also, *Commissioner of Customs and Excise v Bank of Lisbon International Ltd* 1994 (1) SA 205 (N) at 213-214; Joubert (ed) 19 *LAWSA* par 154; Cowen *Negotiable Instruments* 368; Bekker *Dishonouring* 11-14; Malan & Pretorius *Bills of Exchange* 334.

- 10 *OK Bazaars (1929) Ltd v Universal Stores Ltd* 1973 (2) SA 281 (C) at 288; Joubert (ed) 19 *LAWSA* par 154; Bekker *Dishonouring* 11-14; Goodeye *Aspekte* 153-154. Malan & Pretorius *Bills of Exchange* 334 explains the relationship as follows:

"However, in essence the contract between bank and customer obliges the bank to render certain banking services, the so-called services *de caisse*, to the customer on his instructions, and for this reason it can be classified as a contract of *mandatum*. The bank and customer relationship is based on a comprehensive mandate in terms of which the customer lends money to the bank on current account, the bank undertakes to repay it on demand by honouring cheques drawn on it and to perform certain other services for the customer, such as the collection of cheques and other instruments, and the keeping and accounting of his current account."

- 11 Joubert (ed) 19 *LAWSA* par 154. See, also, *Bank of Africa v Evelyn Gold Mining Company Ltd* (1894) 1 OR 24 at 27; *OK Bazaars (1929) Ltd v Universal Stores Ltd* 1973 (2) SA 281 (C) at 288; Malan 1978 *TSAR* 197 at 201; Stassen 1980 *MB* 77 at 79; Faul 1989 *TSAR* 145; Malan & Pretorius *Bills of Exchange* 334.

- 12 See the discussion in par 8.1.2 *infra*.

- 13 1995 (2) SA 740 at 747.

to apply a rigid and pre-existing characterisation of the customer-banker legal relationship, but to examine the specific legal *nexus* which exists between a particular banker and its customer. Indeed, some such relationships would have strong features of a principal and agent; sometimes characteristics of a loan for consumption; and indeed sometimes such relationship is, as I have indicated earlier, one between a debtor and a creditor and very often the relationship would be a collection of features of each of these legal institutions I have referred to."

8.1.2 The multi-functional bank

8.1.2.1 Introduction

The description of the banker-customer relationship as set out in the previous paragraph is of course a narrow one, covering only the most basic or most common relationships between a banker and its customer and does not reflect the fact that banks are multi-functional. The truth is that there are just as many banker-customer relationships as there are different types of contract which a bank may conclude with the customer.¹⁴ In principle, bankers are dealers in money. They are the middle-men between investors and borrowers. Apart from lending and borrowing money they also provide a vast array of financial and other services,¹⁵ and various types of legal relationships can therefore exist between banker and customer.¹⁶

14 Stassen 1983 *MB* 80 at 81.

15 Bankers may, eg, offer any of the undermentioned services. Some services, such as advice on estate planning, drawing of wills, and acting as executors of deceased estates formerly fell within the domain of the attorney's profession, but banks are increasingly active in these areas.

Examples of other services bankers may render include;

- (1) lending money on overdraft, other loans, credit agreements for movables, discounting of contracts, factoring, mortgage bonds;
- (2) foreign-exchange transactions;
- (3) being surety or guarantor;
- (4) acting as executors of deceased estates;
- (5) purchasing and selling of shares, giving advice and information, issuing and underwriting new shares and effects;
- (6) acting as asset managers.

16 Stassen 1983 *MB* 80 at 81.

Although the obligations between a banker and a surety arise principally by way of contract, it is, of course possible that obligations may also arise from delict.¹⁷ The relationship may also be influenced by trade usages and the impact of foreign legal sources of banking law.

8.1.2.2 Legal problems flowing from the multi-functionality of banks

The emergence of the multi-functional bank raises a variety of legal issues. Prominent among them is that of the risk when core banking is combined with other financial activities. It is this concern which prompted the separation of core banking from securities activities in the US Glass-Steagall Act.¹⁸

Furthermore, there is the concentration of economic power in the multi-functional bank and the competition concerns associated with this.¹⁹

Important also is a third issue, namely the conflicts of interest thrown up in the operation of the multi-functional bank. Consider when an issue of securities is being underwritten by a bank or when a bank is a "market maker" in securities, that is, holds itself out as willing to enter into transactions of sale and purchase in investments in securities at prices determined by him generally and continuously rather than in respect of each particular transaction. If these securities are unsold, for example in the case of an underwriting, or the bank has taken a position as a market maker, the bank may be tempted to recommend these securities to customers or place them in accounts or funds it is managing. A variation of this example would be where the securities-retailing or fund-management arms of a bank were placing a company's securities at

17 One thinks here particularly of fraud, (see Van der Merwe & Olivier *Onregmatige Daad* 12 and 228; Scott 1976 *THRHR* 347; Scott 1977 *THRHR* 165) or misrepresentation (see *Administrateur Natal v Trust Bank van Afrika Bpk* 1979 (3) SA 824 (A); *Siman and Co (Pty) Ltd v Barclays National Bank Ltd* 1984 (2) SA 888 (A); *Bayer South Africa (Pty) Ltd v Viljoen* 1990 (2) SA 647 (A)) or negligent investment advice (see *Durr v ABSA Bank Ltd and Another* 1997 (3) SA 448 (A)).

18 S 227 of 12 USC. In the middle of the great Depression of the 1930s, the US Congress passed the Banking Act of 1933. Four provisions of this Act (ss 16, 20, 21 and 32) have become popularly known as the Glass-Steagall Act. These provisions attempt to separate commercial banking from investment banking because affiliations between these institutions were perceived as the main factors which contributed to the stock market crash of 1929 and the Great Depression. As such, the roots of the Glass-Steagall "wall" are steeped in strong and broad public-policy considerations. See Norton 1987 *Bus Law* 327. The Glass-Steagall Act does not, however, create an absolute barrier between commercial and investment banking and, because it only applies to certain banks, its provisions have loopholes. See s 24 of 12 USC (Seventh).

19 See Cranston *Banking Law* 23.

the same time as its corporate-finance arm was about to undercut their value, for example, was about to call up the loan because of the debtor's default. A third example would be where a bank was tempted to trade upon or divulge to favoured customers information it has obtained about a corporate customer or a customer to whom it is giving financial advice. A fourth example of a conflict of interest would be where a bank finances a company which is bidding to take over another of its customers.²⁰

Relevant to these and a variety of other conflicts of interest are provisions in the general and the regulatory law. The English law, for example, proscribes a conflict of interest if there is a fiduciary relationship. As for regulatory law, the English securities laws contain a variety of provisions compelling banks either to avoid any conflict of interest arising, or, where conflicts do arise, to ensure fair treatment to all its customers by disclosure, internal rules of confidentiality, by declining to act or otherwise.²¹

8.1.2.3 South African concepts: *boni mores* to the rescue?

8.1.2.3.1 Fiduciary relationships

Our law recognises fiduciary relationships which, as a matter of law, give rise to an obligation to respect the confidentiality of information imparted or received in confidence, and to refrain from using or disclosing such information otherwise than as permitted by law or by contract. The fiduciary relationships that give rise to such legal duties are in some instances based on contract.²² In such cases the obligation to respect the confidentiality of the information is generally regarded as an implied term of the contract.²³

In other cases the relationships are based on the law of delict and the principles of Aquilian

20 Poser 1988 *Michigan Yearbook of International Legal Studies* 91 at 96-97. See the prominent case in this regard *Washington Steel Corporation v TW Corporation* 602 F 2d 594 (3d Circuit 1979).

21 See Cranston *Banking Law* 23; Blair *et al Financial Services Regulation* 231-236.

22 Eg, the contract between employer and employee. See *Beeton v Peninsula Transport Co (Pty) Ltd* 1934 CPD 53 at 57-58; *Silva's Fishing Corporation (Pty) Ltd v Maweza* 1957 (2) SA 256 (A); *Meter Systems Holdings Ltd v Venter and Another* 1993 (1) SA 409 (W) at 429; McKerron *Delict* 23-24.

23 *Coolair Ventilator Co (SA) (Pty) Ltd v Liebenberg and Another* 1967 (1) SA 686 (W) referred to with approval in *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 (2) SA 173 (T) at 190.

liability.²⁴ These aspects of the law are still in a process of development, and it appears that they are developing in parallel in the sense that the emerging definition of the legal duty relating to confidential information for the purpose of the law of delict is not materially different from the emerging definition of the implied contractual term where the relationship is based on contract.²⁵ As far as English law on the subject is concerned, it is based on principles of equity, and although it cannot be slavishly adopted in South Africa, it can be of considerable assistance in analysing and solving a similar problem on Aquilian principles.²⁶

In *Meter Systems Holdings Ltd v Venter and Another*²⁷ Stegmann J pointed out that no inherent conflict of principle or legal policy has yet emerged in the field of fiduciary relationships and confidentiality of information, between the broad and ample basis of Aquilian liability and English notions of equity. He continued by saying that when English lawyers have analysed and solved a problem in this field on the lines of equity, it can be of considerable assistance in analysing and solving a similar problem on Aquilian principles to have regard to their work.

It is therefore my submission that in the light of the fact that in our banking law we have delved deep into English law for guidance, enacted legislation based on English models, and applied English law in many cases where English law has not been imported by way of statute,²⁸ we can look profitably at developments in English law in regard to the solutions to the problem of

24 As an example, Stegmann J in *Meter Systems Holdings Ltd v Venter and Another* 1993 (1) SA 409 at 426, refers to the relationship between tutor and student or company director and company. A company director owe fiduciary duties to the company. See *Henochsberg Companies Act* 464; *Treasure Trove Diamonds Ltd v Hyman* 1928 AD 464; *Mills v Mills* (1938) 60 CLR 150; *Hogg v Cramphorn Ltd* [1966] 3 All ER 420; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL and Another* (1968) 121 CLR 483. It has been ruled that the liability for breach of a fiduciary duty is not a delictual one, but one *sui generis*, (see *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168 at 199 and 242; *Cohen NO v Segal* 1970 (3) SA 702 (W) at 706; *Du Plessis NO v Phelps* 1995 (4) SA 165 (C) at 170-171). See, however, the article of du Plessis 1993 *THRHR* 11 at 28 *et seq* where the author submits that the source of the liability should be exclusively the *actio legis Aquiliae*.

25 See *Meter Systems Holdings Ltd v Venter and Another* 1993 (1) SA 409 (W) at 427.

26 *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 (2) SA 173 (T) at 179, 185 and 190; *Meter Systems Holdings Ltd v Venter and Another* 1993 (1) SA 409 (W) at 427. English law is developing according to the principles of equity whilst our modern Roman-Dutch Law is developing on what Corbett J (as he then was) called, "the broad and ample basis of the *lex Aquilia*". See *Dun & Bradstreet (Pty) Ltd v SA Merchants Combined Credit Bureau (Cape) (Pty) Ltd* 1968 (1) SA 209 (C).

27 1993 (1) SA 409 (W) at 427.

28 On the importance of English law in the South African banking law, see Willis *Banking* 20-21; Morice 1904 *SALJ* 355; Malan & Pretorius 2001 *THRHR* 268 at 268-271.

fiduciary relationships in a banking context.

In the normal banker-customer relationship, the parties do not owe one another a fiduciary duty.²⁹ In certain cases a particular relationship between parties may be an indication that the one party owes the other a duty of care. In this fashion, the existence of a contractual relationship can point to a legal duty of care.³⁰ Other examples are the relationships between policeman and citizen,³¹ policeman and prisoner,³² and, as discussed, between employer and employee.³³

It is, however, unclear whether the mere existence of a relationship is sufficient to establish a legal duty.³⁴ Every case must be measured, in view of all the surrounding circumstances, including the existence of a particular relationship between the parties, against the measure of the *boni mores*.³⁵

A fact which may tilt the scales in favour of the recognition of a fiduciary relationship in the banker-customer relationship is the fact that the bank may have created the impression that it would look after the interests or protect the assets of the customer.³⁶ This would be the case where the bank, for example, assumes a duty as adviser to the customer, or acts as its asset

29 See *Nedperm Bank Ltd v Verbri Projects CC* 1993 (3) SA 214 (W).

30 See, eg, *Greenfield Engineering Works (Pty) Ltd v NKR Construction (Pty) Ltd* 1978 (4) SA 901 (N); *Van der Merwe & Olivier Onregmatige Daad* 46; *Davel* 1979 *THRHR* 214; *Neethling et al Deliktereg* 60.

31 *Minister van Polisie v Ewels* 1975 (3) SA 590 (A).

32 *Mtati v Minister of Justice* 1958 (1) SA 221 (A); *McKerron Delict* 23-24; *Van der Merwe & Olivier Onregmatige Daad* 46.

33 The concept of a duty of care is an established feature of the South African law of delict. The underlying theory of the duty of care facilitates the introduction of liability for pure economic loss as it has done in the case of recognition of liability for negligent misrepresentation causing pure economic loss. See *Malan & Pretorius* 2001 *THRHR* 269 at 270; *Zimmermann & Visser* (eds) *Southern Cross* 620 *et seq.*

34 See *Bedford v Suid-Kaapse Voogdy Bpk* 1968 (1) SA 226 (C) at 230; *Van der Merwe & Olivier Onregmatige Daad* 46; *Van der Walt Delict* 33; *Neethling et al Deliktereg* 61.

35 *Minister van Polisie v Ewels* 1975 (3) SA 590 (A) at 596-597; *Universiteit van Pretoria v Tommie Meyer Films (Edms) Bpk* 1977 (4) SA 376 (T) at 387; (and on appeal, see 1979 (1) SA 441 (A); *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd* 1982 (4) SA 371 (D) at 384. See, also, *Hawker v Life Offices Association of South Africa* 1987 (3) SA 777 (C) at 781; *Nkumbi v Minister of Law and Order* 1991 (3) SA 29 (E); *Neethling et al Deliktereg* 63.

36 See *Compass Motors Industries (Pty) Ltd v Callguard (Pty) Ltd* 1990 (2) SA 520 (W); *Neethling et al Deliktereg* 62; *Neethling and Potgieter* 1990 *TSAR* 763.

manager. The key question will concern the role which the bank has taken in the customer's affairs³⁷ and whether that gives rise to a reasonable expectation on the part of the customer that the bank is putting the customer's interests before its own (and those of its other customers) and that the customer can therefore relax its consideration of its own position in the belief that the bank is taking care of that.³⁸

Professor (now Judge) Finn has indicated that, given the general recognition that banks are commercial entities with obvious self-interest in the business that they transact, he would not expect fiduciary duties to be owed by the bank to a customer except in three distinct situations:

- (1) where the course of the relationship can found the expectation, not only that advice will be given, but that, where necessary, it will be given adversely to the bank's interests;
- (2) where the bank has created the expectation that it is advising or will advise in the customer's interests in a matter because its own interest therein is represented as being merely formal, nominal or technical;
- (3) where the bank, though expected to act in its own interest in the actual dealing *inter se*, has created the expectation that it will advise in the customer's interests, for example on the wisdom of an investment proposal in respect of which a loan application is made.³⁹

My submission is that, as the nature of banking changes, and measured against the *boni mores*, our banking law will recognize, more and more, the fiduciary duties in the banker-customer relationship. The aforementioned factors as propounded by Finn may be a valuable guide, also in South African banking law, pointing to the existence of fiduciary duties.

37 See Austin 1986 *OJLS* 444 at 446.

38 If one looks at English law, fiduciary duties would prevent the bank from putting its own interests, or the interests of another customer, over those of the customer in question. This will occur:

- (1) where the bank gives advice to a customer in relation to a transaction in which there is a serious conflict of interest between the bank and its customer, such as a bank guarantee to be given by one customer in relation to the existing indebtedness of another customer (see *Woods v Martins Bank Ltd* [1959] 1 QB 55; *Lloyds Bank Ltd v Bundy* [1975] 1 QB 326; *National Westminster Bank plc v Morgan* [1985] AC 686); or
- (2) where a bank gives investment advice or other advice in relation to financial services to a customer; see *LAC Minerals Ltd v International Corona Resources Ltd* (1989) 61 DLR (4th) 14 (Canada); *Indata Equipment Supplies Ltd (t/a Autofleet) v ACL Ltd* [1998] 1 BCLC 412; Law Commission *Rules* pars 2.4.3 to 2.4.17).

39 See Finn in McKendrick (ed) *Fiduciary* 11-12.

It is, of course, so that a large proportion of sureties in respect of bank loans are in fact also customers of the bank. One thinks, for example, of directors of companies signing as sureties for the debts of the company, or members signing for close corporations. Where the surety is also a customer of the bank, and the bank is in a fiduciary relationship with the customer/surety, the banker may well owe the customer/surety a duty of disclosure of all material facts.

8.1.2.3.2 Conflicts of interest

Perceived or real conflicts of interest, where it is thought that a bank is not acting completely in the interests of the customer because of its own interests or those of another customer, are sources of friction between banker and customer. Within the same organisation there may well be traditional bankers, corporate financiers, market makers,⁴⁰ brokers and fund managers. Potential conflicts of interest arising from the diverse activities of personnel in these areas are unavoidable.⁴¹ It is possible that in the development of our law, certain conduct by bankers in relation to customer information, may become unlawful, after determination by the *boni mores* or in terms of statute law such as the existing Insider Trading Act of 1998.⁴²

Banks will have to develop grounds of justification,⁴³ as well as methods to avoid or manage conflicts of interest. By analogy to English law,⁴⁴ the following methods may be used, in order to prevent delictual liability:

- the use of Chinese Walls;⁴⁵

40 As defined in par 8.1.2.2 *supra*.

41 Warne *Litigation* 37.

42 Act 135 of 1998.

43 Van der Walt *Delict* 40-41 states:

"Grounds of justification are practical examples of circumstances justifying a *prima facie* infringement of a recognized right or interest, according to the fundamental criterion of *boni mores* or reasonableness. Although in practice they have developed to the full status of defences to an action in delict, they are in reality the expression of the result of the application of the *boni mores*-test to typically recurring circumstances in practice." See, also, van der Merwe & Olivier *Onregmatige Daad* 70.

44 See Warne *Litigation* 37; Law Commission *Fiduciary Duties* par 2.16; Cranston *Banking Law* 25-26; *Bolkiah v KPMG (A Firm)* [1999] 1 All ER 515.

45 For an explanation of the term see par 1.1.3.3 *supra* at n 76.

- the use of restricted lists and watch lists; and
- disclosure to customers of the existence of an actual or potential conflict of interests and the obtaining of their consent to future action.

It is interesting to note that in terms of the new South African Code of Banking Practice,⁴⁶ participating banks believe that they are entitled to enhance their current relations with customers by giving certain information about customers to their subsidiaries within their groups for marketing purposes, unless the customers instruct them to the contrary.

8.2 BANK CONFIDENTIALITY⁴⁷

There is a dearth of South African authority on the subject of bank confidentiality. The banker's duty of confidentiality has been recognised in *Abrahams v Burns*,⁴⁸ *Cambanis Buildings (Pty) Ltd*

46 See par 9.4.2 *infra*.

47 Writers on the subject, as well as courts pronouncing on confidentiality issues refer to "a duty of secrecy" or "a duty of confidence" or a "duty of confidentiality". The second edition of Neate's book on the subject is called *Bank Confidentiality*. The Review Committee *Banking Services* 34 (the Jack report) refers to a "principle of confidentiality". In *GS George Consultants and Investments (Pty) Ltd v Datasys (Pty) Ltd* 1988 (3) SA 726 (W) at 734-735 the Court refers to the obligation of the bank to preserve the confidentiality of its knowledge of its customer's affairs. Faul *Bankgeheim* uses the term "secrecy". See, also, Malan & Pretorius *Bills of Exchange* 375; Smith 1979 *MB* 24. These concepts are seen as being synonymous. The Oxford Thesaurus contains the following entries:

"confidence n 3 *exchange confidences* secret, private affair, confidentiality, intimacy."

"confidential adj 1 *confidential information* secret, private, classified, non-public, off-the-record, restricted, personal, intimate, privy..."

"secrecy n 1 *the secrecy of the information* confidentiality, privateness."

"secret adj 1 *keep the matter secret* confidential, private, unrevealed, undisclosed, under wraps, unpublished, untold, unknown..."

The Penguin Dictionary describes the word confidential as follows:

"confidential...adj 1 said of information; intended to be kept secret."

For the purposes of this thesis it is accepted that the terms can be used interchangeably.

48 1914 CPD 452 at 452-456.

*v Gal*⁴⁹ and *GS George Consultants and Investments (Pty) Ltd v Datasys (Pty) Ltd*.⁵⁰ There are no other decisions in which the basis of the duty of confidentiality is analysed.⁵¹ On a practical level, banks are aware of the fact that personal financial information about their customers' accounts and transactions are to be kept confidential. In practice banks do comply with such a duty.⁵²

Because of this dearth of authority, South African lawyers rely on English law, subject to peculiarities of English law that have no place in our own legal system,⁵³ and the decision in *Tournier v National Provincial and Union Bank of England*⁵⁴ has accordingly impacted on our law as well.⁵⁵

The duty of a bank to keep its customer's affairs confidential is usually an express or implied

49 1983 (2) SA 128 (N) at 137.

50 1988 (3) SA 726 (W) at 735.

51 In *Cywilnat (Pty) Ltd v Densam (Pty) Ltd* 1989 (3) SA 59 (W) at 59-60 the Court recognised a duty of confidentiality by implication, but in this case found that there was a circumstance which relieved the bank of its duty. The decision of the court *a quo* in this case was confirmed in *Densam (Pty) Ltd v Cywilnat (Pty) Ltd* 1991 (1) SA 100 (A). The court of appeal found it unnecessary to analyse the legal nature of the banker-customer relationship and did not discuss whether a bank indeed has a duty of confidentiality and what the origin and extent of such duty are. The duty of confidentiality was also recognised by implication in *Hindry v Nedcor Bank Ltd and Another* 1999 (2) SA 757 (W) at 773.

52 See Smith 1979 MB 24 at 26.

53 See *Standard Bank of SA Ltd v Minister of Bantu Education* 1966 (1) SA 229 (N) at 237; *Willis Banking* 24.

54 [1924] 1 KB 461.

55 See *GS George Consultants and Investments (Pty) Ltd v Datasys (Pty) Ltd* 1988 (3) SA 726 (W) at 735. In *Densam (Pty) Ltd v Cywilnat (Pty) Ltd* 1991 (1) SA 100 (A) Botha JA remarked as follows in regard to the bank's duty of secrecy:

"...For the purposes of deciding this appeal I shall simply assume ...[but] I must make it plain, without deciding, that the Bank was contractually obliged to [its client] to maintain secrecy and confidentiality about its affairs, in accordance with the decision in *Tournier's* case."

term of the contract between bank and customer.⁵⁶ Malan and Pretorius⁵⁷ state:

"Since this contract can be classified as an instance of mandate, the bank's duty of secrecy can be characterized as an example of a mandatary's duty to perform his mandate in good faith."

Faul⁵⁸ sums up the situation as follows:

"In South African law, the banker-customer relationship can be based on *mandatum* (in the case of a current account holder) or usually *mutuum*. The ordinary principles of *mandatum* gives rise to a banker's duty of confidentiality. In the case of *mutuum* the duty is regarded as an implied term in the contract between banker and customer, which reflects the *sui generis* character of the contract in this case as one based on confidentiality."⁵⁹

In South African law a banker's duty of secrecy exists before, during and after the existence of the contract between banker and customer.⁶⁰ Faul⁶¹ sees a further foundation of a banker's duty of secrecy in delict. Banks have an absolute duty to keep all confidential information secret

56 *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461 at 474, 481 and 484 (England); *Abrahams v Burns* 1914 CPD 452 at 456; *GS George Consultants and Investments (Pty) Ltd v Datasys (Pty) Ltd* 1988 (3) SA 726 (W) at 736-737 (South Africa); Paget's *Banking Law* 10 254; Smith 1979 *MB* 24; Malan & Pretorius *Bills of Exchange* 376.

57 Malan & Pretorius *Bills of Exchange* 376. The authors refer to De Wet & Yeats *Kontraktereg en Handelsreg* 341; Faul *Bankgeheim* 440-443; Aubert *et al Secret* 32-36.

58 Faul *Bankgeheim v.*

59 In *GS George Consultants and Investments (Pty) Ltd v Datasys (Pty) Ltd* 1988 (3) SA 726 (W) at 736 Stegmann J states:

"That the contract [between banker and customer] is *sui generis* need not be doubted. Nevertheless, that conclusion does not exclude the proposition that the contract is fundamentally one of *mutuum* with numerous superadded features, including the banker's duty of secrecy."

60 Faul *Bankgeheim* 466-467; Malan & Pretorius *Bills of Exchange* 377.

61 Faul *Bankgeheim* 472-473. The bank must take reasonable care to protect its systems and information from penetration by unauthorised third parties. The ordinary principles of delict are to be applied to the breach of the banker's duty of secrecy.

whether it relates to a customer⁶² or to anyone else.⁶³ Malan and Pretorius⁶⁴ state:

"Thus, a bank is under a duty to respect the financial and personal privacy of its customers and other members of the public, and not to injure their creditworthiness or personal integrity by disclosing confidential information."

A juristic person has a comparable right to privacy.⁶⁵

In *GS George Consultants and Investments (Pty) Ltd v Datasys (Pty) Ltd*⁶⁶ Stegmann J stated:

"There are circumstances in which a banker may be relieved of the duty of secrecy owed to his customer, and circumstances in which he can be compelled to disclose the confidential information in his possession. Some of the circumstances are considered in *Tournier v National Provincial and Union Bank of England* (*supra*)."

In *Tournier v National Provincial and Union Bank of England*⁶⁷ the court referred to the following grounds of justification:

- where disclosure is under compulsion by law;
- where there is a duty to the public to disclose;
- where the interests of the bank require disclosure;

62 *Cambanis Buildings (Pty) Ltd v Gal* 1983 (2) SA 128 (NC) at 137; *GS George Consultants and Investments (Pty) Ltd v Datasys (Pty) Ltd* 1988 (3) SA 726 (W) at 736.

63 *Faul Bankgeheim* 321 *et seq*; Malan & Pretorius *Bills of Exchange* 377.

64 Malan & Pretorius *Bills of Exchange* 377. The authors refer to *California Bankers Association v Schultz* 1974 US 94 SCT 1494; 39 L Ed 812 where it was said:

"In a sense a person is defined by the checks he writes. By examining them the agents get to know his doctors, lawyers, creditors, political allies, social connections, religious affiliation, educational interests, the papers and magazines he reads and so on *ad infinitum*."

65 *Faul Bankgeheim* 348 *et seq*; *Dhlomo NO v Natal Newspapers (Pty) Ltd* 1989 (1) SA 945 (A) at 953; *Caxton Ltd v Reeva Forman (Pty) Ltd* 1990 (3) SA 547 (A) at 560; *Financial Mail (Pty) Ltd v Sage Holdings Ltd* 1993 (2) SA 451 (A) at 461 *et seq*.

66 1988 (3) SA 726 (W) at 736.

67 [1924] 1 KB 461 at 473. These grounds of justification apply to South African law as well. See *Faul Bankgeheim* 480-481.

- where the disclosure is made by the express or implied consent of the customer.⁶⁸

Banking secrecy is founded on legislation, contract and the protection of privacy.⁶⁹

Statutory measures relating to a banker's duty of confidentiality provide no general foundation for its protection in South African law. As Fourie⁷⁰ points out, several legislative enactments apply to banking secrecy and expressly or impliedly give recognition to it.⁷¹ The new South African Code of Banking Practice also contains a clause informing the customer that its personal information will be treated as private and confidential and will not be disclosed other than in four exceptional cases "permitted by law".⁷²

Large inroads have recently been made into the duty of confidentiality, particularly where disclosure is compelled by law.⁷³ The prevention of money laundering, in particular, is an area where disclosure is increasingly required.⁷⁴

68 See, also, *Cywilnat (Pty) Ltd v Densam (Pty) Ltd* 1989 (3) SA 59 (W); *Densam (Pty) Ltd v Cywilnat (Pty) Ltd* 1991 (1) SA 100 (A) at 110-111. In England, see *Barclays Bank plc (Trading as Barclaycard) v Taylor* [1989] 1 WLR 1066; *Robertson v Canadian Imperial Bank of Commerce* [1995] 1 All ER 824.

69 Faul 1989 *TSAR* 145; Faul 1989 *De Jure* 312; Faul 1986 *TSAR* 180; Itzikowitz 1989 *BML* 225; Scott 1989 *SA Merc LJ* 248; Smith 1979 *MB* 24; Faul *Bankgeheim* 2-4; Fourie 1990 *South African Banker* 20 at 48; Review Committee *Banking Services* ch 28 *et seq.*

70 Fourie 1990 *South African Banker* 20 at 48.

71 See, eg, s 236(4) of the Criminal Procedure Act 51 of 1977; s 31 of the Civil Proceedings Evidence Act 25 of 1965; s 78 (13) of the Attorneys Act 53 of 1979; s 33 of the South African Reserve Bank Act 90 of 1989; s 74 of the Income Tax Act 58 of 1962; s 87(2) of the Banks Act 94 of 1990; Insolvency Act 24 of 1936.

72 See s 4.1.1 of the Code of Banking Practice.

73 See the examples quoted in n 71 *supra*. Neate *Bank Confidentiality* 205 points out that the Jack Committee (Review Committee *Banking Services*) identified at least nineteen statutory exceptions to the duty of confidentiality in England in 1987. Neate states that various new additions have reached the statute books since then. Malan & Pretorius *Bills of Exchange* 377 state:

"Banking secrecy has come under considerable pressure in recent times and disclosure of confidential information in appropriate circumstances in the public interest is increasingly required."

74 Malan & Pretorius *Bills of Exchange* 378 use as an example the money laundering provisions in the South African Drugs and Drug Trafficking Act 140 of 1992 which make it an offence to acquire any property knowing it to be the proceeds of a defined crime, or to convert property "while he knows or has reasonable grounds to suspect" that it is the proceeds of a defined crime. In addition, a duty is placed on directors, managers and

Disclosure of the customer's information to banking subsidiaries within the bank's group only, appears to be permissible.⁷⁵

Banks often obtain status opinions on the creditworthiness of third parties by addressing a request to the bank of the third party.⁷⁶ The provisions of the Code of Banking Practice deal specifically with the question of confidentiality. The Code promises the customer that its affairs shall be kept private and confidential, with the usual common-law exceptions.⁷⁷ As far as credit reference agencies are concerned, the Code reserves the bank's rights to disclose information about a customer's debt owing to the bank, where the customer has fallen behind with payments and has not made satisfactory arrangements for repayment, or where the customer has consented to disclosure. Where a cheque of the customer has been referred to drawer, that information is disclosed to a cheque verification service.⁷⁸ The Code promises that no other information will be given to the credit reference agencies without the customer's prior written consent.⁷⁹

Once it is clear that a bank is authorised to supply information to third parties, the question of the potential delictual liability of the bank supplying the reference to third parties, is raised. Our courts recognise a delictual action for damages where a negligent misrepresentation causes pure

executive officers of financial institutions to report to the authorities if they have reason to suspect that any property they have acquired, is the proceeds of a defined crime. A failure to do so is an offence. See, also, the South African Prevention of Organised Crime Act 24 of 1999. S 7 of this Act compels institutions to report suspicions regarding the proceeds of unlawful activities. See, also, Van Jaarsveld 2001 *SA Merc LJ* 580 for a discussion of the proposed Financial Intelligence Centre Bill.

75 *Bank of Tokyo Ltd v Karoon* [1987] AC 45 at 53-54; [1986] 3 All ER 468; Blair Allison Palmer Richards-Carpenter *Financial Services Act 134 et seq* (England); Faul *Bankgeheim* 180 *et seq*; Malan & Pretorius *Bills of Exchange* 378; s 2.8.1 of the South African Code of Banking Practice.

76 In *Parsons v Barclay and Co Ltd and Goddard* (1910) 103 LT 196, the Court referred to the very wholesome and useful habit whereby one banker in confidence answers, honestly, the query of another banker, with the customer's permission. See, also, *Royal Bank Trust Co (Trinidad) Ltd v Pampellone* [1987] 1 Lloyds Rep 218 (England); *Standard Chartered Bank of Canada v Nedperm Bank Ltd* 1994 (4) SA 747 (A) (South Africa); Holden *Practice* 10-51 *et seq*; Faul *Bankgeheim* 508 *et seq*; Malan & Pretorius *Bills of Exchange* 378; Neate *Bank Confidentiality* 13-14;

77 S 4.1 of the Code of Banking Practice. Importantly, s 4.1.1 states that disclosure will be made at the customer's request or with the customer's written consent.

78 S 4.2.1 of the Code of Banking Practice.

79 S 4.2 of the Code of Banking Practice.

economic loss.⁸⁰ *Standard Chartered Bank of Canada v Nedperm Bank Ltd*⁸¹ is a good example of the application of the delictual principles that applies where a bank has given an inaccurate or misleading status opinion about a customer.⁸²

A banker should constantly keep in mind that he owes his customer a duty of confidentiality.

80 See *Administrateur Natal v Trust Bank van Afrika Bpk* 1979 (3) SA 824 (A); *Siman and Co (Pty) Ltd v Barclays National Bank Ltd* 1984 (2) SA 888 (A); *Lillicrap Wassenaar and Partners v Pilkington Brothers (SA) (Pty) Ltd* 1985 (1) SA 475 (A); *International Shipping Co (Pty) Ltd v Bentley* 1990 (1) SA 680 (A); *Bayer SA (Pty) Ltd v Frost* 1991 (4) SA 559 (A) at 568; Beck 1985 SALJ 222; Boberg *Delict* 193 *et seq*; Boberg 1985 SALJ 213; Burchell 1980 SALJ 1; Hutchinson & Visser 1985 SALJ 587; Neethling & Potgieter 1980 *De Rebus* 179; Pretorius 1986 *De Jure* 57.

81 Case no 12673/89 WLD (19 3 92), overruled on appeal in 1994 (4) SA 747 (A).

82 In this case the court had to decide whether and under what conditions a bank incurred liability for a banker's inaccurate and misleading reference or status opinion concerning a customer. The plaintiff sued the defendant for damages allegedly suffered as a result of a negligent misstatement made by the defendant. Liability for negligent misstatement or negligent misrepresentation is accepted as part of our law. In *Administrateur Natal v Trust Bank van Afrika Bpk* it was established that a delictual action for damages is available to a plaintiff who can establish:

- that the defendant, or someone for whose actions the defendant is vicariously liable, has made a misstatement to the plaintiff;
- that in making this misstatement the person concerned has acted; (1) negligently and (2) unlawfully;
- that the misstatement has caused the plaintiff to sustain loss; and
- that the damages claimed represent proper compensation for such loss.

In *Standard Chartered Bank of Canada v Nedperm Bank Limited* 1994 (4) SA 747 (A) the Appellate Division found that the report given in that case was inaccurate and misleading. On the question of negligence the Appellate Division held that, given the comprehensive and intimate knowledge the defendant's officials had of the affairs of the customer (the defendant was the banker of the customer), a skilled banker, acting reasonably, would not have given the report in question. Corbett CJ said (at 762-763):

"It seems to me, therefore that the bank had either to give a true report [that is a report which truly reflected its knowledge of the position] or decline to give a report."

The court (at 764-765) found a causal connection, both factually and legally, between the loss suffered and the misrepresentation contained in the report, the loss being reasonably foreseeable. As far as unlawfulness is concerned, the court held (at 769 *et seq*) that this case was not of the kind that "raises the spectre of limitless liability or places an undue or unfair burden upon the bank": the defendant could have refused to give the report or it could have disclaimed liability for negligence. The court rejected (at 773 *et seq*) the defendant's contention that the plaintiff had been contributorily negligent and gave judgement (at 774 *et seq*) for delictual damages in a foreign currency, being the currency in which the loss was "felt" and which was foreseeable as such.

When dealing with a surety, it would be preferable for the bank to obtain the customer's consent in order to make full disclosure to the surety.

8.3 THE BANKER'S LIABILITY FOR ADVICE AND OTHER LENDER LIABILITY ASPECTS

8.3.1 Liability to customer

Although a discussion of the banker-customer relationship as far as bills, cheques and notes are concerned, is outside the scope of this thesis, the bank has two important duties that bear mention.

An important consequence of the banker-customer relationship is the banker's duty to honour his customer's cheques. The duty of the banker to pay is subject to certain conditions, which arise by implication from the contract between the customer and the banker and has been defined by Malan and Pretorius⁸³ as follows:

"It is the duty of a bank to pay cheques drawn by the customer that are in all respects genuine and complete, on demand, provided sufficient funds or credit for their payment are available in the customer's account."

Where a bank dishonours a cheque it is bound to pay, it commits a breach of contract and, in certain circumstances, also a delict, which renders it liable to its customer under either or both these heads for loss suffered by him.⁸⁴

As a result of the bank's breach the customer is entitled to claim not only general damages,⁸⁵ but

83 Malan & Pretorius *Bills of Exchange* 348. For authority, the authors refer to *Bate v Heywood* (1882) 2 EDC 153; *Trull v Standard Bank of South Africa Ltd* (1892) 4 SAR 203; *Bank of Baroda Ltd v Punjab National Bank Ltd* [1944] All ER 83 at 87; (1944) AC 176 at 184 (England); *Kircos v Standard Bank of Southern Africa Ltd* (1958) (4) SA 58 (SR); *Volkscas Beperk v Van Aswegen* 1961 (1) SA 493 (A); *Kearney NO v Standard Bank of South Africa Ltd* 1961 (2) SA 647 (T); *Stapelberg NO v Barclays Bank (DC & O)* 1963 (3) SA 120 (T); *Trust Bank of Africa Ltd v Marques* 1968 (2) SA 796 (T); *Karak Rubber Co Ltd v Burden* (2) [1972] 1 All ER 1210 at 1229 (England).

84 *First National Bank of South Africa Ltd v Budree* 1996 (1) SA 971 (N) at 981-982; *Cowen Instruments* 394-415; *Van der Merwe* 1964 *THRHR* 310; *Chorley & Smart Cases* 129; Malan & Pretorius *Bills of Exchange* 371; Joubert (ed) 19 *LAWSA* par 155.

85 This means damages "that flow naturally and generally from the kind of breach of contract in question and which the law presumes that the parties contemplated would

also, if he is a trader or businessman, special damages for injury to his creditworthiness⁸⁶ or goodwill.⁸⁷ Special damages must be specifically pleaded.⁸⁸

Various factors have been taken into account by the courts in determining the amount of special damages.⁸⁹ It must be borne in mind that the plaintiff's claim is directed at obtaining damages for

result from such a breach". See *Shatz Investments (Pty) Ltd v Kalovyrnas* 1976 (2) SA 545 (A) at 550; *Jonker v Boland PKS Bpk* 2000 (1) SA 542 (O) and see *Van der Merwe et al Contract* 304 *et seq.* In *First National Bank of South Africa Ltd v Budree* 1996 (1) SA 971 (N) at 981 it was held that a customer whose cheque had been dishonoured by his bank in breach of its contractual obligations was entitled to recover from the bank such patrimonial loss as was occasioned by the breach and was within the contemplation of the parties to the contract.

86 See *Van der Merwe* 1964 *THRHR* 310.

87 In *Trust Bank of Africa Ltd v Marques* 1968 (2) SA 796 (T) 98 the following was held:

"It is clear... that it is not in every case that a customer, whose cheque has been dishonoured, is entitled to recover damages for injury to his credit. He is only so entitled where he is a business man or trader."

Malan & Pretorius Bills of Exchange 372 n 211 also refer to *Freeman v Standard Bank of South Africa Ltd* 1905 TH 26 at 30-31; *Witbank District Coal Agency v Barclays Bank* 1928 TPD 18 at 23; *Barclays Bank v Giles* 1931 TPD 31 at 34; *Van Aswegen v Volkskas Bpk* 1960 (3) SA 81 (T) at 82-83; *Klopper v Volkskas Bpk* 1963 (1) SA 930 (T) at 933 and 1964 (2) SA 421 (T) at 424-425; *First National Bank of South Africa Ltd v Budree* 1996 (1) SA 971 (N) at 980-981.

88 In *Trust Bank of Africa Ltd v Marques* 1968 (2) SA 796 (T) at 798-799 the court indicated that it must be alleged that the customer conducted a business with the knowledge of the bank in order to show that the damages claimed fell within the contemplation of the parties. In *Lavery v Jungheinrich* 1931 AD 156 at 162 it was said that:

"Not only must the contract be entered into 'with the knowledge and in view of these special circumstances'... but... it must also be 'so far in the mind and contemplation of the parties as virtually to be a term of the contract' that such damages are to be recoverable...."

See *Shatz Investments (Pty) Ltd v Kalovyrnas* 1976 (2) SA 545 (A) 552 where the above passage from *Lavery v Jungheinrich* was cited with approval and see *First National Bank of South Africa Ltd v Budree* 1996 (1) SA 971 (N) at 980; Joubert (ed) 19 *LAWSA* par 155; *Malan & Pretorius Bills of Exchange* 372.

89 See *Malan & Pretorius Bills of Exchange* 373 and the cases that they refer to in the footnotes. Some of these factors are the fact that the plaintiff was a well-regarded inhabitant of a certain town whose cheques had never been dishonoured; the inconvenience suffered by the plaintiff; the number of people who came to know of the dishonour; the words placed on the cheque when it was dishonoured and the size of the plaintiff's business; the fact that the holder was an influential person on whom the plaintiff depended; the seriousness of the injury to the plaintiff's creditworthiness; and the unyielding attitude of the bank as well as the fault of the plaintiff.

injury to his creditworthiness,⁹⁰ therefore, once the breach of contract is proved, loss is presumed and no proof of actual damage is required.⁹¹

Malan and Pretorius identify another ground upon which a customer can base his claim against his bank for the wrongful dishonouring of a cheque, namely on the wrongful and culpable infringement of his right to the goodwill of his business.⁹² If this is the case, the two actions, namely, in delict and for breach of contract, will be cumulative, but if he sues in delict he has to prove fault on the part of the bank.⁹³

The dignity or privacy of the customer may also be injured by the wrongful dishonouring of a cheque, but⁹⁴ to succeed with the *actio iniuriarum* he has to prove that the cheque was

90 In *Barclays Bank v Giles* 1931 TPD 31 at 35 it was stated:

"Whenever it can be established that the occupation of a person is such that credit is an essential element in the conduct of his business, a bank which injures his credit by refusing to honour cheques when funds are available would be liable in damages without proof of actual loss."

See *Witbank District Coal Agency v Barclays Bank* 1928 TPD 18 at 23; Van der Merwe 1964 THRHR 310 at 313; *Bekker Dishonouring* 74; *First National Bank of South Africa Ltd v Budree* 1996 (1) SA 971 (N) at 981.

91 See the authority quoted in the previous footnote. In an earlier Natal case nominal damages were awarded. See *Hodges v Standard Bank of SA Limited* 1916 NPD 91. The concept of awarding nominal damages has, however, been rejected. See *First National Bank of South Africa Ltd v Budree* 1996 (1) SA 971 (N) at 980.

92 Malan & Pretorius *Bills of Exchange* 373. See, also, *Goldsmith v Bank of Africa* (1882) 1 HCG 53 at 55; *Trust Bank of Africa Ltd v Marques* 1968 (2) SA 796 (T) at 799; *First National Bank of South Africa Ltd v Budree* 1996 (1) SA 971 (N) at 982; *Bekker Dishonouring* 119-131.

93 *First National Bank of South Africa Ltd v Budree* 1996 (1) SA 971 (N) at 981-982; Malan & Pretorius *Bills of Exchange* 373. Cumulation has been described by Van Aswegen *Sameloop* 388 as follows:

"In stede van een van die samelopende moontlikhede voor te skryf of uit te kies, word voorgestel dat die eise of eisgronde naas mekaar in dieselfde geding aangewend word."

Freely translated, this means that instead of prescribing or selecting one of the cumulative possibilities, it is recommended that the claims be pleaded alternatively in the same case.

94 *Goldsmith v Bank of Africa* (1882) 1 HCG 53; *Leon v Natal Bank* (1899) 6 OR 177; *Bekker v Standard Bank* (1900) 15 EDC 6.

dishonoured *animo iniuriandi*.⁹⁵

A bank dishonouring a cheque may also be liable for defamation if it uses defamatory words or expressions to indicate the fact of dishonour.⁹⁶ Malan and Pretorius submit that the test for liability would appear to be the intimation that the drawer has defaulted as to the time for performance, being payment on presentation.⁹⁷

In terms of s 78(4) and s 81 of the Bills of Exchange Act 34 of 1964, the possessor of a lost or stolen cheque can be held strictly liable to the owner. Section 78 (4) provides that if a bank on which a cheque is drawn pays it contrary to the provisions of the subsection, it will be liable to the owner for any loss he may suffer as a result of the cheque having been paid. In terms of s 81, the possessor of a lost or stolen cheque that has been crossed and marked "not negotiable" can, provided certain conditions are met, incur liability to the true owner.⁹⁸ Malan and Pretorius

95 In *First National Bank of South Africa Ltd v Budree* 1996 (1) SA 971 (N) at 981-982 Page J states:

"Although the pleading under attack in the present matter is expressly confined to breach of contract as a cause of action, I must make it clear that nothing I have said is intended to deny the client the right to claim, in addition to patrimonial loss for breach of contract, those forms of damages which are recoverable by way of the *actio ex lege Aquilia* and/or the *actio iniuriarum* or an action for defamation, subject only to two provisos. The first is that the conduct of the bank in dishonouring the cheque answers to the requirements for liability under these respective actions, viz wrongfulness and *culpa* for the *lex Aquilia* and wrongfulness and *animus iniuriandi* for the *actio iniuriarum* or defamation. The second is that, if claims based upon one or more of these causes of action are brought in the same proceedings as a claim for breach of contract, they should be entirely separately pleaded, since the requirements for liability for each and the type of damages recoverable under each are different."

See, also, *Brenner v Botha* 1956 (3) SA 257 (T) at 261; *Taljaard v S & VA Rosendorff & Venter* 1970 (4) SA 48 (O) 53; *Bekker Dishonoring* 102; *Cowen Instruments* 412; *Sharrock & Kidd Cheque Law* 49; Malan & Pretorius *Bills of Exchange* 374.

96 Eg, using the words "not provided for". See *Haine v De Nederlandsche Bank voor Zuid Afrika* 1924 WLD 139 and see *Van Aswegen v Volkskas Bank Bpk* 1960 (3) SA 81 (T); *Klopper v Volkskas Bank Bpk* 1963 (1) SA 930 (T); 1964 (2) SA 421 (T); *Trust Bank of Africa Ltd v Marques* 1968 (2) SA 796 (T). *Bekker Dishonoring* 3; Joubert (ed) 19 *LAWSA* par 155; Malan & Pretorius *Bills of Exchange* 374; Burchell *Defamation 7 et seq*. For all the elements of defamation, see Neethling *Persoonlikheidsreg* 125.

97 Malan & Pretorius *Bills of Exchange* 374. As authority, the authors refer to *Baker v Australia and New Zealand Bank* 1958 NZLR 907.

98 Joubert (ed) 19 *LAWSA* par 160

submits that in neither of these two cases is fault a requirement for liability.⁹⁹

A collecting banker can also be held liable under the extended *lex Aquilia* for negligence to the true owner¹⁰⁰ of a cheque, provided all the elements or requirements of Aquilian liability have been met.¹⁰¹ In addition to unlawful conduct, the bank has to be negligent as well in order to incur liability. When the liability of a professional is in question, the standard of care against which his conduct has to be measured is that which may reasonably be expected of a person engaged in that profession.¹⁰²

In the matter of *Durr v ABSA Bank Ltd and Another*¹⁰³ the question of a banker's investment advice to a customer, came under scrutiny. In this case, the regional manager of the brokering division of a bank, professing investment skills, offered expert investment advice to the plaintiff. The manager failed to investigate the creditworthiness of the institutions in which he had recommended the investment. In addition, the manager had, in fact, not been entitled to venture into a field in which he professed certain skills (which he did not have), and to give assurances to the plaintiff about the soundness of the investments, which he had not been qualified to give. The Court found, in this instance, that the manager was negligent in engaging voluntarily in a potentially dangerous activity without the skill and knowledge usually associated with the proper

99 *Malan & Pretorius Bills of Exchange* 427. See, also, *Barlow Motors Investments Ltd v Smart* 1993 (1) SA 347 (W) at 350; Joubert (ed) 19 *LAWSA* par 160; Cowen *Negotiable Instruments* 206.

100 The duty extends only to the true owner of the cheque. See *Strydom NO v ABSA Bank Bpk* 2001 (3) SA 185 (T).

101 See *Indac Electronics (Pty) Ltd v Volkskas Bank Ltd* 1992 (1) SA 783 (A) at 797 followed in *KwaMashu Bakery Ltd v Standard Bank of South Africa Ltd* 1995 (1) SA 377 (D). See, also, *Fedgen Insurance Ltd v Bankorp Ltd* 1994 (2) SA 399 (W); *Greater Johannesburg Transitional Metropolitan Council v ABSA Bank Ltd t/a Volkskas Bank* 1997 (2) SA 591 (W); *Powell and Another v ABSA Bank Ltd t/a Volkskas Bank* 1998 (2) SA 807 (SE) at 815; *Columbus Joint Venture v ABSA Bank Ltd* 2000 (2) SA 491 (W); *ABSA Bank Ltd v Bond Equipment (Pretoria) (Pty) Ltd* 2001 (1) SA (A) 372; Malan & Pretorius 1994 *SA Merc LJ* 218; Nagel 1995 *De Jure* 217.

102 See *Van Wyk v Lewis* 1924 AD 438 at 444; *Bolam v Friern Hospital Management Committee* [1957] 2 All ER 118 at 121-122 (England); *Rhostar (Pvt) Ltd v Netherlands Bank of Rhodesia Ltd* 1972 (2) SA 703 (R) at 717; *Randaree NNO v WH Dixon and Associates* 1983 (2) 1 (A) at 4; *Durr v ABSA Bank Ltd and Another* 1997 (3) SA 448 (SCA) at 460; *Powell and Another v ABSA Bank t/a Volkskas Bank* 1998 (2) SA 807 (SE) at 819; Pretorius 1987 *MB* 56 at 57; Joubert (ed) 19 *LAWSA* par 160.

103 1997 (3) SA 448 (A).

discharge of the duties connected with such an activity.¹⁰⁴

8.3.2 Liability to third parties

As we have seen under the sub-chapter on bank confidentiality,¹⁰⁵ a bank often provides other banks with status opinions on the creditworthiness of a client. A bank can attract delictual liability towards third parties to whom credit references are given, if negligent misstatements or negligent misrepresentations are made by the banker.¹⁰⁶

8.3.3 Suretyship defences

A surety enjoys various defences and benefits in terms of South African law. Firstly, the General Law Amendment Act 50 of 1956¹⁰⁷ provides that no contract of suretyship entered into after the commencement of the Act, shall be valid unless the terms thereof are embodied in a written document signed by or on behalf of the surety.

This piece of legislation has led to much litigation in regard to what terms should be embodied in the contract,¹⁰⁸ the oral variation of the contract,¹⁰⁹ rectification,¹¹⁰ the signing¹¹¹ of blank

104 See, also, *Van Wyk v Lewis* 1924 AD 438; Joubert (ed) 8 *LAWSA* par 94. Malan & Pretorius 2001 *THRHR* 268 at 270 states:

"In the context, the investor was entitled to accept that the adviser was skilled to advise her on her investments and as one backed by a major financial organisation."

105 Sub-chapter 8.2.

106 See *Administrateur Natal v Trust Bank van Afrika Bpk* 1979 (3) SA 824 (A); *Siman and Co (Pty) Ltd v Barclays National Bank Ltd* 1984 (2) SA 888 (A); *Lillicrap Wassenaar and Partners v Pilkington Brothers (SA) (Pty) Ltd* 1985 (1) SA 475 (A); *Standard Chartered Bank of Canada v Nedperm Bank Ltd* 1994 (4) SA 747 (A).

107 S 6 of Act 50 of 1956 as amended by s 34 of the General Law Amendment Act 80 of 1964.

108 *Swiftair Freight CC v Singh* 1993 (1) SA 454 (D); *Standard Bank of SA Ltd v Cohen* (1) 1993 (3) SA 846 (SECL); *Foullamel (Pty) Ltd v Maddison* 1977 (1) SA 333 (A); *Sapirstein and Others v Anglo African Shipping Co (SA) Ltd* 1978 (4) SA 1 (A).

109 *Oceanair (Natal) (Pty) Ltd v Sher* 1980 (1) SA 317 (D); *Plascon-Evans Paints (Tvl) Ltd v Virginia Glass Works (Pty) Ltd* 1983 (1) SA 465 (O); *Ferreira v SAPDC (Trading) Ltd* 1983 (1) SA 235 (A).

110 *Trust Bank of Africa Ltd v Frysch* 1976 (2) SA 337 (C); *Neuhoff v York Timbers Ltd* 1981 (4) SA 666 (T); *Kroukamp v Buitendag* 1981 (1) SA 606 (W) at 609; *Standard Bank of*

spaces,¹¹² and the presence or not of the signature of a co-surety.¹¹³

A surety may rely upon and plead all the defences which the principal debtor has against the creditor, except those defences that are purely personal to the principal debtor.¹¹⁴ Examples of the defences attaching to the principal obligation itself are illegality, fraud, mistake, duress, and payment. After the decision in *Bank of Lisbon and South Africa Ltd v De Ornelas and Another*¹¹⁵ in which the *exceptio doli generalis* was banished, our courts were flooded with matters where defences were raised that suretyship agreements or certain of their clauses were contrary to public policy. Most of these defences were turned down, and where it was found that a certain clause in an agreement was against public policy, it was held to be severable from the rest of the agreement.¹¹⁶

From the fact that the obligation between creditor and surety is contractual, it follows necessarily that a surety can rely on and plead any defence, whether *in rem* or *in personam*, generally available to a contracting party.¹¹⁷

SA Ltd v Cohen (2) 1993 (3) SA 854 (SECL).

- 111 *African Life Property Holdings (Pty) Ltd v Score Food Holdings Ltd* 1995 (2) SA 230 (A).
- 112 *Fourlamel (Pty) Ltd v Maddison* 1977 (1) SA 333 (A); *Standard Bank of SA Ltd v Jaap De Villiers Beleggings (Edms) Bpk* 1978 (3) SA 955 (W); *Johnston v Leal* 1980 (3) SA 927 (A); *Progress Knitting & Textiles Ltd v Nefic Investments (Pty) Ltd* 1992 (4) SA 105 (N).
- 113 *Nelson v Hodgetts Timbers (East London) (Pty) Ltd* 1973 (3) SA 37 (A); *Industrial Development Corporation of SA Ltd v See Bee Holdings (Pty) Ltd* 1978 (4) SA 136 (C) at 137; *Société Commerciale de Moteurs v Ackermann* 1981 (3) SA 422 (A).
- 114 *Pothier Obligations* pars 380-381; *Hastie v Dunstan* (1892) 9 SC 449; *Eaton Robins & Co v Nel* (2) (1909) 26 SC 624; *Worthington v Wilson* 1918 TPD 104; *Ideal Finance Corporation v Coetzer* 1970 (3) SA 1 (A); *Standard Bank of SA Ltd v SA Fire Equipment (Pty) Ltd* 1984 (2) SA 693 (C); *Barclays National Bank Ltd v Von Varendorff* 1985 (2) SA 544 (D) at 549.
- 115 1988 (3) SA 580 (A).
- 116 *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A); *Conshu Holdings Ltd v Lawless* (1992) CLD 275 (W); *Volkskas Bank Bpk v Theron* 1992 CLD 336 (T); *Standard Bank Financial Nominees (Pty) Ltd v Bamberger* 1992 CLD 308 (W); *Pangbourne Properties Ltd v Nitor Construction (Pty) Ltd* 1993 (4) SA 206 (W); *First National Bank of SA Ltd v Sphinx Fashions CC* 1993 (2) SA 721 (W); *Standard Bank of SA Ltd v Wilkinson* 1993 (3) 822 (C).
- 117 Joubert (ed) 26 *LAWSA* par 202; Forsyth & Pretorius 1993 *SAMerc LJ* 187-189; Kotze 1995 *Stell LR* 105.

In addition, a surety is entitled at common law to a number of defences or benefits peculiar to the contract of suretyship, such as the benefit of excussion, the benefit of cession of actions, and the benefit of division.¹¹⁸ A bank would, however, normally require a surety to renounce these benefits, and I do not intend discussing this aspect in detail.

8.4 THE DUTY OF DISCLOSURE OF MATERIAL FACTS IN THE SOUTH AFRICAN LAW OF CONTRACT

8.4.1 Liability for misrepresentation

The general norm or yardstick used to test for unlawfulness in a case of delictual misrepresentation is the *boni mores*.¹¹⁹ The *boni mores* test is an objective test of reasonableness, the central question being whether the delinquent has, in view of all the circumstances of the case, reasonably or unreasonably infringed the rights of the injured party according to the "legal convictions or feelings of the community".¹²⁰

In determining whether conduct is of such a nature as to be determined unlawful, the court must carefully balance and evaluate the interests of the concerned parties, the relationship of the parties and the social consequences of the imposition of liability in that particular type of situation.¹²¹

118 See Joubert (ed) 26 *LAWSA* pars 203-205.

119 See, eg, *Minister van Polisie v Ewels* 1975 (3) SA 590 (A); *Universiteit van Pretoria v Tommie Meyer Films (Edms) Bpk* 1977 (4) SA 376 (T); (and on appeal 1979 (1) SA 441 (AA)); *Administrateur Natal v Trust Bank van Afrika Bpk* 1979 (3) SA 824 (A); *Marais v Richard* 1981 (1) SA 1157 (A); *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd* 1982 (4) SA 371 (D); *Scultz v Butt* 1986 (3) SA 667 (A).

120 *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd* 1982 (4) SA 371 (D) at 380. In *Compass Motors Industries (Pty) Ltd v Callguard (Pty) Ltd* 1990 (2) SA 520 (W) at 528-529 Van Zyl J shows that the *boni mores* yardstick is linked to the concept of good faith in our common law, and continues:

"This indicates that the community's perception of the *boni mores* is closely linked to the concept of good faith in community relations. These concepts, again, are similarly associated with the community's perception of justice, equity, good faith and reasonableness. This has been recognised not only in historical and comparative context, but in the contemporary decisions of our own Courts... From this it appears that public policy, in the sense of *boni mores*, cannot be separated from concepts such as justice, equity, good faith and reasonableness, which are basic to harmonious community relations and may indeed be regarded as the purpose of applying public policy considerations."

121 *Minister van Polisie v Ewels* 1975 (3) SA 590 (A) at 596-597; *Universiteit van Pretoria v Tommie Meyer Films (Edms) Bpk* 1977 (4) SA 376 (T) at 387; *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd* 1982 (4) SA 371 (D) at 384. See, also, *Hawker*

As far as contractual misrepresentation is concerned, it would appear as if our courts have generally accepted that a misrepresentation *in contrahendo* must also be treated as a delict.¹²²

One would expect that the test for the existence of a duty to disclose facts to another contracting party would be the *boni mores* as well. However, that is not always the case¹²³ and, furthermore, there is a difference in opinion as to what the correct test is.¹²⁴

8.4.2 Misrepresentation by silence

The pertinent question raised by disclosure is: when does silence, which by itself, does not as a general rule, give rise to a remedy in law,¹²⁵ come within the rules of non-disclosure? The answer is simply that disclosure is called for when there is a legal duty to disclose.¹²⁶

In *Mutual and Federal Insurance Co Ltd v Oudtshoorn Municipality*¹²⁷ it was held that because

v Life Offices Association of South Africa 1987 (3) SA 777 (C) at 781.

122 See, eg, *Ranger v Wykerd* 1977 (2) SA 976 (A); *Novick v Comair Holdings Ltd* 1979 (2) SA 116 (W) 149-150. Van der Merwe *et al Contract* 78 is of the opinion that a representation which occurs during the course of contractual negotiations will therefore be wrongful if it infringes a norm protecting a contracting party against being misled.

In our modern SA law of contract, the party to whom a representation is made is under no obligation to ascertain whether it is a misrepresentation, and may rely on it without making further enquiries even if the ascertainment of the truth would be a simple matter and he was negligent in not ascertaining it. See *Wiley v African Realty Trust Ltd* 1908 TH 104 at 111-112; *Symons and Moses v Davies* 1911 NPD 69 at 82-83; *Sampson v Union and Rhodesia Wholesale Ltd* 1929 AD 468 at 479-480; *Strydom v Scheepers* 1942 GWL 73 at 84; *Oranje Benefit Society v Central Merchant Bank Ltd* 1976 (4) SA 659 (A).

123 English law draws a clear distinction between misrepresentation and non-disclosure. See *Fox v Mackreth* (1788) 2 Cox Eq Cas 320 at 320; *Walters v Morgan* (1861) 3 De GF & J 718 at 723-724; *Turner v Green* [1895] 2 Ch 205; *Bell v Lever Brothers Ltd* [1932] AC 161 at 227.

124 See Christie *Contract* 311-312 for the test of involuntary reliance; Kerr *Principles* 221 for a good-faith test.

125 See *Speight v Glass and Another* 1961 (1) SA 778 (D) at 781; Millner 1957 SALJ 177.

126 *Meskin NO v Anglo-American Corporation of SA Ltd and Another* 1968 (4) SA 793 (W) at 796; *Gollach & Gomperts (1967) (Pty) Ltd v Universal Mills & Produce Co (Pty) Ltd and Others* 1978 (1) SA 914 (A) at 924; Kerr *Principles* 221.

127 1985 (1) SA 419 (A).

duties to disclose material¹²⁸ facts exist only exceptionally, they could not be said to arise *ex fide bona*, that is on account of the norm of good faith applicable to contracts generally. The duty to disclose, it was said, arises *ex lege* when circumstances demand it.

In a considered *obiter dictum*, Jansen J in *Meskin v Anglo-American Corporation of SA Ltd*¹²⁹ propounds a different view, according to which good faith serves as a criterion for evaluating the conduct of the parties to a contract in respect of its antecedent negotiation:

"Where a contract is concluded the law expressly invokes the dictates of good faith and conduct inconsistent with those dictates may in appropriate circumstances be considered to be fraud."

Jansen J accepted¹³⁰ that good faith was "a concept of variable content the in light of changing mores and circumstances" which "as an objective standard must rest largely upon an ethical basis", and furthermore accepted that ethical ideals had, in the application of the norm of good faith, to be tempered by the "practicalities with which the law is faced". Using this approach, the norm of good faith does not require a general duty to disclose, as Joubert JA in the case of *Mutual and Federal Insurance Co Ltd v Oudtshoorn Municipality*¹³¹ seemed to think. This point is important because the contractual test of *bona fides* may well require a consideration of circumstances not encompassed by the general test for delictual liability for omissions.¹³²

In certain circumstances the case law has already established that silence may amount to a

128 The requirement that a misrepresentation must be material is sometimes expressed on the basis that the representation must be such as would have persuaded a reasonable man to enter into the contract. This postulates an objective test. See Christie *Contract* 312; Van der Merwe *et alia Kontraktereg* 80; Pretorius *v Natal South Sea Investment Trust Ltd (Under Judicial Management)* 1965 (3) SA 410 (W) at 416; Orban *v Stead* 1978 (2) SA 713 (W) at 717; Novick *v Comair Holdings Ltd* 1979 (2) SA 116 (W) at 149; *Standard Bank of SA Ltd v OK Bazaars (1929) Ltd* 2000 (4) SA 382 (W). In *Qilingele v South African Mutual Life Assurance Society* 1993 (1) SA 69 (A) a distinction was created between two different tests for materiality, depending on whether the misrepresentation was by way of omission (in which case it would be governed by the common-law position, namely an objective test) or by way of commission (in which case a subjective test for materiality would apply). This case is discussed further in this paragraph, *infra*.

129 1968 (4) SA 793 (W) at 802.

130 *Ibid*, at 804.

131 1985 (1) SA 419 (A).

132 See Farlam & Hathaway *Contract* 337.

misrepresentation,¹³³ or at least requires a duty of disclosure, for example, where part of the truth has been told, but the omission of the remainder gives a misleading impression,¹³⁴ where a true representation has been made, but before the making of the contract the facts have changed,¹³⁵ where a party, not necessarily with a dishonest motive, has done something which has had the effect of concealing facts which would otherwise have been apparent to the other party,¹³⁶ where a party presents for signature to the other a standard term contract without drawing attention to an unusually onerous clause, in circumstances where he must have known that the signatory would not read the contract and discover the clause.¹³⁷ Certain rules in regard to the duty of disclosure in contracts of sale have also crystallised,¹³⁸ but the disclosure principles relating to sales fall outside the scope of this thesis.

Our law also recognizes the duty of a prospective insured to disclose facts material to the risk to be taken by the insurer.¹³⁹ Much controversy exists in insurance law in regard to the test to be applied to determine materiality of a non-disclosure or misrepresentation. At common law, the insured is required to disclose all material facts to the insurer. Failure to do so renders the insurance contract voidable at the option of the insurer. The insurer has to prove that the non-disclosed fact was material. Materiality of a non-disclosure is judged objectively from the point of view of the average prudent person or reasonable man.¹⁴⁰ The effect of a misrepresentation as to a material fact has a similar effect.¹⁴¹

133 See *Christie Contract* 309.

134 *Marais v Edelman* 1934 CPD 212.

135 *Viljoen v Hillier* 1904 TS 312 at 315-316; *Cloete v Smithfield Hotel (Pty) Ltd* 1955 (2) SA 622 (O) at 626-627.

136 *Dibley v Furter* 1951 (4) SA 73 (C); *Knight v Hemming* 1959 (1) SA 288 (FC).

137 *Kempston Hire (Pty) Ltd v Snyman* 1988 (4) SA 465 (T).

138 *Van der Merwe v Meades* 1991 (2) SA 1 (A); *Truman v Leonard* 1994 (4) SA 371 (SE).

139 See *Iscor Pension Fund v Marine and Trade Insurance Co Ltd* 1961 (1) SA 178 (T); *Mutual and Federal Insurance Co Ltd v Oudtshoorn Municipality* 1985 (1) SA 419 (A); *Gordon v AA Mutual Assurance Association Ltd* 1988 (1) SA 398 (W); *Trust Bank van Afrika Bpk v President Versekeringsmaatskappy Bpk* 1988 (1) SA 546 (W).

140 See *Mutual and Federal Insurance Co Ltd v Oudtshoorn Municipality* 1985 (1) SA 419 (A) at 435; *President Versekeringsmaatskappy Bpk v Trust Bank van Afrika Bpk en 'n Ander* 1989 (1) SA 208 (A) at 216; *Pillay v South African National Life Assurance Co Ltd* 1991 (1) SA 363 (D) at 367.

141 *Christie Contract* 312; *Van der Merwe et al Kontraktereg* 80.

In terms of the common-law position, insurers had a double *onus*, namely to prove not only materiality, but also inducement, or causation in a delictual context.¹⁴² Insurers therefore devised a method of overcoming this burden. In *Clifford v Commercial Union Insurance Co of SA Ltd*¹⁴³ Schutz JA explained their method as follows:

"Long ago insurers discovered a way of lightening the load of this double *onus*. The method used was to exact a warranty from the prospective insured, in which he warranted the truth and materiality of his representations and assented to their inclusion as essential terms of the policy. The effect of this was that all the insurer had to prove was the incorrectness of the insured's statement. That done there was a breach of warranty, giving the insurer a contractual right to repudiate liability. Once the insured had warranted that the answers to questions in the proposal form would be the basis of the insurance contract there was no question of materiality left, ..."

Needless to say, this resulted in inequity and s 63 (3) of the Insurance Act 27 of 1943 was enacted in order to prevent this. It read as follows:

"Notwithstanding anything to the contrary contained in any domestic policy or any document relating to such policy, any such policy issued before or after the commencement of this Act shall not be invalidated and the obligations of an insurer thereunder shall not be excluded or limited and the obligations of the owner thereof shall not be increased, on account of any representation made to the insurer which is not true, whether or not such representation has been warranted to be true, unless the incorrectness of such representation is of such a nature as to be likely to have materially affected the assessment of the risk under the said policy at the time of issue or any reinstatement or renewal thereof."

The effect of the section was that misrepresentations which impacted materially on the insurer's assessment of the risk of insuring the insured, would render the insurance contract voidable at the option of the insurer. The section applied only to positive misrepresentations and not to non-disclosures which continued to be regulated by the principles of the common law.

142 See *Clifford v Commercial Union Insurance Co of SA Ltd* 1998 (4) SA 150 (A) at 156.

143 *Ibid*, at 156-157.

In *Qilingele v South African Mutual Life Assurance Society*¹⁴⁴ the wording of the section was interpreted as creating a subjective test of materiality. Questions of objective reasonableness did not enter the picture — all that was relevant was the particular insurer and how it was likely to have reacted had it known the truth. This subjective approach stands in contrast to the earlier decisions as to the test of materiality in non-disclosure cases.¹⁴⁵

In the *Qilingele*¹⁴⁶ case a distinction was made between misrepresentation by silence and misrepresentation by making a false statement, and it was this distinction that was used as the basis for deviating from the earlier decisions starting with the *Oudtshoorn*¹⁴⁷ case. The reasoning of the Court was that the *Qilingele*¹⁴⁸ case dealt with a positive misstatement as opposed to non-disclosure dealt with in the *Oudtshoorn*¹⁴⁹ case. The *Oudtshoorn* case was governed by the common law whilst the *Qilingele* case was concerned with the proper statutory interpretation of the word "materiality" as used within s 63 (3) of the Insurance Act 27 of 1943.

The *Qilingele* case therefore created a distinction between two different tests for materiality, depending on whether the misrepresentation was by way of omission or by way of commission. This distinction was followed in *Theron v AA Life Assurance Association Ltd* 1995 (4) SA 361 (A).¹⁵⁰ The distinction between the two types of misrepresentation has been criticized by many academic writers.¹⁵¹

144 1993 (1) SA 69 (A) at 74-75.

145 See *Mutual and Federal Insurance Co Ltd v Oudtshoorn Municipality* 1985 (1) SA 419 (A) at 435; *President Versekeringsmaatskappy Bpk v Trust Bank van Afrika Bpk en 'n Ander* 1989 (1) SA 208 (A) at 216; *Pillay v South African National Life Assurance Co Ltd* 1991 (1) SA 363 (D) at 367.

146 1993 (1) SA 69 (A) at 73.

147 1985 (1) SA 419 (A).

148 1993 (1) SA 69 (A).

149 1985 (1) SA 419 (A).

150 1995 (4) SA 361 (A). In this case the divergent tests were adopted and applied to different aspects of the case. See Havenga 1996 *THRHR* 339 for a critical discussion.

151 See, eg, Reinecke 1993 *TSAR* 771; Madhuku 1994 *SALJ* 477; Havenga 1995 *SA Merc LJ* 90; Havenga 1996 *THRHR* 339; Madhuku 1997 *SALJ* 759; Barrett 1998 *JBL* 124; Schulze 1998 *SA Merc LJ* 248; Schulze 2001 *De Rebus* 46. The decision in the *Qilingele* case 1993 (1) SA 69 (A) was followed in *Joubert v ABSA Life Ltd* 2001 (2) SA 322 (W) as the Court was bound by it. The Court applied a subjective, particular insurer, test as formulated in the *Qilingele* case, but found that, even if it had applied an objective test to the facts:

The decision in the *Qilingele* case has also received judicial criticism, albeit *obiter* in *Clifford v Commercial Union Insurance Co of SA Ltd*.¹⁵² Schutz JA found that the words "the assessment of risk under the said policy" were capable of a different interpretation, consistent with the common-law test of materiality,¹⁵³ and invoked the presumption against changing the common law in support of his interpretation, stating that the court in the *Qilingele* case did not give any reasons as to why the legislature could have intended to "cast the well-tryed common-law concept of materiality out of the window" and to change the law in such a drastic yet subtle way.¹⁵⁴ A further criticism leveled against the *Qilingele* case by Schutz JA (at 156-157) concerns the fact that the court in the *Qilingele* case (at 75) incorrectly treated the question of materiality and inducement as a single concept. Schutz JA concludes:

"The manifest purpose of the provision [s 63 (3)] is to improve the lot of the insured, not to worsen it or to give with the one hand and take away with the other. An interpretation of the provision which involves an apparent amelioration of the insured's position but brings with it a benefit for the insurer which the common law steadfastly refused to give him is, in my view, inherently suspect. For these reasons I consider that the decision of Didcott J in *Pillay v South African National Life Assurance Co Ltd* 1991 (1) SA 363 (D) at 367A-E, conferring the common law meaning on the materiality referred to in the subsection, is correct."

Unfortunately, Schutz JA's judgement does not in itself terminate the controversy, as his statements were made *obiter*. The statements were, however, strong statements and appear to be supported by Marais and Howie JJA.¹⁵⁵ It is submitted that the decision can serve as a basis for

"The average reasonable man or prudent person would have considered that that particular information should have been disclosed to the [insurer]."

Schulze 2001 *De Rebus* 46 at 47 states that the fact that the Court deemed it necessary also to apply the objective test to assess the materiality of the undisclosed facts, is a good indication that it too had an uneasy feeling about the correctness of the decision in the *Qilingele* case.

152 1998 (4) SA 150 (A).

153 *Ibid*, at 158. In regard to the distinction made between non-disclosure and positive misrepresentation, Schutz JA states (at 157):

"However the distinction has arisen, it is an extraordinary one in a system of law which gets by without drawing artificial distinctions between falsity by silence and falsity by express statement...."

154 *Ibid*, at 157-158.

155 *Clifford v Commercial Union Insurance Co of SA Ltd* 1998 (4) SA 150 (A) at 162-163.

ending the artificial and confusing distinction between misrepresentations by omission and misrepresentations by commission. New legislation¹⁵⁶ has not resolved the issue and in the interests of clarity, the legislature should clearly provide that the objective test applied in this regard, and bring to an end the distinction between misrepresentation by omission and by commission.¹⁵⁷

Stepping aside from the insurance cases, the question that arises is whether outside these special cases a general test can be established for deciding whether in any particular case silence amounts to a misrepresentation. In this regard the decision in *Pretorius v Natal South Sea Investment Trust Ltd*¹⁵⁸ is important. Relating to a share sale agreement, Vieyra J held in this case:

"There is here 'an involuntary reliance of the one party on the frank disclosure of certain facts necessarily lying within the exclusive knowledge of the other such that, in fair dealing, the former's right to have such information communicated to him would be mutually recognized by honest men in the circumstances'."

It has been said¹⁵⁹ that the test of involuntary reliance applied here is in accordance with the principle underlying the requirement of disclosure of material facts in contracts of insurance. The insured must disclose all material facts because the insurer involuntarily relies on him for information on such facts: it might theoretically be possible to ascertain these facts by other means, but it would not be practical in the business sense.¹⁶⁰ There is ample authority for this explanation in respect of contracts of insurance,¹⁶¹ and the fact that there appears to be no authority for a similar explanation in respect of contracts of partnership or agency does not matter. It is difficult to imagine any basis for the rule that partners and agents must make full

156 See s 59 (1) of the Long-term Insurance Act 52 of 1998; s 53 of the Short-term Insurance Act 53 of 1998.

157 Van Niekerk 1999 *TSAR* 584 is of the opinion that the legal position in the South African law of insurance in connection with non-disclosure, misrepresentation and breach of warranty, is unsatisfactory. He calls for the scrapping of all existing legislation in this respect and suggests that a fresh new start should be made to regulate the legal position afresh.

158 1965 (3) SA 410 (W).

159 *Christie Contract* 310.

160 *Christie Contract* 310.

161 *Bodemer v American Insurance Co* 1960 (4) SA 428 (T) at 433-434; *Iscor Pension Fund v Marine and Trade Insurance Co Ltd* 1961 (1) SA 178 (T) at 185; *Perreira v Marine and Trade Insurance Co Ltd* 1975 (4) SA 745 (A) at 755G.

disclosure, other than that their co-partners and principals are, by the very nature of their relationship, in a position of involuntary reliance on them — it would not be practical in the business sense for them to obtain information on material facts known to their partners or agents by making inquiries elsewhere.¹⁶²

Christie¹⁶³ is of the opinion that this general test of involuntary reliance conforms with prevailing ideas of business morality, because it draws the line between taking advantage of another's ignorance of facts which that person could reasonably be expected to ascertain for himself, and taking advantage of his ignorance of facts which he could not reasonably be expected to ascertain from any source other than from the person with whom he is contracting (which an honest business man would surely regard as overreaching). The concept of dealing at arm's length can well be described as incorporating the doctrine of involuntary reliance.¹⁶⁴

8.4.3 Disclosure and advisory duties: conclusion

I believe that the answer lies therein that the test for a duty of disclosure of facts between contracting parties should be same test as the test for wrongfulness in our law of contract,¹⁶⁵ as well as for wrongfulness in our law of delict,¹⁶⁶ namely the test of the *boni mores*.

Factors such as materiality, involuntary reliance and dealing at arm's length should be considered as factors which may contribute to a finding of whether a duty of disclosure exists in accordance with the legal convictions of the community.¹⁶⁷ The standard of good faith can play an important

162 Christie *Contract* 310.

163 Christie *Contract* 312.

164 Christie *Contract* 312.

165 *Magna Alloys and Research (SA) (Pty) Ltd v Ellis* 1984 (4) SA 874 (A); *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A); *Botha (now Griessel) and Another v Finanscredit (Pty) Ltd* 1989 (3) SA 773 (A).

166 *Minister van Polisie v Ewels* 1975 (3) SA 590 (A) at 597; *Universiteit van Pretoria v Tommie Meyer Films (Edms) Bpk* 1977 (4) SA 376 (T) at 387; *Administrateur Natal v Trust Bank van Afrika Bpk* 1979 (3) SA 824 (A) at 833-834; *Marais v Richard* 1981 (1) SA 1157 (A) at 1168; *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd* 1982 (4) SA 371 (D) at 380; *Schultz v Butt* 1986 (3) SA 667 (A) at 679; *Van der Walt Delict* 22-23; *Boberg Delict* 33 *et seq*; *Neethling Persoonlikheidsreg* 57-58; *Van der Merwe & Olivier Onregmatige Daad* 58 *et seq*.

167 See, in this vein, the remarks of Van Zyl J, in *McCann v Goodall Group Operations Ltd* 1995 (2) SA 718 (C) at 726:

role in determining public policy in this regard.

If good faith in a South African context is to mean that a contracting party should show a measure of recognition of, and respect for, the interests of the other contracting party,¹⁶⁸ factors such as involuntary reliance, materiality and dealing at arm's length will serve to determine the extent of the standard of good faith, and accordingly whether or not a duty of disclosure exists.

The "legal convictions of the community", should be read as the "legal convictions of the community's policy makers, such as legislator and judge".¹⁶⁹ In South Africa the faces of these policy makers are changing from those of a white dominated nationalist movement to those of a socialist, black dominated movement. The concept of the *boni mores* is expected to change dramatically as these new policy makers start putting their stamp on things.

The duty of disclosure shall receive further attention in Chapter 9 of this thesis.

8.5 CONSUMER PROTECTION

8.5.1 Introduction

Prior to the industrial revolution, most consumers were able to inspect goods for themselves and determine their quality. With the growth of modern technology, however, an information gap has developed and consumers are no longer equipped to make decisions concerning the quality of goods and products. Many modern products involve complicated manufacturing procedures, and even foodstuffs are often processed, pre-wrapped or hidden in tins or boxes.¹⁷⁰ Furthermore, advertisers often fail to inform consumers about products and merely appeal to their emotions or create unnecessary wants.¹⁷¹ Matters are further compounded because many consumers are

"A duty to disclose a material fact arises when the fact in question falls within the exclusive knowledge of the defendant and the plaintiff relies on the frank disclosure thereof in accordance with the legal convictions of the community."

168 See Lubbe 1990 *Stell LR* 7 at 20; and SA Law Commission *Unreasonable Stipulations* 14.

169 See Van der Merwe and Olivier *Onregmatige Daad* 58 n 99; *Schultz v Butt* 1986 (3) SA 667 (A) at 679.

170 Cf *Langenberg Voedsel Bpk v Sarculum Boerdery Bpk* 1996 (2) SA 565 (A) 572.

171 See McQuoid-Mason *Consumer* 7; Cranston *Consumers* 2.

ignorant of their rights and unwilling or unable to enforce them.¹⁷² Standard-term contracts are usually presented to a consumer on a "take it or leave it" basis. A consumer awareness study in South Africa has shown that consumer awareness factors such as bargain hunting, product knowledge, information search, price consciousness and general consumer knowledge, vary according to the demographic characteristics of the consumers concerned in respect of age, income, education, area and gender.¹⁷³

The development of consumerism has been a slow process both in Europe and the US. One of the problems is that because there are so many consumers, they are a "disparate mass"¹⁷⁴ and difficult to unite, with no clear identity as consumers. Business organizations, on the other hand, have a profit motive and are able to lobby in their own self-interest.¹⁷⁵ It has been pointed out, however, that consumers share identifiable interests, such as:

"Economic efficiency, diversity of purchasing choice, avoidance of monopoly profits and consumer frauds, optimal purchasing information, and good quality products and services in relation to price."¹⁷⁶

In the United Kingdom and the US, consumer groups have worked towards these goals by undertaking comparative testing of products and employing consumer advocates. Governments have also discovered that it pays to protect the interests of consumers because such protection may lead to more competition, fewer restrictive trade practices and less inflation.¹⁷⁷

In the United Kingdom there are several consumer bodies that look after the interests of

172 See McQuoid-Mason *Consumer 7*. This aspect is related to the general ignorance of people concerning the law and applies not only abroad, but also in South Africa. It was ignorance of the law that prompted the Association of Law Societies of the Republic of South Africa to sponsor the current "Street law" programme which is aimed at teaching secondary school children and community organizations about the law and the legal system in South Africa. See McQuoid-Mason 1987 *De Rebus* 395.

173 See McQuoid-Mason *Consumer 7*; Rousseau & Venter 1996 *J of Industrial Psychology* 26 at 27.

174 Cranston *Consumers* 11.

175 Cranston *Consumers* 11.

176 See McQuoid-Mason *Consumer 7*; Cranston *Consumers* 12.

177 Cranston *Consumers* 12.

consumers.¹⁷⁸ Although, however, there are bodies such as the Consumer Union in the US, most of the US consumer lobbying is done through consumer advocates.¹⁷⁹

In South Africa, however, the consumer movement is still very much in its infancy. Organizations such as the Housewives' League, the South African National Consumer Union and the National Black Consumer Union have existed for several years, but have had a limited lobbying influence on government.¹⁸⁰

In 1972 the government established the South African Co-ordinating Consumer Council as an umbrella body to co-ordinate consumers' interests. In the past the South African Co-ordinating Consumer Council came in for much criticism for being too closely connected with the interests of business and the government's financial departments,¹⁸¹ but at the time of its dissolution it was playing an increasingly important role in consumer affairs.¹⁸² In South Africa, the newspapers have also played an important role in protecting consumers and drawing consumer abuses to the attention of the public.¹⁸³ Likewise, several professional associations provide protection for consumers, but generally these are less effective than independent consumer protection agencies.¹⁸⁴

Sociological studies in other countries have indicated that the poor pay more when it comes to consumer purchases.¹⁸⁵ The poor pay more not only in respect of prices, but also as a result of exploitation by members of the business community. In South Africa the vast majority of poor people are from previously disadvantaged communities and there is no doubt that they are subjected to the same consumer abuses as poor people in other countries.

Caplovitz's study in the US showed that price levels in comparable stores in high-income and

178 See, generally, Harvey & Parry *Consumer* 51-59; and McQuoid-Mason *Consumer* 8 for the protection bodies in the UK.

179 Cranston *Consumers* 1415.

180 McQuoid-Mason *Consumer* 8.

181 McQuoid-Mason *Consumer* 8.

182 The functions of the Council have devolved to the Provincial Departments of Consumer Affairs.

183 McQuoid-Mason *Consumer* 8.

184 McQuoid-Mason *Consumer* 8.

185 See Caplovitz *The Poor Pay More*.

low-income neighbourhoods were similar, but that prices were higher in the small businesses common in low-income areas. Even though large numbers of poor people go outside their neighbourhoods to shop, many buy from the smaller stores despite their higher prices.¹⁸⁶ This is probably also true in South Africa, where for many years under apartheid, restrictions on commercial activity in the townships prevented the development of supermarkets.¹⁸⁷ Even though there is considerable "leakage" from the townships into the central and suburban business districts of the major cities, many township residents still conduct consumer transactions in the informal economy of the townships.¹⁸⁸

The main reason for the leakage is that trade and service facilities are concentrated in the central and suburban business districts where township dwellers work and find shopping convenient. Also, the central and suburban business districts generally offer a greater variety of goods and services at prices lower than those in the townships. Thus the higher-income groups often tend to shop in those areas.

The exploitation of unsophisticated consumers is a world-wide phenomenon. This exploitation of developing countries is being partly addressed by the formation of international consumer bodies and inter-governmental agreements.¹⁸⁹

8.5.2 Who is a consumer?

It is clear that there is no longer such a thing as a single law of contract. Different rules apply to different contractants, notably in the case where one of the contractants is a "consumer". It is therefore imperative to be able to define a consumer. In the broad sense everybody in society is a consumer.¹⁹⁰ This includes citizens entering into exchange relationships with institutions such as hospitals, libraries, police forces and various government agencies as well as with businesses.¹⁹¹ Certain bodies in the USA adopt a very wide definition of consumer — someone

186 Caplovitz *The Poor Pay More* 17; National Consumer Council *For Richer or for Poorer* 9-14 quoted in McQuoid Mason *Consumer* 9. See, also, generally, Sackville *Law and Poverty in Australia* Chapter 4.

187 See Rycroft (ed) *Race* 190 at 197.

188 McQuoid-Mason *Consumer* 9.

189 McQuoid-Mason *Consumer* 10.

190 McQuoid-Mason *Consumer* 1.

191 Cranston *Consumers* 7.

who is equated to a citizen.¹⁹² In the narrow sense a consumer can be regarded as any person who buys or hires goods or services, or any person who uses such goods or services. In the broad sense a consumer can be said to include any person who is affected by the use of goods or services, whether or not he or she bought, hired or used them.¹⁹³

A consumer is a "user of products or purchaser of goods or services"¹⁹⁴ or "one who uses a commodity or service".¹⁹⁵ Consumers have also been referred to as "those who buy, obtain and use all kinds of goods and services".¹⁹⁶ In legal and commercial dictionaries consumers are referred to as "individuals who purchase, use, maintain, and dispose of products and services",¹⁹⁷ or as "a member of that brand or class of people who are affected by pricing policies, financing practices, quality of goods and services, credit reporting, debt collection, and other trade practices".¹⁹⁸

The word "consumer" includes people who buy or hire goods or services, people who use such goods or services and people affected by their use. Consumers in the first category usually enter into contractual relationships with the providers of the goods and services, and are able to rely on contractual remedies for any harm arising from a breach of contract.¹⁹⁹

Consumers in the second and third categories do not have a contractual relationship with the providers of the goods or services and have to rely on delictual remedies.²⁰⁰

Where consumers enter into contractual relationships that are governed by statute the word "consumer" is occasionally defined in the relevant Act. In South Africa the term is defined in a

192 Cranston *Consumers* 8, referring particularly to Ralph Nader.

193 McQuoid-Mason *Consumer* 1.

194 The Oxford Dictionary (1978).

195 Random House Dictionary of the English Language (1966) quoted in McQuoid -Mason *Consumer* 1.

196 Walker *Companion* 281.

197 West's Law and Commercial Dictionary in Five Languages: A-J (1985) 330 quoted in McQuoid-Mason *Consumer* 1.

198 *Ibid.*

199 McQuoid-Mason *Consumer* 16-61.

200 See McQuoid-Mason *Consumer* 64-109.

number of statutes, for example, the Trade Practices Act 76 of 1976, the national Consumer Affairs (Unfair Business Practices) Act 71 of 1988, water legislation²⁰¹ and the provincial Consumer Affairs (Unfair Business Practices) Act 7 of 1996. Thus in the Trade Practices Act "consumer" is defined as including "any person who makes use of any service",²⁰² while in the national Consumer Affairs (Unfair Business Practices) Act 71 of 1988 "consumer" means "a person to whom any commodity is offered, supplied or made available".²⁰³ The provincial Consumer Affairs (Unfair Business Practices) Act 7 of 1996 defines a "consumer" as a person;

- "(a) to whom any commodity²⁰⁴ is offered, supplied or made available; or,
- (b) from whom is solicited, or who supplies or makes available, any investment."²⁰⁵

In commenting on who is a consumer in the context of regulations²⁰⁶ issued in terms of the Trade Practices Act 76 of 1976, the Appellate Division has described a "consumer" as:

"a person to whom or for whom goods or services are to be supplied".²⁰⁷

In the case of credit agreements under the Credit Agreements Act 75 of 1980 the courts have taken the narrow view that the word "consumer" should be restricted to transactions where credit receivers use the goods and do not sell or lease them.²⁰⁸ In *Standard Credit Corporation v*

201 Eg, s 107 of the Water Act 54 of 1956 states that a "consumer" means a person supplied or entitled to be supplied with water by a water board or local authority.

202 S 1 of the Trade Practices Act 76 of 1976.

203 S 1 of the Consumer Affairs (Unfair Business Practices) Act 71 of 1988.

204 "Commodity" is defined as "(a) any property, whether corporeal or incorporeal and whether movable or immovable, including any make or brand of commodity; or... (b) any service, excluding service due in terms of a contract of employment." (See s 1(v)).

205 S 1(vi) of the Consumer Affairs (Unfair Business Practices) Act 7 of 1996.

206 Trade Practices Act Regulations promulgated in GG 6880 of 14 March 1980 in respect of "pyramid selling" schemes (reg 1).

207 *Caxton Ltd v Reeva Forman (Pty) Ltd* 1990 (3) SA 547 (A) at 576-577 Corbett CJ went on to say:

"Linguistically it is more correct to speak of supplying goods to consumers and supplying services for consumers."

208 See *Standard Credit Corporation Ltd v Strydom* 1991 (3) SA 644 (W) at 651.

*Strydom*²⁰⁹ the court suggested that "the underlying idea behind the Act was to protect the consumer and not the persons trading".²¹⁰

It has been submitted²¹¹ that the words used in s 1 of the South African Trade Practices Act 76 of 1976 and s 1 of the national Consumer Affairs (Unfair Business Practices) Act 71 of 1988 are broad enough to be interpreted to include business transactions. The Trade Practices Act 76 of 1976 simply defines "consumer" as including "any person who makes use of any service", and this could be interpreted to mean a small business that uses services provided by wholesalers or retailers (for example, providing suitable packaging for or the final preparation of goods for sale to customers of such small business). Likewise the national Consumer Affairs (Unfair Business Practices) Act 71 of 1988 defines "consumer" as "a person to whom any commodity is offered, supplied or made available" which clearly includes small businesses that are supplied with goods for resale purposes. A similar definition is found in s 2(1)(a) of the Gauteng provincial Consumer Affairs (Unfair Business Practices) Act 7 of 1996.

Given the large numbers of small businesses trading in the informal sector of South Africa's economy, it has been submitted²¹² that our courts should not adopt a restrictive meaning when interpreting the word "consumer" for the purposes of any contract-law protection legislation,²¹³ and should preferably include all natural persons, close corporations, and small traders in the definition of "consumer".

8.5.3 Statutory consumer protection bodies

In South Africa there are a limited number of statutory consumer protection bodies. These include the Business Practices Committee, the Competition Board, the provincial government departments of Consumer Affairs, the Bureau of Standards, the statutory professional bodies and the Public Protector.²¹⁴

209 1991 (3) SA 644 (W).

210 *Ibid*, at 651.

211 See *McQuoid-Mason Consumer* 4.

212 *McQuoid-Mason Consumer* 7.

213 As has been mentioned above, the courts have taken a more restrictive approach when dealing with credit agreements under the Credit Agreements Act 75 of 1980 (cf *Standard Credit Corporation Ltd v Strydom* 1991 (3) SA 644 (W) 651).

214 *McQuoid-Mason Consumer* 327.

In regard to unfair contract terms, the Consumer Affairs Committee, which is responsible for the administration of the national Consumer Affairs (Unfair Business Practices) Act 71 of 1988, is expected to play a larger role in the prohibition or control of business practices that prejudice consumers.

Furthermore, the provincial departments of Consumer Affairs will become the main governmental agencies responsible for the enforcement of consumer protection legislation in South Africa.²¹⁵ Consumer affairs is a provincial competency in terms of the Constitution.²¹⁶ Therefore, with the dissolution of the South African Co-ordinating Consumer Council, its functions were devolved to the nine provinces together with the Department of Trade and Industry.²¹⁷ Thus, many of the functions of the Department of Trade and Industry, such as policing the Credit Agreements Act 75 of 1980, the Usury Act 73 of 1968, and the Sale and Service Matters Act 25 of 1964, have been devolved to the provincial Departments of Economic Affairs and Touring under the Directorate of Tourism, Trade and Industry which, in some provinces, includes consumer affairs, tourism and small, medium and minor enterprises.²¹⁸

It may, of course, happen that a totally new structure may be born out of the activities of the South African Law Commission.²¹⁹

8.6 Conclusion

It is submitted that the test for a duty of disclosure of facts between contracting parties should be the same test as the test for wrongfulness in our law of contract, as well as wrongfulness in our law of delict, namely the test of the *boni mores*.²²⁰

215 See McQuoid-Mason *Consumer* 334, quoting from an interview with Mr Siva Naidoo, Acting Executive Director SA Interim Co-ordinating Consumer Council, 22 August 1996.

216 Constitution of the Republic of South Africa Act, 200 of 1993 Schedule 6; Constitution of the Republic of South Africa Act 108 of 1996 Schedule 4 Part A.

217 Department of Trade and Industry Annual Report 1995 11, quoted in McQuoid-Mason *Consumer* 334.

218 Department of Trade and Industry Annual Report 1995 8 and 10-11, quoted in McQuoid-Mason *Consumer* 334.

219 SA Law Commission *Unreasonable Stipulations*.

220 See par 8.4.3 *supra*.

Factors such as materiality, involuntary reliance and dealing at arm's length should be considered as factors which may contribute to a finding of whether a duty of disclosure exists in accordance with the legal convictions of the community. The standard of good faith can play an important role in determining public policy in this regard.

Strong consumer tendencies,²²¹ and a change of policy makers in South Africa, convince me that, notwithstanding the fact that it may not strictly be faced with a duty of disclosure to an intending surety, a bank should approach the issue much more openly, disclose material facts freely and insist upon the debtor's obtaining independent advice, when the possibility of undue influence or a lack of understanding is present, particularly when dealing with consumers .

More detailed discussions on proposals for reform will appear in the following chapter.

221 See par 8.5.3 *supra*.

CHAPTER 9: ANTICIPATED REFORMS IN THE BANKER-CUSTOMER AND BANKER-SURETY RELATIONSHIP

9.1 INTRODUCTION

In this chapter, the trends in international and national contract law are summarized. Suggestions about what direction the efforts of the SA Law Commission should take,¹ fall outside the scope of this thesis. However, in this chapter certain assumptions will be made as to future reformative steps to be taken by the legislature.

Certain proposals will be made about how bankers can take the lead in a reform process of the banker-surety relationship, thus ensuring, firstly, the legality of their contract and secondly, ensuring the future utilisation of suretyship as a relatively cheap and effective form of security.

9.2 INTERNATIONAL TRENDS REGARDING UNFAIR CONTRACT TERMS

9.2.1 General criteria of fairness in contract

A common pattern among most Western jurisdictions is that they are either already using a general fairness provision or, having lacked such a provision initially, and upon reflection, they are now developing one.² The general provision of the United States provides that a court may refuse to enforce an unfair contract, may enforce the fair part of a contract, or may limit the effect of any unfair contract. A court may issue such an order if it finds as a matter of fact that the contract or any part thereof was unconscionable at the time when it was made.³ Parties are

1 That is, in their search for a general criterion of fairness in contract law.

2 In the USA, see the Uniform Commercial Code (UCC); in Australia, the Uniform Consumer Credit Code of 1996, the Trade Practices Act of 1974 (Cth), the various Fair Trading Acts in the States and Territories; in England, the Unfair Contract Terms Act of 1977 and the Consumer Credit Act of 1974; in Germany, the AGB-Gesetz of 1976; in Israel, the Standard Contracts Act of 1982; in Sweden, the Act to Prohibit Improper Contract Terms of 1971; and in the EEC, the EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC:[1993] OJ L95/29.

3 S 2-302(1) of the UCC.

afforded a reasonable opportunity to adduce evidence as to the commercial setting, the purpose and the effect of the contract to aid the court in making a determination when it is claimed or when it appears to the court that the contract or any clause thereof may be unconscionable.⁴ The general provisions of the Swedish,⁵ Israeli,⁶ and Australian⁷ legislation correspond substantially to the American provision, since the unfairness or unreasonableness of the clause is the criterion which is used for interference with the contract. The English legislation⁸ is aimed only at certain types of terms, but grants the courts a discretion in this regard on the basis of reasonableness. English law, at least as far as consumers are concerned, also has to comply with the Directive of the EC in regard to unfair contract terms.⁹

Under German law, terms in standard form-contracts are void where the other party is excessively prejudiced if regard is had to the requirement of good faith.¹⁰ If doubt arises, a term is deemed to be excessively prejudicial where:

- the term is incompatible with the fundamental principle of the statutory measures (*ie*, the regulatory law) departed from; or
- substantial rights and obligations arising out of the nature of the contract are limited in such a way as to jeopardise the realisation of the object of the contract.

A standard term is void under the Dutch *algemene voorwaarden* if it is unreasonably prejudicial in view of:¹¹

- the nature and the remaining content of the contract;

4 S 2-302 of the UCC.

5 Act to Prohibit Improper Contract Terms of 1971.

6 Standard Contracts Act of 1982.

7 Trade Practices Act of 1974 (Cth) and UCCC.

8 Unfair Contract Terms Act of 1977.

9 The Directive has been implemented in Britain by the Unfair Terms in Consumer Contracts Regulations of 1994.

10 S 9 AGBG.

11 Art 6.233 BW.

- the way in which the contract came about;
- the other circumstances of the case; and
- the fact that the other party was not granted a reasonable chance to take note of the standard term.

The European Parliament adopted the Directive on Unfair Contract Terms in Consumer Contracts (hereinafter referred to as "the EC Directive") on 5 April 1993¹² by which consumers have a choice of being bound or not to standard-form contracts which contain unfair terms. Such a contract is in fact binding upon the parties if it is capable of continuing without the unfair terms. A standard term which has not been individually negotiated is unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations under the contract, to the detriment of the consumer.¹³

Unfairness is determined by good faith, significant imbalance between the supplier and the consumer, the nature of the goods or services for which the contract was concluded, and by having regard to all the circumstances surrounding the contract as well as to all the other terms of the contract or to any other contract on which it is its dependent. Furthermore, unfairness is not to be determined by reference to the subject matter of the contract, nor by the adequacy of the price and remuneration. The danger is thus avoided of asserting that the contractual terms are unfair merely because the goods or services are overpriced.¹⁴ The preamble to the EC Directive contains the following guidelines for the assessment of good faith:¹⁵

"[I]n making an assessment of good faith, particular regard shall be had to the strength of the bargaining positions of the parties, whether the consumer had an inducement to agree to the term and whether goods or services were sold or supplied to the special order of the consumer . . . the requirement of good faith may be satisfied by the seller or supplier where he deals fairly and equitably with the other party whose legitimate interests he has to take into account."

12 EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC: [1993] OJ L 95/29.

13 See s 3 (1); see, also, Dean 1993 *MLR* 581 at 581-590 for a discussion; Ogilvie 1996 *Canadian Business LJ* 439; Hondius 1994 *Journal of Contract Law* 34.

14 Dean 1993 *MLR* 581 at 585.

15 Dean 1993 *MLR* 584.

9.2.2 Control over unfair contract terms in South Africa

It is outside the scope of this thesis to dwell on future control measures relating to unfair contracts.¹⁶ For the immediate future, it is expected that our courts will be the primary control institution in regard to unfair contract terms.

It is, however, expected that, as consumer protection agencies grow in stature and the Provincial Departments of Consumer Affairs find their feet in the constitutional dispensation, and as the public become more aware of these bodies,¹⁷ a larger portion of control, particularly preventative control, should shift from the courts to these control bodies.

Of interest to the banking community is the appointment in South Africa of a Banking Adjudicator.¹⁸ There is no statutory obligation on banks to submit to the jurisdiction of an adjudicator; therefore participating banks will submit to the Adjudicator's jurisdiction voluntarily.

The purpose of the Adjudicator will be to provide customers of participating banks with a dispute resolution mechanism which is easily accessible, informal, quick, affordable and effective, without affecting the right of the customer to resort to litigation at any time.

The powers and functions of the Adjudicator are set out in his "Terms of Reference", which are binding on all participating banks in terms of the articles of the Company.

Briefly, the Adjudicator's jurisdiction is limited to complaints by individuals, partnerships, trusts and juristic persons whose turnover for the last financial year was less than R3 million. The Adjudicator may consider claims up to R500,000.

As to its operation, the adjudicator must in the first instance refer complaints to the bank involved, in an effort to settle the matter. If the matter cannot be settled the Adjudicator should

16 See, in this regard, Van der Walt 1993 *THRHR* 65 at 70 *et seq*; SA Law Commission *Unreasonable Stipulations* 24 and 49 (South Africa); Goldring *et al Consumer* 33-34; Terry 1982 *ABLR* 311 (Australia).

17 Particularly the activities of the Consumer Affairs Committee of the Consumer Affairs (Unfair Business Practices) Act 71 of 1988.

18 The Banking Adjudicator's office shall be constituted as a s 21 Companies Act 61 of 1973 company called "The Office of the Banking Adjudicator".

make a ruling¹⁹ or a recommendation.²⁰

A bank will not be bound to accept a recommendation, but if it does not do so, the Adjudicator will have the power to publish the recommendation and the fact that the bank has refused to abide by it. The bank will be bound to accept a ruling although an appeal process is provided for.²¹

The extent to which this mechanism will curtail litigation between banker and customer remains to be seen. Furthermore, it will be interesting to see what legal effect the Code will have on our courts' interpretation of the banker-customer relationship, in view of the statement in the Code that none of the provisions of the Code will be justiciable in a court of law, or may be used to influence the interpretation of the legal relationship between a customer and the bank, or will give rise to a trade custom or tacit contract or otherwise between a customer and the bank.²² Schulze²³ comments as follows:

"A client of a bank may therefore not rely on the provisions of the Banking Code to prove a banking practice or trade usage. However, I believe that the mere fact that a particular banking practice or trade usage has been acknowledged and explained in the Code in the first place, is already a strong indication that it qualified or existed as a banking practice or trade usage on its own right before its inclusion in the Code. Further, because the Banking Code is not incorporated by reference in the banker-customer contract (and does not for that reason qualify as a consensual term of the contract), it is doubtful whether the Banking Code can operate extra-contractually to exclude the inclusion of a term implied by trade usage."

Schulze²⁴ cites Cranston²⁵ as authority for the fact that in spite of a similar provision excluding

19 If the law of the case is reasonably certain, and the Adjudicator is not relying on the Code of Banking Practice, he should make a ruling on how the matter should be settled.

20 If the law is uncertain or the Adjudicator is relying on the Code, he should make a recommendation.

21 S 18 of the founding recommendations.

22 This question is also posed by Melville *Adjudicator* 26. Melville asks the further question as to how serious the banks are in implementing the provisions of the Code.

23 Schulze 2000 *SA Merc LJ* 38 at 40.

24 *Ibid.*

25 Cranston *Banking Law* 169 n 96.

the British code as evidence of trade usage, the British courts have regard to the code's provision in formulating legal principles.

9.2.3 The growth in consumer protection

In Chapter 8 above, I have briefly surveyed consumerism in South Africa and I shall not dwell further on that aspect save to state that there is an overall international trend towards consumer protection.²⁶

The exploitation of unsophisticated consumers is a world-wide phenomenon. This exploitation of developing countries is being partly addressed by the formation of international consumer bodies and inter-governmental agreements.²⁷

The abuses perpetrated against consumers in the First and Third world have led to a number of international developments concerning consumer protection, and various bodies have been established to prevent abuse, such as the establishment of Consumers International, the proposed Code of Conduct of the Inter-governmental Working Group's Commission on Transnational Corporations, and the United Nations Guidelines on Consumer Protection. It is outside the scope of this thesis to discuss the activities of these agencies. For purpose of summary, however, reference must be made to the list of consumer rights that Consumer International has adopted.²⁸ The following rights are recognised:

- the right to satisfaction of basic needs — to have access to basic, essential goods and services: adequate food, clothing, shelter, health care, education and sanitation;²⁹
- the right to safety — to be protected against products, production processes and services which are hazardous to health and life;
- the right to be informed — to be given the facts needed to make an informed choice and to be protected against dishonest or misleading advertising and labeling;
- the right to choose — to be able to select from a range of products and services, offered at competitive prices with an assurance of satisfactory quality;

26 Cranston *Consumers 2* (England); McQuoid-Mason 1987 *De Rebus* 395 (South Africa); Harvey & Parry *Consumer* 51-59 (England).

27 McQuoid-Mason *Consumer* 10.

28 On the CI, see Warne in Gaedeke & Etchison (eds) *Consumerism* 1718.

29 These rights are consistent with s 26 (housing), s 27 (health care, food, water, and social security), and s 29 (education) of the Constitution of the Republic of South Africa, 1996.

- the right to be heard — to have consumer interests represented in the making and execution of government policy and in the development of products and services;
- the right to redress — to receive a fair settlement of just claims, including compensation for misrepresentation, shoddy goods or unsatisfactory services;
- the right to consumer education — to acquire the knowledge and skills needed to make informed, confident choices about goods and services, while being aware of basic consumer rights and responsibilities and how to act on them; and
- the right to a healthy environment — to live and work in an environment which is non-threatening to the well-being of present and future generations.³⁰

Most Western jurisdictions protect consumers in commerce in some way or another. It may be that normal contract principles differ depending on whether or not the one party is a "consumer" or other protected entity. The law of contract is sometimes divided into consumer law and commercial law. This differentiated treatment of parties to a contract may affect the bank's duty of disclosure. Although the bank and the surety may not be in a fiduciary relationship, the fact that the surety is a consumer, will be one of the factors to be taken into account in establishing a legal duty of disclosure of material facts by a banker.

9.2.4 Addressing the problem of standard-term contracts

The process of mass production and distribution which has largely supplemented, if not supplanted, individual effort, has introduced the mass contract³¹ — uniform documents which must be accepted by all who deal with large-scale organisations,³² including banks. These agreements are extremely prevalent.³³ Such documents are not in themselves novelties: in England the classic lawyer of the mid-Victorian years found himself struggling to adjust his simple conceptions of contract to the demands of such powerful bodies as the railway

30 See South African Consumer Council Annual Report (1993/4) 6 quoted in Mcquoid-Mason *Consumer* 14.

31 In other words a concept contract, drawn *in abstracto* in order to be utilized in a series of future transactions with hitherto unknown parties.

32 Raiser *AGB* 16 *et seq.*

33 See Slawson 1971 *Harvard LR* 529 (USA); Hondius *Standaardvoorwaarden* 16 (The Netherlands); Raiser *AGB* 29; Held 1973 *BB* 573; Wolf Horn Lindacher *AGB-Gesetz Kommentar* 16-33; Münchener Kommentar *BGB* 1615-1621; Ulmer Brandner Hensen *AGB-Gesetz Einl* 4; Bunte 1980 *BB* 325 at 326 (Germany); Turpin 1965 *SALJ* 144 at 144-145; Harker 1981 *SALJ* 15 at 16 (South Africa).

companies.³⁴

In the present century many corporations, public and private, have found it useful to adopt as the basis of their transactions, a series of standard forms with which their customers can do little but comply.³⁵

In England, Lord Diplock³⁶ pointed out that standard forms of contracts are of two kinds. The first, of very ancient origin, are those which set out the terms on which mercantile transactions of common occurrence are to be carried out. Examples are bills of lading, charterparties, policies of insurance, and contracts of sale in the commodity markets. The standard clauses in these contracts have been settled over the years by negotiation by representatives of the commercial interests involved and have been widely adopted because experience has shown that they facilitate the conduct of trade. Contracts of these kinds affect not only the actual parties to them, but also others who may have a commercial interest in the transactions to which they relate, as buyers or sellers, charterers or shipowners, insurers or bankers. If fairness or reasonableness were relevant to their enforceability the fact that they are widely used by parties whose bargaining power is fairly matched would raise a strong presumption that their terms are fair and reasonable. The same presumption, however, does not apply to the other kind of standard form contract. This is of comparatively modern origin. It is the result of the concentration of particular kinds of business in relatively few hands. The ticket cases in the 19th century provide what are probably the first examples. The terms of this kind of standard form contract have not been the subject of negotiation between the parties to it, or approved by any organisation representing the interest of the weaker party. They have been dictated by that party whose bargaining power, either exercised alone or in conjunction with others providing similar goods or services, enable him to say: "If you want these goods or services at all, these are the only terms on which they are obtainable. Take it or leave it."

It has, however, to be added that even in Lord Diplock's second class there are good as well as bad reasons for the adoption of standard-form contracts. In many cases the actual conclusion of the contract is in the hands of relatively junior personnel, who are not trained in contract negotiation and drafting and it should prove tremendously economical for the company or bank

34 *Cheshire Contract* 21; *Parker v South Eastern Railway* 46 LJ (1877) QB 768 at 772; *Richardson & Spence v Rowntree* 1894 HL (E) 217 at 219.

35 See *Cheshire Contract* 21; Wolf Horn Lindacher *AGB- Gesetz Kommentar* 16-17; Münchener *Kommentar AGB-Gesetz* 1616-1617.

36 In *A Schroeder Music Publishing Co Ltd v Macaulay (Formerly Instone)* [1974] 3 All ER 616 at 624.

if it employs one (or at most a few) standard form(s) of agreement.³⁷ As regards the first class, we should note that large areas of commercial practice are governed by the prevalent standard forms which exist in a symbiotic relationship with the courts, so that a historical analysis of the development of a particular form would show that the clauses represented a response to decisions in the past.

In the complex structure of modern society the device of the standard-form contract has become prevalent and pervasive. French, but not English lawyers, have a name for it. The term *contrat d'adhésion* is employed to denote the type of contract whose conditions are fixed by one of the parties in advance and are open to acceptance by anyone. The contract, which frequently contains many conditions is presented for acceptance *en bloc* and is not open to discussion.³⁸

The use of standard terms of contract is a common phenomenon in modern contractual practice, which has created considerable problems. These contracts are useful in rationalising business operations, tailoring contracts for specific purposes and providing for new developments where the common law has proven inadequate.³⁹ These positive aspects are, however, clouded by the inclusion of very harsh and unreasonable terms by means of the standard-term mechanism.⁴⁰ Despite this, a modern economy and a banking environment without standard terms are virtually unthinkable.

The traditional contract theory has been unable to cope with the problems caused by the use of unconscionable standard terms. There is a definite difference between standard terms and terms which have been the object of bargaining, but this difference has not been clearly recognised in South African law.

Theoretically, standard terms are treated in exactly the same way as individually bargained terms. The courts have up to this stage been loathe to control the unconscionability caused by standard

37 Macaulay 1966 *Vanderbilt LR* 1051 at 1059 (USA); Yates *Exclusion Clauses* 2-3 (England); Kliege *Rechtsprobleme* 18-19; Münchener Kommentar *BGB* 1616-1617; Fischer 1957 *BB* 481 (Germany).

38 Amos *et al French Law* 152; Atiyah *Contract* ch 1.

39 Silberberg 1968 *Rhodesian LJ* 89 at 90 (Zimbabwe); Kliege *Rechtsprobleme* 48; Raiser *AGB* 92; Wolf Horn Lindacher *AGB-Gesetz Kommentar* 16-17 (Germany).

40 Kliege *Rechtsprobleme* 21-22; Raiser *AGB* 21 (Germany); Macaulay 1966 *Vanderbilt LR* 1051 (USA).

terms because of the immense influence of the freedom-of-contract doctrine.⁴¹ The courts therefore usually rely on rules of interpretation to control standard terms.⁴² Freedom of contract has different meanings, which are used for different purposes.⁴³ The doctrine has never been an absolute principle, but is subject to definite limitations.⁴⁴ An analysis of the relationship between freedom of contract in its different meanings and contractual justice, shows that the latter principle is the more important despite being neglected.⁴⁵ There can therefore be no objection to control if the object of that control is to re-establish contractual justice.

Although the standard-term problem is mostly seen as a result of the unequal bargaining strength between parties⁴⁶ or as a problem relating solely to consumer law,⁴⁷ a closer analysis leads one to the conclusion that it is a problem in its own right.⁴⁸ The root of the problem is found in the way in which the sheer bulk of terms, the size of the print⁴⁹ and typographical outlay, the

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- 41 See, eg, *Linstrom v Venter* 1957 (1) SA 125 (SWA) at 127-E; *Western Bank v Sparta Construction Co* 1974 (1) SA 839 (W) at 840; *Nedbank v Van der Berg and Another* 1987 (3) SA 449 (W) at 452.
- 42 There is always a danger that such rules of interpretation can be abused. See Raiser *AGB* 271 (Germany); *Galloon v Modern Burglar Alarms (Pty) Ltd* 1973 (3) SA at 647 (C); Devenish 1979 *De Rebus* 72; Beck 1982 *SALJ* 203 at 206 (South Africa).
- 43 Aronstam *Protection* 13-14 (South Africa); Feenstra & Ahsman *Contract* 5-7 (The Netherlands); Hippel 1967 *ICLQ* 591 at 592-593; Raiser *AGB* 303 (Germany).
- 44 See, eg, Zweigert & Kötz *Introduction* 324 *et seq*; and generally, Hondius *Standaardvoorwaarden* (The Netherlands); Jacobs 1985 *ICLQ* 297; Williston 1921 *Cornell LQ* 379; Kessler 1943 *Columbia LR* 629 (USA).
- 45 See, eg, Schmidt-Rimpler 1941 *AcP* 130 at 131; Raiser 1958 *JZ* 1 at 5; Schmidt-Salzer 1971 *NJW* 5 at 8; Hackl *Vertragsfreiheit* 18; Glück 1979 *ICLQ* 72 at 75-76 (Germany); Wilson 1965 *ICLQ* 174; Kessler 1943 *Columbia LR* 629 at 640; *Henningsen v Bloomfield Motors Inc* 32 NJ 358 161 A 2d 69 (NJ 1960).
- 46 Deutch *Unfair Contracts* 41 *et seq*; Murray 1969 *University of Pittsburgh LR* 1 *et seq*; Leff 1967 *University of Pennsylvania LR* 485 *et seq*; Rakoff 1983 *Harvard LR* 1174; Kessler 1943 *Columbia LR* 629-642; Bolgar 1972 *Am J of Comp L* 53 (USA); Raiser *AGB* 302 (Germany).
- 47 Silberberg 1968 *Rhodesian LJ* 89 at 101-107; Aronstam *Protection* 16-24 (South Africa); Lindacher 1972 *BB* 296; Eith 1974 *NJW* 10 at 17; Bernitz 1974 *ZHR* 336 (Germany); Deutch *Unfair Contracts* 117-118 (USA).
- 48 Krause 1955 *BB* 265; Raiser 1958 *JZ* 1 at 7.
- 49 Mellinkoff 1953 *Stanford LR* 418 at 419 (USA); Hondius *Standaardvoorwaarden* 302 (The Netherlands); Aronstam *Protection* 23; Van den Bergh *Leesbare Verbruikerskontrakten* 1 (South Africa).

complexity and technicality of the language⁵⁰ and the psychological effect of printed matter⁵¹ hide the true content of the standard terms. The severity of the crisis thus caused for the maintenance of contractual justice is amplified by the absence of bargaining.

Western jurisdictions are not alone in facing problems in regard to standard contracts. An empirical look taken at the incidence and impact of the phenomenon on the South African law of contracts demonstrates that it suffers equally from this crisis. Courts have up to now applied several indirect methods to try and cope with these problems, amongst these rules relating to inclusion, interpretation, illegality, *bona fides* and the *exceptio doli*.⁵²

Although not everybody likes them,⁵³ many modern, unfair contract term statutes do contain (apart from a general clause) a list of terms which aims at giving the general clause some clarification.

German legislation contains two sets of guidelines on standard terms, namely, a so-called blacklist of terms (which simply nullifies those terms) and a grey list of terms (rendering those terms assailable).⁵⁴

The EC Directive on Unfair Contract Terms⁵⁵ contains a schedule, consisting of two parts, in which unfair terms are set forth. The first list contains 17 terms that are regarded as unfair, and the criterion that is used is whether those terms have a certain aim or effect. The second list contains five exceptions to this rule. This schedule is regarded as a list of so-called grey terms. These terms can be judged against the circumstances of each case, although it is not likely that

50 Speidel 1970 *University of Pittsburgh LR* 359; Macaulay 1966 *Vanderbilt LR* 1051 (USA); Raiser *AGB* 21; Kliege *Rechtsprobleme* 21; Fausel *Schutz* 7; Weber 1970 *Betrieb* 2355 at 2360 (Germany); Van den Bergh *Leesbare Verbruikerskontrakte* 57; Silberberg 1968 *Rhodesian LJ* 89 at 104 (South Africa).

51 Raiser *Gerichtliche Kontrolle* 158; Fausel *Schutz* 7-8; Lindacher 1972 *BB* 296 at 297; Schmidt-Salzer *AGB* 15; Weber 1970 *Betrieb* 2355 at 2360 (Germany); Hondius *Standaardvoorwaarden* 1 (The Netherlands).

52 SA Law Commission *Unreasonable Stipulations* 21-47.

53 Trade and Industry often see such lists as unwanted patronising — see UNICE in Alpa & Bessone (eds) *Contratti* 220 and 223. The Scandinavian countries consider lists useless in their control system of Consumer Ombudsmen — see Wilhelmsson 1992 *European Consumer LJ* 77 at 87.

54 Ss 11 and 10 *AGBG*.

55 EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC: OJ L95/29.

they will be found to be fair. Nor is the list exhaustive: member states may add further terms to it.⁵⁶ In the schedule, terms are identified which will seldom pass the test of fairness and which consequently are in effect void, whilst the other tests as set forth in ss 3 and 4 of the EC Directive are to be applied to other terms.⁵⁷

In Australia, the following guidelines for determining whether a term is assailable evolved from legislation and the judicature: a party's poverty or any indigence; poor health; advanced age; gender; physical or psychological defect; drunkenness; illiteracy; lack of legal assistance or advice, if assistance or advice is necessary.⁵⁸ The Australian consumer, of course, is protected by a lethal array of weapons against unfairness in contract, particularly the Trade Practices Act of 1974 (Cth) (together with the Fair Trading Acts of the States and Territories), Contracts Review Act of 1980 (NSW) and UCCC, as discussed in Chapter 4 above.

Courts in America have laid down guidelines for fairness, namely: the relative bargaining positions of parties; the relative experience and knowledge of parties; the commercial framework of or circumstances surrounding the transaction; the nature and pattern of previous commercial transactions; the transfer of commercial risks from one party to the other; deceit or fraud; oppressive terms; exorbitant price; denial of fundamental remedies and defences to the detriment of the opponent; and the use of adhesion contracts.⁵⁹

The following guideline was given by the Swedish Minister of Justice⁶⁰ in making a case for the Swedish legislation⁶¹ on unfairness:

56 Dean 1993 *MLR* 581 at 587.

57 See Hondius 1994 *Journal of Contract Law* 34 at 39-41 (The Netherlands); Ogilvie 1996 *Canadian Business LJ* 439 (Canada).

58 S 70(2) of the UCCC provides a "shopping list" of factors which are to be taken into account in determining if a transaction is unjust.

59 SA Law Commission *Unreasonable Stipulations* 28; see, also, in regard to unconscionability, Leff 1967 *University of Pennsylvania LR* 485; Cellini & Wertz 1967 *Tulane LR* 193; Blumberg 1986 *Am J of Comp L* 99; Anderson 1972 *Notre Dame Lawyer* 879 at 888 *et seq*; Ellinghaus 1969 *Yale LJ* 757; Mair 1984 *Pacific LJ* 247 (USA).

On adhesion contracts, see Bolgar 1971 *Am J of Comp L* 53; Dauer 1962 *Akron LR* 1; Ehrenzweig 1953 *Columbia LR* 1072; Sales 1953 *MLR* 318; Slawson 1971 *Harvard LR* 529; Schmitthoff 1968 *ICLQ* 551.

60 Bernitz 1973 *Scandinavian Studies in Law* 11 at 45.

61 Act to Prohibit Improper Contract Terms of 1971.

"A contract term may be considered improper to consumers if, in deviating from non-mandatory law, it gives entrepreneurs an advantage or deprives consumers of a right and thereby causes such one-sided relations in the parties' rights and obligations under the contract that a reasonable balance between the parties no longer exists."

Israel has an open-ended list of presumptions according to which terms are *prima facie* unfair.⁶² The Dutch legislation contains two lists of guidelines, one consisting of terms which are, *per se*, unreasonably oppressive⁶³ and the other of terms presumed to be unreasonably oppressive.⁶⁴

In my opinion, the publication of lists of *prima facie* unfair terms can certainly assist in obtaining legal certainty. The Working Committee of the SA Law Commission⁶⁵ is, however, against the enactment of such guidelines as it believes that the laying down of guidelines may result in the Courts considering themselves bound exclusively by those guidelines, notwithstanding the so-called open-ended list of unfairness factors that can be supplemented by the circumstances. The Working Committee foresees that the danger of enacting guidelines may be that, if unfairness factors exist within a set of facts not covered by the guidelines, the term in question will not be found to be unfair. I fear that the Working Committee is seriously underestimating our courts' ability to make use of guidelines, and the advantages of legal certainty which guidelines will entail, outweigh the Working Committee's objection by far.

One can only hope that lessons can be learnt from the highly developed systems discussed earlier on in this sub-chapter,⁶⁶ and that guidelines will be part and parcel of the South African battle against unfairness in contract law, whilst preserving an adequate measure of legal certainty.

9.2.5 Expected South African legislative reforms

Although it is unclear what legislative reforms will take place in the field of unfair contract terms, one cannot ignore the draft Bill which the Working Committee of the SA Law

62 S 4 of the Standard Contracts Act of 1982. See, also, Comment 1966 *Columbia LR* 1340.

63 Art 6.236 BW.

64 Art 6.237 BW.

65 SA Law Commission *Unreasonable Stipulations* 31-32.

66 Sub-chapter 9.2.4. Notably the systems of Western Germany, the Netherlands and the EC are worthy of consideration.

Commission proposes be presented to the Minister of Justice.⁶⁷

The Working Committee of the SA Law Commission suggests the following provision for inclusion in an Act of Parliament to be entitled the Unfair Contractual Terms Act:⁶⁸

"(1) If a court, having regard to all relevant circumstances, including the relative bargaining positions which parties to a contract hold in relation to one another and the type of contract concerned, is of the opinion that the way in which the contract between the parties came into being or the form or content of the contract or any term thereof or the execution or enforcement thereof is unreasonable, unconscionable or oppressive, the court may rescind or amend the contract or any term thereof or make such other order as may in the opinion of the court be necessary to prevent the effect of the contract being unreasonably prejudicial or oppressive to any of the parties, notwithstanding the principle that effect shall be given to the contractual terms agreed upon by the parties.

(2) In deciding whether the way in which a contract came into existence or the form or content of the contract or any term thereof is contrary to the principles set out above, those circumstances shall be taken into account which existed at the time of the conclusion of the contract.

3. (1) The provisions of this Act shall apply to all contracts concluded after the commencement of this Act.

(2) Any agreement or contractual term purporting to exclude the provisions of this Act or to limit the application thereof shall be void."

The standards contained in this proposal, if it becomes law, could be ignored by a banker only at his peril, when drafting suretyships and mortgage bonds.

67 Keeping in mind that these proposals are not final yet and the SA Law Commission is still entertaining comments in this regard.

68 SA Law Commission *Discussion Paper* 26-27.

9.2.6 The anticipated role of good faith in contract law

9.2.6.1 Introduction

Notwithstanding severe problems in defining and describing the concept of good faith,⁶⁹ it is clear that the concept, whether as a standard or a norm, will play an important role in contract law, internationally. Even in England, staunch opponents of the concept of good faith will have to contend with the concept in consumer contracts as a result of their membership of the EU.⁷⁰

9.2.6.2 The USA

During the nineteenth century, the US common law was reluctant to recognize explicitly any "generalized duty to act in good faith".⁷¹ US law now imposes a duty of good faith across a broad spectrum of commercial transactions.⁷² For example, it applies to commercial paper and other negotiable instruments, bank deposits and collections, electronic funds transfers (wire transfers), letters of credit, bulk transfers, documents of title, investment securities, and secured transactions.⁷³

The Uniform Commercial Code (UCC),⁷⁴ the Restatement (Second) of Contracts,⁷⁵ and a majority of the states⁷⁶ recognize the duty to perform a contract in good faith. The Uniform Commercial Code states that:

"Every contract or duty within this Act imposes an obligation of good faith in its

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- 69 See the discussion on the various approaches to the concept in chapter 4, dealing with the USA, above.
- 70 See Unfair Terms in Consumer Contracts Regulations of 1994.
- 71 Holmes 1978 *University of Pittsburgh LR* 381 at 384; Zimmermann & Whittaker (eds) *Good Faith* 119.
- 72 Farnsworth 1963 *University of Chicago LR* 666 at 667; Eisenberg 1971 *Marquette LR* 1; Zimmermann & Whittaker (eds) *Good Faith* 118-120.
- 73 See ss 3-302; 4-406; 4A-105; 5-114; 6-107; 7-206; 8-406 & 9-504 of the UCC (1992).
- 74 S 1-203 of the UCC.
- 75 S 205 of the Restatement (Second) of Contracts.
- 76 See Burton 1980 *Harvard LR* 369.

performance or enforcement."⁷⁷

The Restatement provides that:

"Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."⁷⁸

Neither the Code nor the Restatement provisions deal with good faith in the negotiation and formation of a contract.⁷⁹ Rather, they apply to the performance and enforcement of contracts.

The duty of good faith may not be disclaimed by the parties.⁸⁰ They may, however, determine by agreement the standards by which the performance of this obligation is to be measured if the standards are not manifestly unreasonable.⁸¹

The UCC defines good faith generally to be "honesty in fact in the conduct or transaction concerned".⁸² This definition applies a subjective standard: the reasonableness of a person's belief is irrelevant to good faith.⁸³

In the case of sales or leases of goods by a merchant (a person who or entity that deals in goods

77 S 1-203 of the UCC.

78 S 205 of the Restatement (Second) of Contracts.

79 Summers 1982 *Cornell LR* 810 at 824 n61:

"This Section, like Uniform Commercial Code s 1-203, does not deal with good faith in the formation of a contract."

See comment c to s 205 of the Restatement (Second) of Contracts.

80 S 1-102 of the UCC.

81 *Ibid.*

82 S 1-201(19) of the UCC.

83 Since the section is in Article 1, it applies to the entire Code. Braucher 1958 *Columbia LR* 798 points out that the test is subjective and refers to the test as the rule of "the pure heart and the empty head". The subjective nature of the test has been severely criticized as there is a strong feeling that the test should have an objective element. See Farnsworth 1963 *University of Chicago LR* 666; Summers 1968 *Virginia LR* 195; Calamari & Perillo *Contracts* 510.

of the kind involved in the contract)⁸⁴ a more rigorous standard of good faith applies. Good faith in these transactions means not only honesty in fact, but also the observance of reasonable commercial standards of fair dealing in the trade.⁸⁵ This definition includes both the subjective and the objective tests.⁸⁶

The Restatement goes beyond the Code by imposing a duty of good faith and fair dealing — which includes both the subjective and objective tests — on all parties, not just merchants.⁸⁷ When the test of good faith involves the objective standard of fair dealing the courts can police against subterfuges and evasions even though the party engaging in the challenged conduct believed it to be proper.⁸⁸

In applying the obligation of good faith, the courts have recognized that the concept of good faith is broad, nebulous, and variable.⁸⁹ As the comments to the Restatement observe, good faith is used in a variety of contexts and its meaning varies somewhat with the context.⁹⁰ The comments further explain that good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.⁹¹ Moreover, bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty.⁹²

In an extremely influential article, Summers concluded that good faith is an "excluder".⁹³ He maintained that:

84 S 2-104 of the UCC.

85 S 2-103(1)(b) of the UCC.

86 Calamari & Perillo *Contracts* 510; Anderson *Uniform Commercial Code* 107; s 1-201 of the UCC.

87 S 205 of the Restatement (Second) of Contracts. See Summers 1982 *Cornell LR* 810 at 824-25.

88 Comment d to s 205 of the Restatement (Second) of Contracts.

89 Eisenberg 1971 *Marquette LR* 1 at 3-4.

90 Comment a to s 205 of the Restatement (Second) of Contracts.

91 *Ibid.*

92 Comment d to s 205 of the Restatement (Second) of Contracts.

93 Summers 1968 *Virginia LR* 195 at 262.

"[i]t is a phrase without general meaning (or meanings) of its own and serves instead to exclude a wide range of heterogeneous forms of bad faith."⁹⁴

The Restatement has endorsed this approach,⁹⁵ stating that good faith excludes a variety of conduct characterized as "bad faith" because these forms of conduct violate community standards of decency, fairness, or reasonableness.⁹⁶

Thus, the obligation of good faith and fair dealings has amorphous proportions and varies from context to context.⁹⁷ In applying the obligation of good faith to the performance of contracts, the courts have identified a set of behaviours as bad faith, including evasion of the spirit of the bargain, lack of diligence and slacking off, wilful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to co-operate in the other party's performance.⁹⁸

Most states apply good-faith requirements to contract enforcement. As described in the Restatement of Contracts:

"[t]he obligation of good faith and fair dealing extends to the assertion, settlement and litigation of contract claims and defences."⁹⁹

94 *Ibid*, at 201-02.

95 Burton 1984 *Iowa LR* 497 at 498-99.

96 Comment a to s 205 of the Restatement (Second) of Contracts.

97 Calamari & Perillo *Contracts* 511; Eisenberg 1971 *Marquette LR* 1; Kunz 1990 *Wm Mitchell LR* 1105 at 1110, has observed that the UCC provisions on good faith serve one or more of the following functions:

- (1) restrict the exercise of one-sided power in a contract, in order to avoid unfair or unexpected results;
- (2) restrict the range of possible responses to defective performance or to an unexpected event, in order to salvage the contractual relationship or preserve the parties' negotiating positions;
- (3) impose a duty to mitigate losses, in order to avoid giving the aggrieved party a windfall beyond the expectations of the contract; and
- (4) protect the innocent third party buyer or purchaser against claims of the original owner and other claimants.

98 Summers 1968 *Virginia LR* 195 at 232-42; Comment d to s 205 of the Restatement (Second) of Contracts.

99 Comment e to s 205 of the Restatement (Second) of Contract.

The Restatement offers a number of examples where the courts have found bad faith in the enforcement of contractual enforcement terms: conjuring up a pretended dispute; asserting an interpretation contrary to one's own understanding; falsification of facts; harassing demands for assurances of performance; rejection of performance for unstated reasons; wilful failure to mitigate damages; and abuse of a power to determine compliance or to terminate the contract.¹⁰⁰

9.2.6.3 Europe and England

The principle of good faith and fair dealing is known as a guideline for contractual behaviour in all EC countries. There is, however, a considerable difference amongst the legal systems in the matter of how far and how powerful the penetration of the principle has been. At one end of the spectrum is a system such as the one in Germany, where the principle has revolutionized the contract law and added a special feature to the style of that system. At the other end we find systems such as those in England and Ireland, which do not recognize a general obligation of the parties to conform to good faith in the performance of a contract, but which in many cases, by specific rules, reach the results which the other systems reach by the principle of good faith.¹⁰¹

The other systems within the EC range between these two opposites. They recognize a principle of good faith and fair dealing as a general clause, but have not given it the importance that it has in German law. In respect of the German concept of good faith, there has been what certain authors¹⁰² calls a "moralization" of contractual relationships in Germany.¹⁰³ Section 242 BGB states in general terms that everyone must perform his contract in the manner required by good faith and fair dealing (*Treu und Glauben*) taking into consideration the general commercial practice.

This provision has been used to qualify the rigorous individualism of the original contract laws

100 *Ibid.* See Summers 1968 *Virginia LR* 195 at 243-52 for a discussion of many forms of bad faith contracting.

101 This is not so surprising as English law has been influenced by Roman law to a larger extent than admitted. See Gorla & Moccia 1981 *J of Legal History* 143; Gordley *Origins*; Gordley 1993 *ZeUP* 498. Continental legal systems are far more practice oriented than might seem, (see Frier 1991 *Michigan LR* 2201, who points out at 2213-4 that a code like the continental codes result in what he calls an "expanded interpretive community": the judiciary, the bar and (academic) legal authors) and English law did develop general concepts in equity.

102 See Zweigert & Kötz *Introduction* 150.

103 *Ibid.*, at 156.

of the BGB.¹⁰⁴ It has operated as a "superprovision" or "supernorm" which may modify the effect of other statutory provisions.¹⁰⁵ Based on s 242 BGB, the German courts have developed new concepts and have created a number of obligations to ensure the loyal performance of a contract; such as the duty of the parties to co-operate, to protect each other's interests, to disclose information, and to submit accounts.¹⁰⁶

There is, however, one important limitation to the operation of the good-faith principle. It does not permit the courts to establish a general principle of fairness and equity. A court may not replace the effects of a contract or of a statutory provision by an outcome which it believes to be more fair and equitable.¹⁰⁷

Among the concepts created by the courts that rely on the good faith principle, the following should be mentioned:

- (1) A change of circumstances (*Wegfall der Geschäftsgrundlage*) which makes the performance of the contract extremely onerous for one party and may lead to the modification or termination of his contractual obligation.¹⁰⁸
- (2) The limitation or loss of a party's right if enforcing it would amount to an abuse of that right.¹⁰⁹ The abuse of a right is found in the following typical cases.¹¹⁰
 - (a) Dishonest behaviour. A party cannot acquire a right in this way (*exceptio doli specialis*).¹¹¹
 - (b) Breach of a party's own duty. A party will lose a right in this way.
 - (c) Claiming a performance which one will soon have to return to the obligor. A party

104 It is generally recognized that s 242 BGB operates *supplendi causa*. See Zimmermann & Whittaker (eds) *Good Faith* 24.

105 Hartkamp *et al* (eds) *European Code* 207; Horn *et al* *Introduction* 86-87.

106 Hartkamp *et al* (eds) *European Code* 206.

107 See Soergel-Siebert *BGB* 242.

108 See Markesinis *Contract* 510 *et seq*; Hartkamp *et al* (eds) *European Code* 206; Zimmermann & Whittaker (eds) *Good Faith* 26-27.

109 Zweigert & Kötz *Introduction* 150; Zimmermann & Whittaker (eds) *Good Faith* 24-25.

110 Hartkamp *et al* (eds) *European Code* 206.

111 Palandt *BGB* 231-233; Zimmermann & Whittaker (eds) *Good Faith* 25.

cannot claim a right in this way.¹¹²

(d) Relying on behaviour which is inconsistent with one's earlier conduct. A party cannot rely on behaviour in this way (*venire contra factum proprium*).¹¹³

(3) The ending of contractual obligations which extend over a period of time. These obligations may be ended for compelling reasons even though this is not supported by a statutory or contractual provision. The right to end these obligations may be limited by the contract, but it may not be completely excluded.¹¹⁴

As far as England is concerned, English common law does not recognize any general obligation to conform to good faith and fair dealing in the performance of a contract.¹¹⁵ Consumers are protected against unfair contract clauses by the EC Council Directive (Unfair Terms in Consumer Contracts)¹¹⁶ implemented in England¹¹⁷ and which prescribes the dictates of good faith. UNIDROIT principles will be incorporating good faith into its principles for international commercial contracts, and this may affect English contract law.

However, many of the results which in other legal systems are achieved by requiring good faith in performance have been reached under English and Irish law by more specific rules. For example, the courts have limited the right of a party who is the victim of a slight breach of contract to terminate the contract on that ground when the real motive appears to be the desire to escape a bad bargain.¹¹⁸ Conversely, the victim of a wrongful repudiation is not permitted to ignore the repudiation, complete his own performance and claim the contract price from the

112 Zimmermann & Whittaker (eds) *Good Faith* 25.

113 *Ibid.*

114 See, in regard to the above aspects, Hartkamp *et al* (eds) *European Code* 206-207; Zweigert & Kötz *Introduction* 150; Hedemann 1950 *JR* 1; Zimmermann & Whittaker (eds) *Good Faith* 26.

115 In a recent case, the House of Lords made it unequivocally clear that the introduction of good faith in English contract law would not, and even could not happen. See *Walford v Miles* [1992] 2 AC 128 at 138. Recourse has, however, been had in English law to "piecemeal solutions in response to demonstrated problems of unfairness" See *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] QB 433 at 439.

116 EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC: [1993] OJ L95/29.

117 Unfair Terms in Consumer Contracts Regulations of 1994.

118 *Hoening v Isaac* [1952] 2 All ER 176 and *Hong Kong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd* [1962] 2 QB 26.

repudiating party, unless the victim has a legitimate interest in doing so.¹¹⁹ There are many examples of the courts interpreting the terms of a contract in such a way as to prevent one party from using a clause in circumstances in which it was probably not intended to apply. The clearest examples of this occur in relation to exclusion clauses,¹²⁰ but other terms have been construed similarly¹²¹ where, for example, it was held that an architect under a construction contract could not exercise a power to order work to be omitted simply in order to give the same work to another contractor, who was prepared to do it for less. Thus to some extent the good faith principle merely articulates trends already present in English law. But the English approach based on the construction of the agreement is a weak one as it cannot prevail against clear contrary provisions in the agreement.¹²²

Good faith plays an important role in the other EC systems as well. Statutory provisions laying down a principle of good faith in the performance of the contract are to be found in: France — see Civil Code Article 1134 (3); the Netherlands — see BW Article 6. 2 and Article 6.248; as well as in several other European codes — see, for example, Article 1375 and Article 1175 of the Italian Civil Code.

The Dutch BW uses powerful language. Good faith will not only supplement obligations arising from contract (*aanvullende werking*), but may also modify and extinguish them (*beperkende werking*).¹²³ An obligor and obligee must act in their mutual relationship in accordance with the

119 *Attica Sea Carriers v Ferrostaal Poseiden Bulk Reederei GmbH; The Puerto Buitrago* [1976] 1 Lloyds Rep 250.

120 Coote 1970 *Cambridge LJ* 221; *Chitty Contract* 636.

121 See, eg, *Carr v JA Berriman Pty Ltd* (1953) 89 CLR 327.

122 See *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827, (exclusion clauses); *Bunge Corporation v Tradax Export SA* [1981] 1 WLR 711 (right to terminate for breach which might not have any serious consequences).

123 Hondius *et al* (eds) *Verbintenissenrecht* note 20. The concept of reasonableness and fairness has a limiting as well as a supplementary role in contract law. It is supplementary in the sense that, where a legal relationship between debtor and creditor leaves a gap (*leemte*) various additional rights and duties may flow based on reasonableness and fairness. See 5; HR 1976-09-24 NJ 1978 245; Rb Zuthpen HR 1981-03-13 NJ 1981 635; 1983-07-7 NJ 1985 679. Reasonableness and fairness therefore can play a supplementary role in, eg, duties to consult, (HR 1923-02-23 NJ 1923 802; Hof Amsterdam 1979-05-10 NJ 1980 369) duties to account, (Hof 's Gravenhage 1960-12-02 NJ 1961 498; Rb Alkmaar 1966-05-12 NJ 1967 167) duties of disclosure, (HR 1923-02-23 NJ 1923 802; HR 1964-03-13 NJ 1964 188; HR 1974-01-11 NJ 1974 179; HR 1987-11- 06 NJ 1988 212; HR 1988-06-17 NJ 1988 958; Hof Arnhem 1975-05-27 NJ 1976 291) duties to make information available, (Rb Alkmaar 1966-05-12 NJ 1967 167; Rb Amsterdam 1979-04-26 NJ 1979 623) duties to pay a monetary compensation, (Rb Alkmaar 1965-03-

requirements of reasonableness and equity. Under art 6.2(2) BW a rule which binds the parties by virtue of law, usage or legal act shall not apply to the extent that under the circumstances this would be unacceptable under the standards of reasonableness and equity. Art 6.248 BW which applies to contracts, provides that a contract has not only the effects agreed to by the parties, but also those which according to the nature of the contract result from law, usage and the requirements of reasonableness and equity.¹²⁴

Since the coming into force of the current BW, the Hoge Raad has developed its own style in arriving at judgments on the subject of the notion of good faith, which can be regarded as a model of its kind. It compels courts to take into account a comprehensive "checklist" of elements, and to include in their grounds for judgment the reason why, in the light of these elements, the principle of good faith requires a certain interpretation, or conditions in a certain manner the rights or obligations of the parties. It provides for certain — but not many — indications regarding the relative value of these elements. It introduces some rules of thumb which may be overruled, but only for convincing reasons.¹²⁵

In France, the courts have not given the rule expressed in Article 1134 (3) of the Code Civil the same importance it has in Germany and the other above-mentioned countries. However, similar results have often been reached without a reference to good faith, for instance by using the well-established theory of an abuse of right.¹²⁶ In the last two decades the courts have openly used the

25 BR 1965 558; Rb 's Hertogenbosch 1971-10-15 NJ 1973 118) and duties to contract, (HR 1956-12-21 NJ 1959 180; Hof Arnhem 1988-12-12 NJ 1989 444).

In its limiting role, reasonableness and fairness may also limit rights and duties flowing from the statute, usage or legal act. In this sense, the Dutch refer to the *beperkende werking van redelijkheid en billikheid*. (See HR 1990-04-20 NJ 1990 526.) In this role, reasonableness and fairness can be determining in cases, eg, of abuse of law, (Hof Leeuwarden 1987-04-29 NJ 1988 364; HR 1990-01-5 NJ 1990 728; HR 1990-04-20 NJ 1990 526) in ameliorating compulsory law or *dwingende wetbepalingen*, (HR 1983-07-01 NJ 1984 149; HR 1989-01-20 NJ 1989 322) and a broad range of obligations in Dutch law.

124 See Sande Bakhuijzen *WPNR* 5387 248-9; Zimmermann & Whittaker (eds) *Good Faith* 55.

125 For a classic example of this style see HR 1967-05-19 NJ 1967 261 (*Saladin v Hollandse Bank Unie*). The elements taken into account by the HR in this case were the degree of negligence related to the nature and seriousness of the interests involved, the nature and remaining contents of the contract, the social position of, and mutual relationship between the parties, the manner in which the clause was made and the level of awareness by the parties of its purpose. See further Storme in Hartkamp *et al* (eds) *European Code* 185-186.

126 See Zimmermann & Whittaker (eds) *Good Faith* 34-35.

good-faith principle in the determination of the parties' obligations.¹²⁷ The writers invoke this principle in order to impose upon the parties a duty of mutual loyalty, of information and co-operation, and to restrict the operation of clauses exempting a party from liability for breach of contract.¹²⁸

In the Commission of European Contract Law and in UNIDROIT, the good-faith principle has been established. The UNIDROIT Principles¹²⁹ provide that "each party must act in accordance with good faith and fair dealing in international trade". The UNIDROIT principle applies to all the subjects covered by the Principles. The PECL which has hitherto dealt only with the performance of the contract provides that "in exercising his rights and performing his duties each party must act in accordance with good faith and fair dealing".¹³⁰

9.2.6.4 South African developments

In the majority decision in *Bank of Lisbon & South Africa Ltd v De Ornelas and Another*,¹³¹ it has once more been confirmed that the South African law of contract does not allow a judicial discretion concerning the enforcement of an unfair contract or contract term. According to the majority decision, neither Roman-Dutch law nor South African law offers a point of contact for a general substantive defence based on fairness.¹³² The acceptance that contracts today, as in Roman-Dutch law, are regulated by good faith,¹³³ does not, according to the Court, imply such a judicial discretion of fairness.¹³⁴ Joubert JA points out that¹³⁵ the Dutch Courts, unlike the English Courts until the Judicature Act of 1873 became operative in 1875, did not administer a system of equity as distinct from a system of law. Roman-Dutch law is itself inherently an

127 *Ibid*, at 37.

128 Malaurie & Aynes *Obligations* 614; Marty & Raynaud *Obligations* no 246; Zimmermann & Whittaker (eds) *Good Faith* 39.

129 10th consolidated version, Articles 1.8. and 2.14.

130 See, in general, Hartkamp *et al* (eds) *European Code* 208-209.

131 1988 (3) SA 580 (A).

132 *Bank of Lisbon v De Ornelas and Another* 1988 (3) SA 580 (A), *per* Joubert JA, at 605, 606 and 609-610.

133 *Ibid*, at 599, 601 and 605.

134 *Ibid*, at 605-606 and 609-610.

135 *Ibid*, at 605-606.

equitable legal system. In administering the law the Dutch Courts paid due regard to considerations of equity, but only where equity was not inconsistent with the principles of law. Equity could not override a clear rule of law. That is also the position of our courts as regards their equitable jurisdiction.

It is, however, unlikely that the decision in *Bank of Lisbon* will remain the last word on the matter of good faith and contract law.¹³⁶ As Jansen JA pointed out in his minority judgment,¹³⁷ the twin concepts of freedom of contract and *pacta sunt servanda* have, in the course of this century, come increasingly under assault as a result of, *inter alia*, rampant inflation, monopolistic practices giving rise to unequal bargaining power, and the large-scale use of standard-form contracts. The heyday of extreme individualism was short-lived and thus we are witnessing today all over the world, a transition from freedom of contract to social responsibility. In a broader context, the development can be described as a return to the ethical foundations of the earlier *ius commune*.¹³⁸

136 See, eg, *Van der Merwe v Meades* 1991 (2) SA 1 (A) confirming the existence of the *replicatio doli*; See, also, Kerr *Principles* 483 and 488.

In a recent Appellate Division decision, *Eerste Nasionale Bank van Suidelike Afrika Bpk v Saayman NO* 1997 (4) SA 302 (A), Olivier JA in a minority judgement, at 318, concluded that the appeal in that case had to be dismissed on the basis of the application of the *bona fides* principle.

Olivier JA held that where a surety was, as in this case, obviously physically weak and confused and possibly unable to understand fully the contents of the suretyship, or where the surety was, to the knowledge of the creditor, the debtor's spouse or elderly parent, public policy requires that the creditor ensure that the surety has understood the full import of the agreement and of any consequent cessions. This could be achieved by insisting that the surety obtain independent legal advice or by having the creditor explain to the surety the full implications of the agreement and any related documents. In *casu*, Olivier JA held, at 330, that what had happened fell short of these requirements. In the circumstances the *bona fides* required that the surety agreement and cession not be enforced against the surety.

137 *De Ornelas case, ibid*, at 613.

138 See Zimmermann & Visser (eds) *Southern Cross* 256; On the topic of equality in exchange, see Gordley 1981 *California LR* 1587 *et seq*; Zimmermann *Obligations* 851, 873, 885 *et seq*. The principle of good faith is rooted deep in the Roman-Dutch tradition and history of our law. However, as an abstract concept it will add little to the resolution of specific issues. It cannot — and does not profess to — resolve specific problems. The circumstances of a case may be such that a duty to inform or warn a surety or to advise him to take independent advice is imposed on a creditor. To deduce specific rules from *bona fides* in the abstract and without reference to the circumstances would distort it and destroy its systematising and corrective value. See Malan & Pretorius 2001 *THRHR* 268 at 287-288.

Many of the doctrines designed to accommodate this concern for substantive justice have been abandoned,¹³⁹ the will theories of contract replacing them have now turned out to be deficient in many ways.¹⁴⁰

In certain fields the South African legislature has intervened to readjust the balance. Particularly important in this regard are the Credit Agreements Act 75 of 1980, the Usury Act 73 of 1968, and the Alienation of Land Act 68 of 1981. Section 3 of the Conventional Penalties Act 15 of 1962 gives the courts power to reduce a penalty found to be excessive to such "extent as it may consider equitable in the circumstances".¹⁴¹

However, the perception has been gaining ground that the problem of unfair contract terms will have to be tackled in a more fundamental, less fragmentary manner.¹⁴² According to some writers,¹⁴³ the doctrine of undue influence has paved the way for the recognition of "abuse of circumstances" as a general ground for the rescission of contracts.

As an alternative, a more enlightened approach to the construction of contracts has been advocated to avoid the inequity which has arisen in cases like *Bank of Lisbon and South & Africa Ltd v De Ornelas and Another*¹⁴⁴ and *Rand Bank v Rubenstein*.¹⁴⁵ One cannot, however, assume¹⁴⁶ that this is the only remaining problem area for which, after the demise of the *exceptio doli*, another route to contractual equity, has to be devised.¹⁴⁷ Others have argued that a change of

139 See, for instance, the *clausula rebus sic stantibus*. See Zimmermann *Obligations* 579 *et seq.* Furthermore, the doctrine of *laesio enormis* was formally abolished by s 25 of the General Law Amendment Act 32 of 1952. See Hahlo 1952 *SALJ* 392; Farlam & Hathaway *Contract* 387.

140 Zimmermann & Visser (eds) *Southern Cross* 256.

141 On these and other statutory enactments levelling the playing ground between contracting parties, see Aronstam *Protection* 49 *et seq.*

142 See Van der Walt 1986 *SALJ* 646 *et seq.*; SA Law Commission *Unreasonable Stipulations* 8-21; Van der Merwe *et al* 1989 *SALJ* 235-242; Lubbe 1990 *Stell LR* 7 at 20; Carey Miller 1980 *SALJ* 531 at 536.

143 See Van Huyssteen *Onbehoorlike Beïnvloeding* 127 *et seq.*

144 1988 (3) SA 580 (A).

145 1981 (2) SA 207 (W). See, on a new approach to construction, Lewis 1990 *SALJ* 26 *et seq.*

146 But see Lewis 1990 *SALJ* 26 at 33.

147 Zimmermann & Visser (eds) *Southern Cross* 256.

circumstances may effectively render a contract unenforceable; and they have based their argument on the concept of good faith in contract law.¹⁴⁸ There are, however, no signs of this kind of renaissance of the *clausula rebus sic stantibus* in South African case law.

It has also been submitted that legislative intervention will be necessary to enable South African courts openly to perform their duty of policing unfair contract terms.¹⁴⁹ A rather sweeping proposal along these lines has been submitted to the South African Law Commission.¹⁵⁰ Its framework of reference is not confined to standard-form contracts; a statutory provision is recommended according to which the courts may either declare invalid or modify any contract or any clause within a contract which, in the light of all the circumstances, does not conform to the standard of good faith. If adopted, this provision would effectively overrule the decision in *Bank of Lisbon and South Africa Ltd v De Ornelas and Another*.¹⁵¹

It is my opinion that as far as South Africa is concerned, our law has developed a "super control norm". Public policy, the *boni mores* has been recognised explicitly by our Appellate Division as the *Grundnorm* for determining illegality in contract,¹⁵² and in delict.¹⁵³ Several standards are taken into account when adjudicating policy aspects, such as the protection of the sanctity of contract, prevention of an abuse of right, prevention of an abuse of superior bargaining power and the protection of the public interest.

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- 148 Van Huyssteen & van der Merwe 1990 *Stell LR* 244; Farlam & Hathaway *Contract* 773 *et seq.*
- 149 Carey Miller 1980 *SALJ* 531; Van der Walt 1986 *SALJ* 646 at 647; 1988 *THRHR* 333; 1991 *THRHR* 367; 1993 *THRHR* 65; Hawthorne 1995 *THRHR* 157.
- 150 Van der Walt 1991 *THRHR* 367; 1993 *THRHR* 65.
- 151 *Ibid.*
- 152 *Magna Alloys and Research (SA) (Pty) Ltd v Ellis* 1984 (4) SA 874 (A); *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A); *Botha (now Griessel) and Another v Finanscredit (Pty) Ltd* 1989 (3) SA 773 (A).
- 153 *Minister van Polisie v Ewels* 1975 (3) SA 590 (A) at 597; *Universiteit van Pretoria v Tommie Meyer Films (Edms) Bpk* 1977 (4) SA 376 (T) at 387; *Administrateur Natal v Trust Bank van Afrika Bpk* 1979 (3) SA 824 (A) at 833-834; *Marais v Richard* 1981 (1) SA 1157 (A) at 1168; *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd* 1982 (4) SA 371 (D) at 380; *Schultz v Butt* 1986 (3) SA 667 (A) at 679; Van der Walt *Delict* 22-23; *Boberg Delict* 33 *et seq.*; *Neethling Persoonlikheidsreg* 57-58; Van der Merwe & Olivier *Onregmatige Daad* 58 *et seq.*

In my opinion, good faith is one¹⁵⁴ of these standards,¹⁵⁵ namely that standard which imports into contractual dealings the requirement that the parties should take into account the legitimate interests of one another.¹⁵⁶ Furthermore, good faith serves as a technique to fend off bad faith in contractual dealings.¹⁵⁷

Be that as it may, if European and American trends are anything to go by, the concept of good faith will play a decisive role in the future of South African contract law. It may also be the ideal vehicle by which to import the spirit of constitutionality¹⁵⁸ and affirmative action into contract law.¹⁵⁹

9.3 IMPACT OF TRENDS ON THE BANKER'S DUTY OF DISCLOSURE, OR ADVISORY AND INFORMATION DUTIES IN THE BANKER-SURETY RELATIONSHIP

9.3.1 The future of suretyship as a form of security

In discussions of the modern law of suretyship the creditor is sometimes depicted as an unscrupulous villain, a Shylock, taking advantage of an artless surety who has guaranteed the

154 As Van der Merwe *et al* 1989 *SALJ* 235 at 241-242, point out, good faith, whatever substance it may be given by the law, is not the only value that gives structure and substance to contracts. Good faith is one factor, the other factors being individualism, economic goals and certainty.

155 Farlam & Hathaway *Contract* 391 states that the ethical principle of good faith fulfils a controlling function within the law of contract which is subordinate to the substantive law.

156 See Lubbe 1990 *Stell LR* 7 at 20; SA Law Commission *Unreasonable Stipulations* 14.

157 See Summers 1968 *Virginia LR* 195 at 262 concluding that good faith is an "excluder"; *Occusafe Inc v EG & G Rocky Flats Inc* 54 F 3d 618 at 624 (10th Cir 1995); *Bank of China v Chan* 937 F 2d 780 at 789 (2d Cir 1991); *Kedra v Nazareth Hosp* 868 F Supp 733 at 737 (ED Pa 1994); *Coca-Cola Bottling Co v Coca-Cola Co* 769 F Supp 599 at 652 (D Del 1991); *Kleiner v First Nat'l Bank* 581 F Supp 955 at 960 n.5 (ND Ga. 1984); *Larson v Larson* 636 NE 2d 1365 at 1368 (Mass App Ct 1994); *Bourgeois v Horizon Healthcare Corporation* 872 P 2d 852 at 856 (NM 1994); *Somers v Somers* 613 A 2d 1211 at 1213 (Pa Super Ct 1992); *Garrett v Bankwest Inc* 459 NW 2d 833 at 845 (SD 1990); *Carmichael v Adirondack Bottled Gas Corporation* 635 A 2d 1211 at 1216-17 (Vt 1993).

158 See *Mort NO v Chiat* [2000] 2 All SA 515 (K).

159 It has been said that good faith serves to dispel the creeping danger of fossilization to which the law is always vulnerable. Teubner 1982 *ZHR* 625.

principal debtor's obligation because of friendship or family ties.¹⁶⁰ The surety, on the other hand, has long been a favoured creditor in the eyes of the law, and the courts have developed a plethora of technical principles on which a surety can be relieved of his obligation.¹⁶¹ The escape routes of the surety, especially if he is a consumer as well, on new grounds of public policy, unconscionability, good faith or unreasonableness, are growing.

In an illuminating article entitled "He that Hateth Suretyship is Sure",¹⁶² O'Donovan, a professor at the University of Western Australia has sketched a nightmarish obstacle course a banker faces in order to rely on his suretyship, in a country where extensive legislative consumer protection has been enacted.

Assuming that the drafter of the suretyship has inserted the usual clauses to protect the creditor from the common traps, and that the creditor has not acted fraudulently or has not been a party to undue influence or duress applied to the principal debtor, O'Donovan points out how the bank must satisfy the requirements of various concepts and principles in order to rely on its guarantee. The scope of this thesis does not allow a full examination of each aspect and reference is made only to the following concepts, where problems may arise:¹⁶³

- the process of offer and acceptance;
- the problems in regard to conditions precedent and the parol evidence rule;
- compliance with the requirement of consideration;
- determination of the scope of the guarantee;
- factors affecting the validity of the contract, such as undue influence, disadvantaged parties, inequality of bargaining power, common-law unconscionability, the duty of disclosure, innocent misrepresentation, *non est factum*, mistake, the treatment and effect of exclusion clauses and indemnity clauses;
- a vast array of statutory enactments, such as the Trade Practices Act of 1974 (Cth), the

160 O'Donovan 1992 *ALJ* 641.

161 The surety has defences available to him connected with the principal obligation, such as fraud, illegality, duress, as well as defences peculiar to the suretyship obligation. In addition the surety enjoys various benefits, such as the benefit of excussion, division, and cession of actions. Pothier *Obligations* pars 380-381; *Hastie v Dunstan* (1892) 9 SC 449; *Eaton Robins & Co v Nel (2)* (1909) 26 SC 624; *Ideal Finance Corporation v Coetzer* 1970 (3) SA 1 (A); *Bankorp Ltd v Leipsig* 1993 (1) SA 247 (W). In regard to the benefits, see Joubert (ed) *LAWSA* 26 pars 203, 204 and 205.

162 O'Donovan 1992 *ALJ* 641.

163 For a detailed and insightful discussion, see the article of O'Donovan, quoted above.

UCCC of 1996, the Contracts Review Act of 1980 (NSW) and the Consumer Transactions Act of 1972 (SA).¹⁶⁴

While in many instances sureties deserve the sympathy of the courts and the attention of law reformers, one should not ignore the plight of the creditor who acts innocently in taking a guarantee and advancing money in reliance upon it. The factors which have been highlighted in this thesis show that the law of suretyship can be a minefield for such a creditor. Certainly he can strengthen his position by inserting appropriate provisions in the guarantee itself, but even an astute draftsman might have difficulty avoiding all the pitfalls.

9.4 SUGGESTED PROPOSALS FOR VOLUNTARY REFORM BY BANKERS

9.4.1 Introduction

The trends affecting modern contract law and suretyships in particular, make it clear that bankers will have to take a pro-active approach in regard to their suretyships, in future, in order to prevent unconscionability or non-disclosure findings.

South African Bankers seem to have taken note of the pro-active steps taken by their Australian, UK and New Zealand brethren in establishing a code of banking practice. Voluntary acceptance of an appropriate code of conduct towards the surety may prevent more onerous legislative steps.

9.4.2 A code of banking practice

Fruitful lessons can be learnt from the codes of banking practice in the United Kingdom, New Zealand and particularly that of Australia.

Both the UK and the New Zealand codes, like the Australian code, are bank codes. The UK code is subject to review once every two years. It (1) applies to banks as well as building societies and card issuers; (2) covers electronic funds transfers as well; and (3) contains a glossary of banking terms.

The New Zealand code is also to be reviewed "at least every two years". It is slightly wider than the UK code although it is limited to banks. It is in three parts. The first part deals with banks and their personal customers, the second with card issuers, and the third with complaints. It also

¹⁶⁴ These statutory protection measures were discussed in some detail in Chapter 7 above in the sub-chapter on Australia.

contains a glossary of banking terms and a list of statutes that govern personal banking services and which enable third parties to have access to customer information held at banks.

The Australian code is far wider in both content and coverage than its UK and New Zealand counterparts. Also, in Australia, a separate code applies to "card issuers" and EFT transactions. The Australian code, however, contains no glossary of commonly used banking terms.

The Australian CBP is divided into two sections — a preamble and the code itself. The preamble is the code's spirit. It says that the code seeks to foster good relations between banks and their customers and promote good banking practice by formalising standards of disclosure and conduct for banks to observe when dealing with their customers.

A full discussion of any of these codes falls outside the ambit of this thesis. Germane to this thesis, however, is the Australian Code's treatment of Bank Guarantees. In this context, the following provisions of the CBP (ss 17-17.7) are of practical importance, namely:

- (1) A bank can only accept a guarantee if the amount of the guarantor's liability is limited to a specific amount plus other liabilities (for example, interest, recovery costs) described in the guarantee.
- (2) The bank must give written warning to the prospective guarantor that he may become personally liable for the borrower's indebtedness and the guarantor must be shown a copy of the relevant documentation.
- (3) The bank must recommend that the prospective guarantor obtain independent legal advice.
- (4) With the borrower's approval the bank must, on request, inform the guarantor about the borrower's account.
- (5) A guarantor may at any time extinguish his liability to the bank under the guarantee by paying the sum then due or by making other arrangements satisfactory to the bank.

The Banking Council of South Africa has also accepted a Code of Banking Practice. The Code professes to deal with the banks' relationship with personal and small business customers.

What is immediately striking is the fact that the Code's preamble¹⁶⁵ specifically states that none of its provisions:

- will be justiciable in a court of law; or
- may be used to influence the interpretation of the legal relationship between a customer and the bank; or
- will give rise to a trade custom or tacit contract or otherwise between a customer and the bank.

The Code is couched in promissory fashion and it will be interesting to see how the courts are going to interpret the promises made against the clear disclaimer.

The Code is more of a handbook and guide to the "consumer" customer and an explanation of services available. A discussion of the full text is not relevant to this thesis.

As far as suretyship is concerned, the Code informs the customer that the surety is entitled to the customer's confidential financial information, and that the banks will do the following:

- Encourage sureties to take independent legal advice to make sure that they understand their commitment and the potential consequences of their decision. All the documents that the surety will be requested to sign will contain this recommendation as a clear and prominent notice.
- Advise and caution sureties that by giving the surety or other security, they may become liable instead of or as well as the customer.
- Advise the surety whether it is a limited (and the maximum value) or unlimited suretyship.

Although the adoption of the Code is laudable, the question remains as to its effect on the common law of the banker-customer relationship.

9.4.3 Education: compliance with legislation

9.4.3.1 Ensuring procedural fairness

This thesis has attempted to demonstrate the legal pitfalls that await the unwary taker of

165 Code of Banking Practice 1.

suretyships. The law of suretyship is complex and escape routes for debtors are plentiful and growing day by day.

Drafting an enforceable suretyship cannot be left in the hands of legally uneducated staff members, but should preferably be done by staff well trained in the basics of contract law, the banking environment in general, and in suretyship especially.¹⁶⁶ To assist these staff members, bankers should invest time and effort in compiling a detailed, step-by-step manual dealing specifically with suretyship aspects, once a decision has been taken to accept suretyship as security.¹⁶⁷

The main purpose of drafting a manual or banking code should be to prevent unconscionability, mistakes and actionable non-disclosure. In order to prevent, or at least minimize the risk of a finding in regard to unconscionability, these manuals or codes should contain guidelines to two aspects¹⁶⁸ which I believe are of the utmost importance and assistance in combating procedural unconscionability findings in suretyship, namely those of independent legal advice, and the bank's duty of disclosure of material facts to the surety. These two issues will be referred to further hereunder.

Briefly, the banker's conduct towards the surety should at all relevant times be imbued with good

166 In Australia, banks specifically employ "compliance lawyers", whose principal duty it is to ensure compliance with all common-law and statutory prescriptions in regard to a bank's conduct towards a customer. This trend is being followed to a growing extent in South Africa.

167 *Prins v ABSA Bank* 1998 (3) SA 904 (C) is a classic example of a suretyship contract gone wrong. The surety had intended to sign a deed of suretyship which was limited both as to amount and as to duration, which would provide security for bridging financing of a project by the principal debtor.

The bank drafted an unlimited suretyship. When the surety came into the bank to sign, he saw only the back page of the document and under the mistaken belief that the document set out the terms he had previously agreed upon, he signed the document.

The court held, at 911, that it behoved the bank to alert the appellant to the true nature of the document. This it had failed to do, where, in the circumstances, there was a duty upon the bank to have ensured that the prospective surety had been under no misunderstanding as to the true nature of the obligations which he was undertaking.

168 Other aspects, of course, could deal with ascertaining that the bank's promotional literature conforms with the business that it is in and that it does not oversell what it will do for customers. The bank should also ensure that persons authorised to give advice to customers are properly trained and aware of the role they are playing in the bank's transactions with the customer. Contractual documentation with the customer should exclude liability for pre-contractual representations.

faith, in the sense that the banker should recognize the legitimate interests of the surety. In particular, a banker should carefully evaluate his own bargaining position and that of his intended sureties; he should recognize high-risk situations and personalities, discern in particular consumers and men of business, and in those high-risk cases disclose all material facts fully. Furthermore, should the bank be of the opinion that the intended surety is in need of clarification or advice in regard to the intended suretyship, it should insist upon the surety's obtaining independent legal advice, unless the bank is prepared to undertake such duties of clarification and advice itself, and at its own risk.

9.4.3.2 Ensuring substantive fairness

In order to ensure substantive fairness, legally educated staff, well versed in practical banking law, should be employed. The function of this compliance staff would be continuously to monitor trends in the development of contract law. As the legal convictions of the community change, adaptations to standard-term contracts may be required.¹⁶⁹

Various barometers can be consulted in this regard. For the South African banking lawyer, a good start would be a consideration of certain terms highlighted by the investigating team of the SA Law Commission.¹⁷⁰ Furthermore, the black lists and grey lists in the German AGB-Gesetz of 1976, the EC Directive on Unfair Consumer Contracts,¹⁷¹ (which applies to English Consumers as well)¹⁷² as well as in the Dutch BW, should give a fair indication as to trends in our major trading partners.

The compliance staff should continuously evaluate its contract terms, assess whether they are strictly necessary, and above all, endeavour to accommodate any amendments suggested by the customer or surety.

The duties of the compliance staff will not be easy. Drafting an unbreakable contract, as most lawyers are painfully aware, is almost impossible. A party may challenge a contract on a number of issues. The contract of suretyship is almost always at the forefront of new defences and is

169 This is, of course, easier said than done. Unfortunately, if a bank considers a suretyship to be security, it will have to comply with the trends in contract law.

170 SA Law Commission *Unreasonable Stipulations* 30-31; Van der Walt 1993 *THRHR* 65 at 80-81.

171 EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC: [1993] OJ L 95/29.

172 Unfair Terms in Consumer Contracts Regulations of 1994.

particularly susceptible to challenges owing to the judicial tendency to favour borrowers and sureties over lenders. One commentator¹⁷³ wrote that many of the suretyship cases:

"[M]ay be reconciled only by concluding that when confronted by a guarantor who elicits sympathy, the courts are willing to find numerous reasons to abrogate the guarantee contract."

The approach to drafting an enforceable guarantee differs widely. At one end of the spectrum is the "short and simple" approach, producing a guarantee which contains a brief description of the scope of the guaranteed obligations and broad waivers of common suretyship defences. At the other end of the spectrum is the "hell or high water" approach,¹⁷⁴ producing a guarantee which contains a broad, all-encompassing description of the scope of the guaranteed obligations and waivers of all conceivable suretyship defences. Both approaches have serious flaws. The short-and-simple approach may result in the court's refusal to enforce ambiguous waiver provisions or a court's admission of parol evidence because of the vagueness and uncertainty of the guarantee instrument. The hell-or-high-water approach may result in a court's refusal to enforce onerous and or vague waiver provisions or the guarantee itself, in the United States, on the grounds that it is a contract of adhesion.

The drafting of an enforceable guarantee therefore requires careful planning and continuous updating.

9.4.3.3 Assuming duties to disclose, advise and inform: relationships and bargaining positions

9.4.3.3.1 England and Europe

In English law, a contracting party does not have a general duty on grounds of good faith or on any other ground, to disclose facts known to him, but not to the other party, even if he is aware that a knowledge of those facts would deter the other from entering into the contract.¹⁷⁵ This

173 Alces 1983 *N Carolina LR* 655 at 660.

174 Heitner & Frank 1990 *California Real Property Journal* 1.

175 *Carter v Boehm* (1766) 3 Burr 1905 at 1910; *Cornfoot v Fowke* (1840) 6 M & W 358 at 380; *Turner v Green* (1895) 2 Ch 205 at 208; *Banque Financière de la Cité SA v Westgate Insurance Co Ltd* sub nom *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1991] 2 AC 249 and *Bank of Nova Scotia v Hellenic Mutual War*

principle is, however, mitigated in a number of different ways, notably through the use of implied terms,¹⁷⁶ through an extensive interpretation of what constitutes a representation,¹⁷⁷ the recognition of a duty of disclosure in certain specific instances such as contracts *uberrimae fidei*,¹⁷⁸ insurance contracts,¹⁷⁹ and in fiduciary relationships.¹⁸⁰ Of course, the legislature has set certain disclosure requirements.¹⁸¹

Apart from the protection of consumers in terms of the EC Directive against unfair contract terms,¹⁸² English law relating to disclosure seems to diverge from European trends. In regard to a general duty of disclosure in the pre-contractual stage, the principle laid down in *Smith v Hughes*¹⁸³ still applies.

The present position of English law is quite clear, as was recently affirmed in the case of *Banque Financière de la Cité SA v Westgate Insurance Co Ltd sub nom Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1991] 2 AC 249¹⁸⁴ and *Bank of Nova Scotia v Hellenic Mutual War Risks Association (Bermuda) Ltd*.¹⁸⁵ Basically, the principle as laid down in *Smith v*

Risks Association (Bermuda) Ltd [1991] 2 WLR 1279; Spencer Bower *Non-Disclosure* 3.

- 176 *Smith v Hughes* (1871) LR 6 QB 597; Atiyah *Rise* 469-476; Nicholas 1974 *Tulane LR* 946; Sale of Goods Act of 1979.
- 177 Keeton 1936 *Texas LR* 1 at 20 (USA); *Ward v Hobbs* (1878) 4 App Cas 13 (England); Zimmermann & Whittaker (eds) *Good Faith* 45.
- 178 *Bell v Lever Brothers Ltd* [1932] AC 161. See Spencer Bower *Non-Disclosure* 89; Zimmermann & Whittaker (eds) *Good Faith* 46.
- 179 *Ionides v Pender* (1874) LR 9 QB 531; *Yorke v Yorkshire Insurance Co Ltd* [1918] 1 KB 662; *Rozanes v Bowen* (1928) 32 Lloyds Rep 98; *Glicksman v Lancashire and General Insurance Co Ltd* [1927] AC 139; *Jester-Barnes v Licences and General Insurance Co Ltd* (1934) 49 Lloyds Rep 231.
- 180 Spencer Bower *Non-Disclosure* 304; Sealy 1962 *Cambridge LJ* 69; *Re Coomber, Coomber and Coomber* [1911] 1 Ch 723; Zimmermann & Whittaker (eds) *Good Faith* 46-47.
- 181 See, eg, the Unfair Contract Terms Act of 1977.
- 182 EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC:[1993] OJ L95/29.
- 183 (1871) LR 6 QB 597. The principle is set out in the following paragraph.
- 184 [1991] 2 AC 249.
- 185 [1991] 2 WLR 1279. Both of these decisions concern a duty to inform in the case of an insurance contract.

*Hughes*¹⁸⁶ still applies generally to contracts, with some exceptions, for example, insurance contracts.¹⁸⁷ In the words of Cockburn CJ:¹⁸⁸

"I take the true rule to be, that where a specific article is offered for sale, without express warranty, or without circumstances from which the law will imply a warranty — as where, for instance, an article is ordered for a specific purpose — and the buyer has full opportunity of inspecting and forming his judgment, if he chooses to act on that judgment, the rule *caveat emptor* applies."

Or, as Blackburn J put it in even stronger words:¹⁸⁹

"... whatever may be the case in a court of morals, there is no legal obligation on the vendor to inform the purchaser that he is under a mistake, not induced by the act of the vendor."

English and Anglo-Canadian authors appear to be supportive of the approach taken by the House of Lords. Nicholas certainly seems to be sustaining the English piecemeal acceptance of a duty of disclosure.¹⁹⁰ Similarly, Waddams¹⁹¹ also favours the incremental approach, based on the further development of existing situations¹⁹² where a duty to disclose has been accepted; this approach "has more to recommend it than the revolutionary". Lord Steyn has observed that there is no need for English law to introduce a general duty of good faith as it is unnecessary as long

186 (1871) LR 6 QB 597.

187 See, also, Cartwright *Bargaining 90 et seq.* Two further recent decisions underlining the approach taken by the House of Lords are *Barclays Bank plc v Khaira and Another* [1992] 1 WLR 623 and *Barclays Bank plc v O'Brien and Another* [1993] 4 All ER 417. In the latter case, Purchas LJ, in the House of Lords, on the one hand refused to categorise the existing case law in this area, but on the other hand did rephrase the authorities by putting forward what he called "propositions".

188 *Smith v Hughes* (1871) LR 6 QB 597 at 603.

189 *Ibid.*, at 606-7.

190 Nicholas in Harris & Tallon (eds) *Contract Law 166 et seq.*

191 Waddams in Cane & Stapleton (eds) *Essays 256*. See, also, Waddams 1991 *Canadian Business LJ 349* and the comments on Waddams' article by Farnsworth 1991 *Canadian Bus LJ 351*. As was the case with the introduction of a general concept of good faith, it seems that Australian contract law is more receptive towards a general duty of disclosure than its English and Anglo-Canadian counterparts. See Finn (ed) *Torts 150 et seq.*

192 Such as undue influence. See Zimmermann & Whittaker (eds) *Good Faith 44*.

as the courts respect the reasonable expectations of the parties "in accordance with [English law's] own pragmatic tradition".¹⁹³

On a practical level, in particular in regard to suretyship, a duty of disclosure may arise in certain circumstances. The obligation is to reveal anything in the transaction between the banker and the surety, which will have the effect of making the position of the surety different from that which the surety would normally expect, particularly if it affects the nature or degree of the surety's responsibility.¹⁹⁴ In *Levett and Others v Barclays Bank plc*¹⁹⁵ the principle was stated as being that the bank has imposed on it a duty to disclose what in general terms can be described as the unusual features which are unknown to the surety.

Looking at French, German and Dutch law, one cannot but conclude that there is an unmistakably different attitude to be found. It is argued by authors like Ghestin and Legrand¹⁹⁶ that a general duty of disclosure of essential information necessary for an informed consent to contract does exist in French law. Ghestin summarizes French law in the following way;

"To sum up, a party who was or (having regard especially to any professional qualification) ought to have been aware of a fact which he knew to be of determining importance for the other contracting party is bound to inform the latter of that fact, provided that he was unable to discover it for himself or that, because of the nature of the contract, the character of the parties, or the incorrectness of the information provided by the other party, he could justifiably rely on that other to provide the information."

A conclusion which, no doubt, could also have been formulated for German law.¹⁹⁷

Thus, it can be said that the Continental law systems are more generous in recognizing a duty of disclosure, provided that the mistaken party was unable to discover the information for himself. Some guidelines for the determination of the existence of a duty of disclosure are: the nature of

193 Steyn 1997 *LQR* 442.

194 *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 457.

195 [1995] 2 All ER 615 at 628.

196 Ghestin & Goubeaux *Traité* 502 *et seq*, Legrand 1986 *OJLS* 337 and also 1991 *Canadian Bus LJ* 318 at 332-3. See, also, for a comparison of French-Canadian with American law, Legrand 1989 *Ottawa LR* 585 discussing, *inter alia*, the opposite of a duty of disclosure: the right to remain silent about certain secrets.

197 Larenz *Lehrbuch I* 110 *et seq*.

the contract, the standing of the parties, their relationship and their safety.

9.4.3.3.2 The USA

As far as the USA is concerned, we note that good faith¹⁹⁸ plays a role in determining a duty of disclosure, but, by and large, the determination of such a duty takes place piecemeal and incrementally.¹⁹⁹

The general principles in regard to the duty of disclosure in a suretyship context have already crystallized from court decisions²⁰⁰ and have been summarised as follows:

- (1) In all suretyship relations, the creditor owes the surety a duty of continuous good faith and fair dealing.²⁰¹

198 S 161 of the Restatement (Second) of Contracts sums up the law as follows:

"When Non-disclosure is Equivalent to an Assertion. A person's non-disclosure of a fact known to him is equivalent to an assertion that the fact does not exist in the following cases only:

...(b) where he knows that disclosure of the fact would correct a mistake of the other party as to a basic assumption on which that party is making the contract and if non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing..."

Clearly the formulation in terms of good faith and fair dealing poses as many questions as it answers.

It would appear as if current commercial practice and judicial attitudes, which may vary over time, determine the limits of good faith and fair dealing. Thus Comment 1 to s 551 Restatement (Second) of Torts determines:

"There are indications...that with changing ethical attitudes in many fields of modern business, the concept of facts basic to the transaction may be expanding and the duty to use reasonable care to disclose the facts may be increasing somewhat."

199 On the incremental approach to disclosure see, also, Waddams 1991 *Canadian Bus LJ* 349; Nicholas in Harris & Tallon (eds) *Contract Law* 166 *et seq.*

200 Notably *Sumitomo Bank of California v Iwasaki* 73 Cal Rptr 564 447 P 2d 956 (1968); *St Charles National Bank v Ford* 39 Ill App 3d 291 349 NE 2d 430 (1976); *First National Bank and Trust Company of Racine v Notte* 97 Wis 2d 207 293 NW 2d 530 (1980); *People's National Bank of Washington v Taylor* 42 Wash App 518 711 P 2d 1021 (1985).

201 *Sumitomo Bank of California v Iwasaki* 73 Cal Rptr 564 447 P 2d 956 at 959 (1968).

- (2) The creditor must not misrepresent or conceal facts so as to induce or permit the surety to enter or continue in a relationship in reliance on a false impression as to nature of risk.²⁰²
- (3) A creditor's fraud, which may consist of intentional or negligent misrepresentation or active suppression of the truth, will discharge a surety from any subsequently incurred liability.²⁰³
- (4) A creditor, such as a bank, does not owe an absolute duty to a surety to disclose, without request by the surety, all facts within its knowledge which may materially affect the surety's risk.²⁰⁴
- (5) Particularly in those cases in which a surety assumes risk at a debtor's rather than the creditor's request, the creditor may reasonably assume that the surety will acquire from the debtor himself all information which the surety reasonably believes to be relevant to the risk.²⁰⁵
- (6) The creditor owes the same duty of disclosure in the course of a suretyship relationship as he does at its inception.²⁰⁶

9.4.3.3.3 South African projections

After consideration of the trends in regard to good faith and disclosure, it would appear as if the test for the existence of a duty of disclosure, at least for South African contract law, is correctly described by Van Zyl J in *McCann v Goodall Group Operations Ltd*²⁰⁷ as follows:

"A duty to disclose a material fact arises when the fact in question falls within the

202 *Ibid.*

203 S 124 of the Restatement of Security.

204 *Sumitomo Bank of California v Iwasaki* 73 Cal Rptr 564 447 P 2d 956 at 960 (1968).

205 *St Charles National Bank v Ford* 39 Ill App 3d 291 349 NE 2d 430 (1976).

206 See par 4.8.3.4 *supra*.

207 1995 (2) SA 718 (C) at 726.

exclusive knowledge²⁰⁸ of the defendant and the plaintiff relies on the frank disclosure thereof in accordance with the legal convictions of the community."

To this I would add:

"Good faith, in the sense of taking into account the legitimate interests of the other contracting party, shall be an important determinant of the legal convictions of the community."

To sum up:

- (1) There is no general duty of disclosure of material facts in a contractual relationship.
- (2) The legal convictions of the community may determine the existence of such a duty, depending on the facts, circumstances and relationships involved.
- (3) An important standard used in the determination of a duty of disclosure is the concept of good faith.

9.4.4 Independent legal advice

9.4.4.1 Introduction

It should be clearly understood that independent advice cannot be a substitute for disclosure. The duty of disclosure relates to material facts, whilst advice is given in regard to conclusions, opinions and expectations which can be derived from these facts.

A duty to disclose can be imposed by law and its breach is actionable. There is no general duty to give advice, but advice may play an important role in assessing a stronger party's contractual conduct.²⁰⁹

208 As far as suretyship is concerned, there could hardly be said that the banker has exclusive knowledge of material facts relating to the debtor's account, as the principal debtor knows these facts as well as the bank, and the surety could approach the debtor for information.

209 Spencer Bower *Non-Disclosure* 691 puts it this way:

"In many situations, that (seeing that the weaker party has the advice of a third party entirely independent of the stronger party's influence) will be a very simple and obvious means of escaping the difficulties of proof, and a means which affords an excellent test of the conscientiousness of the transaction. This course so plainly suggests itself to an honest and scrupulous man that, when proved to

As we have seen in the *excursus*,²¹⁰ independent advice plays a prominent role in the English and Australian law of non-disclosure. For the purposes of this chapter, I merely wish to refer to the guidelines in respect of independent legal advice issued by the Australian College of Law,²¹¹ and which I believe South African bankers should try to emulate.

The following is a summary²¹² relating to this topic, keeping in mind the obligations of attorneys, prudent conveyancing practice, general law, statutory provisions and a growing body of judicial decisions:

- (1) Numerous modern decisions considered endeavours by guarantors and by mortgagors under third-party mortgages to set aside transactions and to avoid liability on a variety of grounds, frequently relying on two or more of the following defences:
 - (a) that the guarantor/mortgagor did not execute the documents; or
 - (b) did not know the nature of the documents signed;
 - (c) that the documents were executed —
 - (i) under the undue influence (of the actual borrower or someone else);
 - (ii) following misrepresentation to the guarantor;
 - (iii) without the guarantor's having received independent legal, financial or any advice regarding the documents or the transaction,²¹³
 - (d) that the transaction was an unconscionable bargain;²¹⁴

have been adopted by the stronger party, it goes a very long way, and in most cases is sufficient of itself, to sustain the validity and *bona fides* of the transaction: whereas the omission to resort to it raises an inevitable suspicion that the only reason for the omission must have been a consciousness on the part of the [stronger] party that the transaction was unrighteous and unfair, and that any impartial person would so advise."

See, also, *Pratt v Barker* (1826) 1 Sim 1; *Blackie v Clark* (1852) 15 Beav 595; *Potts v Surr* (1865) 34 Beav 543; *Taylor v Johnston* (1882) 19 Ch D 603; *Re Coomber, Coomber v Coomber* [1911] 1 Ch 723.

210 Chapter 5 *supra*.

211 See Lang, Anderson & Skinner *Protecting Mortgagors and Guarantors*. Papers presented for the Continuing Legal Education Department of the College of Law, 93/19.

212 *Ibid*, at 20.

213 See par 3.5.1 *supra*.

214 See pars 3.5.2.2 and 3.5.2.3 *supra*.

- (e) statutory defences, for example, under the Trade Practices Act of 1974 (Cth), the Fair Trading Acts; Contracts Review Act of 1980 (NSW), and the UCCC of 1996.²¹⁵
- (2) Some of the following issues arise when such defences are raised:
- (a) What explanation or advice has the guarantor received at or before the signing of the documents?
 - (b) Did the guarantor receive legal, financial or any other advice?
 - (c) Was the advice independent advice?
 - (d) How thorough was the advice?
 - (e) What was the guarantor's appreciation of the transaction, the documents and the risks assumed?²¹⁶
- (3) It has proved to be legally risky for lenders to entrust documents to the borrower, to have guarantees and related security documents executed, without ensuring that the documents have actually been signed by the guarantors with awareness of the nature of the documents, the transaction and the risks assumed.²¹⁷
- (4) Mortgagees' attorneys need to provide their lender clients with adequate advice on what precautions should be taken to ensure that guarantors should, for practical purposes, be unable to deny liability after default on the grounds as set out in (1) above, except in a very small percentage of transactions.²¹⁸
- (5) The most effective mode of achieving the goal set out in (4) is to ensure that the guarantor receive independent legal advice, that the guarantor's signature is witnessed by the attorney rendering the advice, and that that attorney provide some written evidence for the lender relating to the execution and advice.²¹⁹
- (6) The question of the presence or absence of independent advice has arisen in mortgages

215 See par 3.5.2.3.2 *supra*.

216 See Lang, Anderson & Skinner *Protecting Mortgagors and Guarantors* 20.

217 *Ibid*, at 21.

218 See par 5.3.7.2 *supra*.

219 See Lang, Anderson & Skinner *Protecting Mortgagors and Guarantors* 21.

involving banks, finance companies and private lenders. Furthermore, this has occurred when an attorney has acted for the borrower and subsequently the question of determining whether any of the mortgagors or guarantors were also represented by or independently advised by that attorney, became a difficult one. Similar problems have occurred when attorneys have acted for all parties in the transaction, that is the borrowers and the lenders and parties providing collateral securities and guarantees. Determining for whom the particular attorney has acted can subsequently be a difficult and contested issue — one that should have been clearly established and evidenced at the time of the transaction.²²⁰

- (7) It is suggested that attorneys should adopt a conservative approach, particularly when acting for clients in any actual or potential conflict situation and that:
- (a) the client should receive detailed professional and cautionary advice, which should be diarized;
 - (b) there should be some insistence on the client's obtaining independent legal advice (to protect the attorney and also other parties to the transaction);
 - (c) there should be a full disclosure to the client or to the independent attorney rendering advice, of all material facts known to the attorney;
 - (d) it should be ensured that the independent attorney is aware of all those material facts when rendering independent advice.²²¹
- (8) It has been held that an attorney is not debarred from being independent merely because of having been chosen by the stronger party to the transaction. However, it is suggested that it is prudent for the attorney rendering "independent" advice: (a) to interview the party receiving the advice without the other party to the transaction being present; (b) to charge that party separately for the advice; (c) and to record in writing the nature and scope of the advice. When an attorney acts for all parties, independent advice should still be given to each borrower and guarantor.²²²
- (9) It is suggested that independent legal advice should:
- (a) cover the real effect of any documents on the party's rights and position;
 - (b) ensure that the party or client understands the nature and consequences of the

220 *Ibid*, at 21. See, also, par 5.3.7.1 *supra*.

221 See Lang, Anderson & Skinner *Protecting Mortgagors and Guarantors* 21-22.

222 *Ibid*, at 22.

transaction;

- (c) cover the more fundamental questions relating to the viability and advisability of the transaction.²²³

(10) If any certificate is given by the advising attorney to the lender, it should be appreciated that:

- (a) the attorney assumes a legal responsibility to the lender, as well as to the client to whom advice was rendered;
- (b) it is undesirable for lawyers to render commercial or financial advice unless qualified and retained to do so;
- (c) certificates should be confined to what the attorney did and observed, what the client did or said, but not what the client "understood" (which the attorney could not confidently state);
- (d) care should be taken before certifying that the attorney fully explained the purport and effect of documents, because that may not have occurred and could involve several hours of consultation in the case of complex transactions.²²⁴

9.4.4.2 The interaction between disclosure and independent advice

Although disclosure of facts and the rendering of advice are different concepts, their interaction may be vital in preventing a banker's suretyship from being pronounced unlawful.

A banker, when dealing with an intending surety, should first of all discern whether the intending surety is a consumer or a business entity (or, dare I say, "non-consumer"). A non-consumer carries the risk of having to investigate facts for itself and must ask questions if it needs facts or advice.

If the surety is a consumer, the banker should be on guard. In defining a "consumer" as widely as possible, I believe that a field of potential high-risk people should be included. In fact, I would include in the definition of "consumer" all natural persons, and close corporations, whether or not they are acting as "consumers" in a strict sense, or in a business capacity. Rather than risking the setting aside of its suretyship, there should be disclosure of material facts to an intending consumer surety. A standard form containing these facts may form part of the bank's standard

²²³ *Ibid*, at 22.

²²⁴ *Ibid*, at 22-23. See, also, pars 5.3.7.6.1 *supra*.

stationery. This duty of disclosure, although going much further than our current common law, seems to be a vital pro-active step in ensuring contractual fairness and one which a court of law is bound to consider. Obviously, the banker would have obtained his customer's consent to the release from his duty of secrecy in this regard.

This distinction between a consumer and non-consumer obviates an investigation of whether a duty of disclosure exists as a result of good faith, inequality of bargaining power, involuntary reliance, the interests of the parties, the nature of the transaction, the relationship between the parties and the circumstances of the case.

Once a duty of disclosure of material facts has been established, the bank must carry out its duty, truthfully and without misrepresentation.²²⁵

Once a duty of disclosure has been attended to, it is possible that the intending consumer surety may be in need of advice in regard to the transaction.

A banker would be well advised to recognize such a need, which need may be discerned during negotiations, owing to the fact that the surety is a customer of the bank and the bank has a duty to protect his financial interests,²²⁶ whether contractually or implied, or where the customer is one of a perceived high-risk group. In this regard factors such as the inequality of the parties, the position of certain disadvantaged persons such as wives, questions of involuntary reliance, the interests of the parties, the nature of the transaction, and the relationship between the parties can point to a need for advice.

If a need for advice has been established, the bank should advise the customer diligently, or, if it does not want to undertake any advisory duties, it should insist that the surety obtain independent legal advice.

Briefly, the independent advice should consist of a clear explanation of the terms of the

225 See *Standard Chartered Bank of Canada v Nedperm Bank Ltd* 1994 (4) SA 747 (A).

226 Our courts' attitude in regard to a banker-customer relationship is that it is a simple debtor and creditor relationship and not a fiduciary relationship. See *Nedperm Bank Ltd v Verbri Projects CC* 1993 (3) SA 214 (W). Bankers may be entering into a myriad of relationships with their customers, some of which definitely are fiduciary in character. As an example, if a banker undertakes a function as the "personal asset manager" of a customer, with the object of maximising the customers wealth, would he have a duty of advice if the suretyship transaction were not in his customer's interest. Furthermore, banks give investment advice, do tax- and estate-planning, which tasks would in my opinion, impose an advisory duty on the bank.

documents, the effects of the transaction on the surety, and the propriety of the surety entering into the suretyship transaction.

If a bank goes out of its way in order to promote fairness in contract, if it liberally discloses material facts, and insists upon independent legal advice, a court of law is bound to take these steps into account when pronouncing upon the legality of a contract.

It is furthermore hoped that, once statutory measures in regard to unfair contract terms are taken, recognition will be given to the voluntary actions taken by creditors to combat unfairness.

9.5 THE ALTERNATIVE TO SURETYSHIP

Carrying out the aforementioned pro-active steps will come at a price. If our law adopts such stringent protection measures, as is the case in Australia, for example, banks, particularly those who deal mostly with consumers, may wish to reconsider whether suretyship is in fact security, or an invitation to litigation.

Walking away from suretyships, however, will not mean the end of the bank's problem in regard to unfair contracts. The real security documentation used by banks in regard to mortgage bonds and surety mortgage bonds, contains clauses which are similar (and in the same vein) to those clauses which are now coming under attack in regard to suretyship. It is also expected that in the foreseeable future, the problems in regard to disclosure and advice, discussed in this thesis, will manifest themselves in the taking of real security.

Unfortunately, the consumer may be the real loser in the end. If banks can no longer rely upon their security documentation, their credit approval standards will probably be set so high as to prevent the persons who were supposed to have been protected, from ever obtaining vital financing. Such defensive lending practices will hinder entrepreneurship.

9.6 CONCLUSIONS AND RECOMMENDATIONS

9.6.1 Introduction

After a comparative analysis of the various factors, standards and policy considerations which are currently having an impact on contract law and on the banker-customer relationship, I have drawn certain conclusions which are set out hereunder. From the conclusions drawn certain recommendations for South African bankers have been formulated and are set out hereunder.

9.6.2 Aspects of lender liability

9.6.2.1 Risk

Banks face risk in a variety of situations. A frequent risk for banks is that of default by a borrower. As a further risk, banks may be held liable to borrowers, potential borrowers, the shareholders, directors, creditors²²⁷ and sureties of borrowers and potential borrowers,²²⁸ and even to other lenders.²²⁹ "Lender liability"²³⁰ is the elastic description generally used to cover situations where lenders may be held liable to borrowers.²³¹

For borrowers, the common-law and statutory theories²³² of lender liability represent a legal arsenal to help balance what often, traditionally, had been a "one-sided" playing field. In terms of these theories, a borrower has a far greater chance than in the past to right excessive, unnecessary or unreasonable lender conduct, or attempt to minimise the adverse impact of such conduct.

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- 227 In the United States, eg, a lender may be held liable in terms of what is called the "Instrumentality Theory", where his control and dominance over a borrower is so substantial as to indicate that the effective control of the borrower's affairs rests with the lender, in such a manner that the dominance causes harm to the borrower or its other creditors through misuse of the lender's control. See *Re Clark Pipe & Supply Co Inc* 893 F 2d (5th Circuit 1990).
- 228 See, eg, the situation in Germany where a bank may be held liable on the grounds of *culpa in contrahendo*, if the bank refuses to honour its promise to grant credit. See OLG Koblenz BB 1992 2175. German banks can also attract liability in cases known as *Konkursverschleppung*, where the bank tries to postpone bankruptcy of the customer to recover its own claims at the expense of the other, new creditors, thus knowingly and purposefully prejudicing the other creditors. See Cranston *Risk* 212.
- 229 See pars 7.2.6.2.2.2 and 7.2.6.2.2.3 *supra*.
- 230 German lawyers talk of *Kreditgeberhaftung*.
- 231 See Cranston *Risk* 1.
- 232 Various fundamental legal theories such as contract theories, tort theories, good-faith theories and fiduciary duty notions, have been utilised innovatively to create lender liability by borrowers and other persons.

9.6.2.2 Common risk issues faced by bankers

9.6.2.2.1 The multi-functional bank and conflicts of interest

Although, previously, the banker-customer relationship was not seen as a fiduciary relationship, bankers should be aware that, as they engage in commerce in an ever-widening sphere, and as banking becomes more multi-faceted, certain relationships between banker and customer may require a special duty of care towards the customer.

A major problem that has arisen as a result of multi-functioning banks, is that of conflicts of interest.²³³ Although it is nothing new in the financial field, conglomerates combining banking and securities business in the same group increase the risk of generating conflicts of interest. The policy aim is to achieve a reasonable balance between the interests of clients, who rightly expect that a firm acting for them will not have a conflict with either its own or another client's interests, and what is (apparently) the operational reality that the conduct of a modern financial services business will inevitably give rise to some conflicts of interest. Difficult legal questions arise about whether such conflicts must be avoided or whether they can be "managed", and if they can be managed, how this should be done. These issues are presently far from being resolved.²³⁴

Disclosure has sometimes been treated as a solution to the problem of conflicts of interest. Make full disclosure of the conflict to the customer, and the bank is absolved of any wrongdoing,²³⁵ provided that the disclosure of a conflict of interest may not be in breach of a duty to another customer.²³⁶

The most important and preferred means of "managing" conflicts of interest is the so-called Chinese Wall. In essence, this is an arrangement by which different parts of a business are

233 For an analysis of the problem of conflicts of interest arising from multi-functional banking, see par 2.1.2 *supra* (England); par 3.2 *supra* (Australia); par 4.5 *supra* (USA); par 6.2.4.3 *supra* (Germany); and par 7.2.4 *supra* (the Netherlands); par 8.1.2.2 *supra* (South Africa).

234 The English Law Commission has published a consultation paper to address these issues in 1992. See Law Commission *Fiduciary Duties*.

235 Cranston *Banking Law* 25; Warne *Litigation* 47; *Prince Jefri Bolkiah v KPMG (A Firm)* [1999] 1 All ER 517; par 2.1.2 *supra*.

236 See, eg, *Winterton Constructions Pty Ltd v Hambros Australia Ltd* [1993] ATPR 41-205.

compartmentalized to avoid the leakage of sensitive information from one part to the other.²³⁷

9.6.2.2.2 Bank confidentiality

European, South African and Australian jurisdictions recognize a form of bank confidentiality in which banks are legally compelled to keep the financial affairs of their customers secret.²³⁸ Although, as a matter of policy, bank confidentiality is based on the customer's right of privacy, as a concept it tends to have other origins.²³⁹ This discrepancy can lead to privacy being breached with the law's sanction. The duty of confidentiality is not an absolute duty, but a duty qualified by exceptions.²⁴⁰

Multi-functional banking is one reason why confidentiality is under attack at present: banks distribute information throughout the corporate group so that the whole range of bank services can be marketed to customers, despite the fact that this may be in breach of the principle. The other, and more defensible reason why bank confidentiality is currently being undermined is because the banking system has been used for fraudulent and criminal activity. The prevention

237 Chinese Walls have been broadly defined as procedures for restricting the flow of information within an organisation to ensure that information that is confidential to one department is not improperly communicated (whether deliberately or inadvertently) to other departments in the organisation. See the English Law Commission *Fiduciary Duties* par 2.16; par 2.1.2 *supra*. See, also, the concept of Chinese Walls in the Dutch Gedragscode van de Nederlandse Vereniging van Banken (NVB). A primary role of these walls is to prevent the spread of *koersgevoelige informatie*, in regard to trading in securities. See Van Dijk 1997 *TVVS* 235 at 236; par 7.2.4 *supra*.

238 See *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461; par 2.1.3 *supra* (England); *Densam (Pty) Ltd v Cywilnat (Pty) Ltd* 1991 (1) SA 100 (A); par 8.2 *supra* (South Africa); the Dutch Privacy Act of 1989 (Wet persoonsregistraties); par 7.2.5 *supra* (the Netherlands). In Germany, see Rehbein 1985 *ZHR* 139; Sichter mann *et al Bankgeheimnis* 111; the AGB-Banken of 1993; par 6.2.4.2 *supra*; in the USA, see par 4.6 *supra*; *Peterson v Idaho First National Bank* 367 P 2d 284, 290 (1961); *Milohnich v First National Bank of Miami Springs* 224 So 2d 759 760 (Fla 1969) and the Algemene Bankvoorwaarden in the Netherlands.

239 Banking secrecy is said to be founded on legislation, contract and the protection of privacy. See Faul 1989 *TSAR* 145; Faul 1989 *De Jure* 312; Faul 1986 *TSAR* 180; Itzikowitz 1989 *BML* 255; Scott 1989 *SA Merc LJ* 248; Fourie 1990 *South African Banker* 20; par 8.2 *supra*.

240 See par 8.2 *supra*.

of money laundering is of primary importance,²⁴¹ but other concerns include tax evasion,²⁴² securities violations and insolvency offences.²⁴³

9.6.2.2.3 The bank's liability for advice

Advice can be given to customers or to third parties. Delictual liability enables third parties to sue banks for negligent advice,²⁴⁴ as well as for fraudulent advice.²⁴⁵

There is no general duty that banks have to advise their customers. However, a customer may in certain instances also be able to sue its banker for negligent advice. In general a bank does not owe a customer a duty to advise on the prudence of borrowing, or on tax implications, and a bank's duty of care does not extend to requiring it to advise the customer of the risks involved in the collecting of cheques. Liability for negligent advice may be founded in contract or in tort. A legal duty to advise may arise out of a misrepresentation (including a failure to speak or act and conduct capable of giving rise to an estoppel). A duty may also arise where there has been a voluntary assumption of responsibility to advise, and reliance on that assumption. Finally, a duty may arise from a fiduciary relationship, or through regulation.²⁴⁶

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- 241 See South African Drugs and Drug Trafficking Act 140 of 1992; English Drug Trafficking Act of 1994; Australian Financial Transaction Reports Act of 1988 (Cth); Bank Secrecy Act of 1970 (US); the Dutch Disclosure of Unusual Transactions Act of 1993 and Identification Financial Services Act of 1993.
- 242 See, South African Income Tax Act 58 of 1962; In Australia, see the Australian Income Tax Assessment Act of 1936; *Smorgon v Australia and New Zealand Banking Group Ltd*; *Smorgon v Commissioner of Taxation of the Commonwealth of Australia* (1976) 134 CLR 475; *Commissioner of Taxation of the Commonwealth of Australia and Others v The Australia and New Zealand Banking Group Ltd* (1979) 143 CLR 499; the Dutch Algemene Wet inzake Rijksbelastingen of 1959. In Germany, the bank has an unlimited duty to to inform the authorities in regard to tax fraud (s 385 Abgabenordnung (Federal Taxation Act)).
- 243 For an analysis of a bank's duty of confidentiality, see par 2.1.3 *supra* (England); par 3.3 *supra* (Australia); par 4.6 *supra* (USA); par 6.2.4.2 *supra* (Germany); and par 7.2.5 *supra* (the Netherlands).
- 244 *Hedley Byrne Co Ltd v Heller & Partners Ltd* [1964] AC 465; [1963] 2 All ER 575 (England); s 826 BGB (Germany); *Standard Chartered Bank of Canada v Nedperm Bank Ltd* 1994 (4) SA 747 (A) (South Africa). See, also, par 6.2.4.4 *supra* in regard to the position in Germany; par 3.3.3.5 *supra* (Australia); par 7.2.6.1 *supra* (the Netherlands); and par 8.3.1 *supra* (South Africa).
- 245 *Derry v Peek* (1889) 14 App Cas 337 (England); *Commercial Banking Co of Sydney Ltd v RH Brown & Co* (1972) 126 CLR 336 (Australia).
- 246 On the bank's liability for advice, see par 2.1.4 *supra* (England); par 3.4 *supra* (Australia); par 4.7 *supra* (USA); par 6.2.4.4 *supra* (Germany); par 7.2.6.1 *supra* (the

In South African law, where investment advice is concerned, the investor is entitled to assume that an adviser backed by a major financial institution is skilled to advise him on his investments. Such an adviser is under a duty to investigate the investment before offering his advice. His failure to do so may result in liability for the bank.²⁴⁷

9.6.3 Common defences pleaded by customers and particularly sureties

In most Western countries, suretyships given in favour of banks are being challenged in the courts on the basis of equitable doctrines of unconscionable conduct, undue influence, or statutory provisions²⁴⁸ dealing with unfair conduct or unfair contract terms.

The cases demonstrate that there are many sureties who have not understood the nature and extent of their obligations under the suretyship and the financial risk represented by the debtor or the project being financed,²⁴⁹ or who have been misled by the principal debtor or the lender as far as these are concerned.²⁵⁰ It appears that sureties have also been subjected to undue influence or unfair pressure by the principal debtor or the lender, to enter into the transaction, under circumstances in which they did not have the opportunity to reflect on the risks involved²⁵¹ or to seek adequate independent advice,²⁵² and who were not informed of defaults by the principal debtor, or who were unaware that a suretyship, believed to be for a fixed sum loan or advance, was a suretyship for all the debts of the debtor.

Netherlands); par 8.3.1 *supra* (South Africa).

247 See *Durr v ABSA Bank Ltd* 1997 (3) SA 448 (SCA) at 469 and par 8.3.1 *supra*.

248 See par 2.4.2 *supra* (England); pars 3.5.4.4 and 3.5.4.5 *supra* (Australia); par 4.8.4.3.8 *supra* (USA); par 6.4 *supra* (Germany); par 7.2.8 *supra* (the Netherlands); par 8.5.3 *supra* (South Africa).

249 See par 5.1 *supra*.

250 See pars 3.5.1; 3.5.2.3; 3.5.4.5; 5.1 *supra* (Australia); pars 4.8.3.3.1; 4.8.3.3.2; 4.8.3.3.3 *supra* (USA); par 6.5.1.2.3 *supra* (Germany); pars 7.2.3 and 7.2.6.2.1 *supra* (the Netherlands); pars 8.4.1 and 8.4.2 *supra* (South Africa); par 9.2.1 *supra*.

251 See pars 2.3.4 and 2.3.5 *supra* (England); pars 5.1; 3.5.2.2.1 and 3.5.2.2.2 *supra* (Australia); par 6.5.1.2.3 *supra* (Germany); par 9.2.4 *supra*.

252 See chapter 5 *supra* and pars 9.4.4.1 and 9.4.4.2 *supra*.

9.6.4. General fairness provisions and legislation in regard to standard term contracts

9.6.4.1 General fairness provisions

A common pattern among most Western jurisdictions, is that they are either already using a general fairness provision or, having lacked such a provision initially, and upon reflection, they are now developing one.²⁵³

The general provision of the United States provides that a court may refuse to enforce an unfair contract, may enforce the fair part of a contract, or may limit the effect of any unfair contract. A court may issue such an order if it finds as a matter of fact that the contract or any part thereof was unconscionable at the time when it was made. Parties are afforded a reasonable opportunity to adduce evidence as to the commercial setting, the purpose and the effect of the contract in order to aid the court in making a determination when it is claimed or when it appears to the court that the contract or any clause thereof may be unconscionable.²⁵⁴

In Australia, a credit contract or associated mortgage or guarantee may be re-opened if a court is satisfied that it was unjust.²⁵⁵ The definition of "unjust" includes "unconscionable, harsh or oppressive".²⁵⁶ The Trade Practices Act of 1974 (Cth) has broad scope and reach. It promotes competition, controls mergers and acquisitions, misuse of market power, anti-competitive agreements, exclusive dealings, price maintenance and discrimination, misleading, deceptive and unconscionable conduct, sharp practices, and ensures that goods are of merchantable quality and covers product and manufacturers' liability.²⁵⁷

In German law, s 242 BGB creates a general duty to perform according to the dictates of good faith (*Treu und Glauben*). This principle has been used in various ways by the courts to develop

253 In the USA, see the Uniform Commercial Code (UCC); in Australia, the Uniform Consumer Credit Code of 1996, the Trade Practices Act of 1974 (Cth), the various Fair Trading Acts in the States and Territories; in England, the Unfair Contract Terms Act of 1977; Consumer Credit Act of 1974; In Germany, the AGB-Gesetz of 1976; in Israel, the Standard Contracts Act of 1982; in Sweden, the Act to Prohibit Improper Contract Terms of 1971; and in the EEC, the EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC:[1993] OJ L95/29.

254 S 2-302 of the UCC; pars 4.8.4.3.8 and 9.2.1 *supra*.

255 S 70(1) of the UCCC.

256 S 70(7) of the UCCC. See par 3.5.4.4 *supra*.

257 See par 3.5.4.5 *supra*.

a control mechanism for the whole law of contract.²⁵⁸ There is neither a general rule which allows the person acting as a result of economic pressure to rescind the contract, nor a general concept of undue influence. However, under s 138 BGB a contract is void if a fiduciary relationship exists and one party abuses another's poverty, dependency, irresponsibility or inexperience, which resembles cases of economic duress and undue influence.²⁵⁹

In Dutch law, there is an overall duty on contracting parties to act in good faith once a legally relevant relationship has come into existence. This also means that the negotiating parties can be bound by this duty. The concept of good faith has a limiting influence in the sphere of contract law (*beperkende werking van de goede trouw*).²⁶⁰ In addition Art 6.2 BW requires that debtor and creditor act towards one another according to the dictates of reasonableness and fairness, and Art 6.248 BW states that a contract has not only the legal consequences agreed upon, but also those which, according to the nature of the agreement, flow from statute, usage, or the dictates of reasonableness and fairness.²⁶¹

In South Africa it was widely believed that the general equitable remedy, the *exceptio doli generalis*, which was granted to ward off the claim of a creditor acting unconscionably, was available where a creditor sought to use a suretyship for a purpose never envisaged at the time that the suretyship was concluded. However, the Appellate Division²⁶² held that the *exceptio doli generalis* never formed part of Roman-Dutch law and that it was therefore not part of modern South African law. The rejection of the *exceptio doli generalis* called for the consideration of other approaches to the question of unconscionable contracts. After the decision in the *De Ornelas* case our courts were flooded with matters where defences were raised that suretyship agreements or certain of their clauses were contrary to public policy. Most of these defences were turned down, and where it was found that a certain clause in an agreement was against public policy, it was held to be severable from the rest of the agreement.²⁶³

258 See par 6.5.1.1 *supra*.

259 See par 6.5.1.2.3 *supra*.

260 See Art 3.11 BW.

261 See par 7.3.2.1 *supra*.

262 In *Bank of Lisbon and South Africa Ltd v De Ornelas & Another* 1988 (3) SA 580 (A) at 607.

263 See *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A); *Conshu Holdings Ltd v Lawless* (1992) CLD 275 (W); *Standard Bank Financial Nominees (Pty) Ltd v Bamberger* 1992 CLD 308 (W); *Volkskas Bank Bpk v Theron* 1992 CLD 336 (T); *Pangbourne Properties Ltd v Nitor Construction (Pty) Ltd* 1993 (4) SA 206 (W); *First National Bank of SA Ltd v*

In *Botha (Now Griessel) v Finanscredit (Pty) Ltd*²⁶⁴ it was held that a court's power to declare contracts contrary to public policy should be exercised sparingly and only in cases in which the impropriety of the transaction and the element of public harm are manifest.

Although it is unclear what legislative reforms will take place in the field of unfair contract terms in South Africa, one cannot ignore the draft Bill which the Working Committee of the SA Law Commission proposes be presented to the Minister of Justice.²⁶⁵ The Working Committee of the SA Law Commission suggests the following provision for inclusion in an Act of Parliament to be entitled the Unfair Contractual Terms Act:²⁶⁶

"(1) If a court, having regard to all relevant circumstances, including the relative bargaining positions which parties to a contract hold in relation to one another and the type of contract concerned, is of the opinion that the way in which the contract between the parties came into being or the form or content of the contract or any term thereof or the execution or enforcement thereof is unreasonable, unconscionable or oppressive, the court may rescind or amend the contract or any term thereof or make such other order as may in the opinion of the court be necessary to prevent the effect of the contract being unreasonably prejudicial or oppressive to any of the parties, notwithstanding the principle that effect shall be given to the contractual terms agreed upon by the parties.

(2) In deciding whether the way in which a contract came into existence or the form or content of the contract or any term thereof is contrary to the principles set out above, those circumstances shall be taken into account which existed at the time of the conclusion of the contract."

9.6.4.2 Legislation regarding standard term contracts

The process of mass production and distribution which has largely supplemented, if not supplanted, individual effort, has introduced the mass contract — uniform documents which must

Sphinx Fashions CC 1993 (2) SA 721 (W); *Standard Bank of SA Ltd v Wilkinson* 1993 (3) 822 (C). See, also, par 8.3.3 *supra*.

264 1989 (3) SA 773 (A) at 782-783. See, also, *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A); *Standard Bank of SA Ltd v Wilkinson* 1993 (3) 822 (C); par 8.3.3 *supra*.

265 Keeping in mind that these proposals are not final yet and the SA Law Commission is still entertaining comments in this regard.

266 See SA Law Commission *Discussion Paper* 26-27 and par 9.2.5 *supra*.

be accepted by all who deal with large-scale organisations, including banks. Many corporations, public and private, have found it useful to adopt, as the basis of their transactions, a series of standard forms with which their customers can do little but comply.²⁶⁷ A common pattern amongst the legal systems investigated, is that they are taking steps against unreasonably prejudicial standard-term contracts.²⁶⁸

Courts in America have laid down guidelines for fairness, namely: the relative bargaining positions of parties; the relative experience and knowledge of parties; the commercial framework of or circumstances surrounding the transaction; the nature and pattern of previous commercial transactions; the transfer of commercial risks from one party to the other; deceit or fraud; oppressive terms; exorbitant price; denial of fundamental remedies and defences to the detriment of the opponent; and the use of adhesion contracts.²⁶⁹

In Australia, the following guidelines for determining whether a term is assailable evolved from legislation and the judicature: a party's poverty or any indigence; poor health; advanced age; gender; physical or psychological defect; drunkenness; illiteracy; lack of legal assistance or advice, if assistance or advice is necessary.²⁷⁰

In terms of German law, terms in standard form-contracts are void where the other party is excessively prejudiced if regard is had to the requirement of good faith.²⁷¹ If doubt arises, a term is deemed to be excessively prejudicial where the term is incompatible with the fundamental principle of the statutory measures (ie, the regulatory law) departed from; or substantial rights and obligations arising out of the nature of the contract are limited in such a way as to jeopardise the realisation of the object of the contract.

German legislation contains two sets of guidelines on standard terms, namely, a so-called blacklist of terms (which simply nullifies those terms) and a grey list of terms (rendering those

267 See par 9.2.4 *supra*.

268 *Ibid*.

269 *Ibid*. See, particularly, SA Law Commission *Unreasonable Stipulations* 28 (South Africa); see, also, in regard to unconscionability, Leff 1967 *University of Pennsylvania LR* 485; Cellini & Wertz 1967 *Tulane LR* 193; Blumberg 1986 *Am J of Comp L* 99; Anderson 1972 *Notre Dame Lawyer* 879 at 888 *et seq*; Ellinghaus 1969 *Yale LJ* 757; Mair 1984 *Pacific LJ* 247 (USA).

270 See par 9.2.4 *supra*.

271 S 9 AGBG. See pars 6.2.1; 6.2.3 and 9.2.4 *supra*.

terms assailable).²⁷²

A standard term is void under the Dutch *algemene voorwaarden* if it is unreasonably prejudicial in view of²⁷³

- the nature and the remaining content of the contract;
- the way in which the contract came about;
- the other circumstances of the case; and
- the fact that the other party was not granted a reasonable chance to take note of the standard term.

The European Parliament adopted the Directive on Unfair Contract Terms in Consumer Contracts²⁷⁴ in terms of which consumers have a choice of being bound or not to standard-form contracts which contain unfair terms. Such a contract is in fact binding upon the parties if it is capable of continuing without the unfair terms. A standard term which has not been individually negotiated is unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations under the contract, to the detriment of the consumer.²⁷⁵ The Directive contains a schedule, consisting of two parts, in which unfair terms are set forth. The first list contains 17 terms that are regarded as unfair, and the criterion that is used is whether those terms have a certain aim or effect. The second list contains five exceptions to this rule. This schedule is regarded as a list of so-called grey terms.²⁷⁶

In regard to unfair contract terms in South African law, at least as far as consumers are concerned, the national Consumer Affairs (Unfair Business Practices) Act 71 of 1988, and the regional (Gauteng) Consumer Affairs (Unfair Business Practices) Act 7 of 1996²⁷⁷ are expected

272 S 11 and 10 AGBG. See pars 6.2.1; 6.2.3 and 9.2.4 *supra*.

273 Art 6.233 BW. See, also, pars 7.1.2 and 9.2.4 *supra*.

274 EC Directive (Unfair Terms in Consumer Contracts) 93/13/EEC: [1993] OJ L 95/29.

275 See s 3 (1); see, also, par 9.2.4 *supra*; Dean 1993 *MLR* 581 at 581-590; Ogilvie 1996 *Canadian Business LJ* 439; Hondius 1994 *Journal of Contract Law* 34.

276 See par 9.2.4 *supra*.

277 See par 8.5.3 *supra*.

to play a larger role in the prohibition or control of business practices that prejudice consumers.

It may, of course, happen that a totally new structure may be born out of the activities of the SA Law Commission.²⁷⁸

9.6.4.3 The covenant of good faith

Notwithstanding severe problems in defining and describing the concept of good faith,²⁷⁹ it is clear that the concept, whether as a standard or a norm, will play an important role in contract law, internationally.²⁸⁰ Even England, staunch opponent of the concept of good faith, will have to contend with the concept in consumer contracts as a result of its membership of the EU.²⁸¹ One finds that even systems such as those in England and Ireland, which do not recognize a general obligation of the parties to conform to good faith in the performance of a contract, in many cases by specific rules, reach the results which the other systems reach by the principle of good faith.²⁸²

In the USA, the Uniform Commercial Code (UCC),²⁸³ the Restatement (Second) of Contracts,²⁸⁴ and a majority of the states²⁸⁵ recognize the duty to perform a contract in good faith. Neither the Code nor the Restatement provisions deal with good faith in the negotiation and formation of a contract. Rather, they apply to the performance and enforcement of contracts.²⁸⁶

278 SA Law Commission *Unreasonable Stipulations*. See, also, par 8.5.3 *supra*.

279 See SA Law Commission *Unreasonable Stipulations* 14. See, also, par 4.8.4.3 *supra*, where various approaches to the concept in the USA are discussed. A recurring theme in regard to good faith is that a contracting party, in pursuing his own interests, should show a measure of recognition and respect for the interests of his opponent. See Lubbe 1990 *Stell LR* 7 at 20.

280 See par 4.8.4.3 *supra* (USA); par 6.5.1.1 *supra* (Germany); par 7.3.2.1 *supra* (the Netherlands); par 9.2.4 *supra* (EC); par 9.2.6.3 *supra* (England).

281 See pars 2.2.1 and 9.2.6.3 *supra*.

282 See par 9.2.6.3 *supra*.

283 S 1-203 of the UCC.

284 S 205 of the Restatement (Second) of Contracts.

285 See Burton 1980 *Harvard LR* 369; par 9.2.6 *supra*; pars 4.8.4.1 and 4.8.4.2 *supra*.

286 Summers 1982 *Cornell LR* 810 at 824 n 61:

"This Section, like Uniform Commercial Code s 1-203, does not deal with good faith in the formation of a contract."

In German law s 242 BGB creates a general duty to perform according to the dictates of good faith (*Treu und Glauben*).²⁸⁷

In Dutch law the concept of good faith has a limiting influence in the sphere of contract law (*beperkende werking van de goede trouw*).²⁸⁸

In the majority decision in *Bank of Lisbon & South Africa Ltd v De Ornelas and Another*,²⁸⁹ it has once more been confirmed that the South African law of contract does not allow a judicial discretion concerning the enforcement of an unfair contract or contract term. The acceptance that contracts today, as in Roman-Dutch law, are regulated by good faith, does not, according to the Court, imply such a judicial discretion of fairness.²⁹⁰ It is, however, unlikely that the decision in *Bank of Lisbon* will remain the last word on the matter of good faith and contract law.²⁹¹

It has also been submitted that legislative intervention will be necessary to enable South African courts openly to perform their duty of policing unfair contract terms. A rather sweeping proposal along these lines has been submitted to the South African Law Commission. A statutory provision is recommended in terms of which the courts may either declare invalid or modify any contract or any clause within a contract which, in the light of all the circumstances, does not conform to the standard of good faith.²⁹²

It is submitted that as far as South Africa is concerned, our law has developed a "super control norm". Public policy, the *boni mores*, has been recognised explicitly by our Appellate Division as the *Grundnorm* for determining illegality in contract, and in delict. Several standards are taken

See comment c to s 205 of the Restatement (Second) of Contract.

287 See par 6.5.1.1 *supra*.

288 See Art 3.11 BW and par 7.3.2.1 *supra*.

289 1988 (3) SA 580 (A).

290 See par 9.2.6.4 *supra*.

291 See, eg, *Van der Merwe v Meades* 1991 (2) SA 1 (A) confirming the existence of the *replicatio doli*; See, also, Kerr *Principles* 483 and 488.

In a recent Appellate Division decision, *Eerste Nasionale Bank van Suidelike Afrika Bpk v Saayman NO* 1997 (4) SA 302 (A), Olivier JA in a minority judgement, at 318, concluded that the appeal in that case had to be dismissed on the basis of the application of the *bona fides* principle. See par 9.2.6.4 *supra* and the activities of the SA Law Commission *Unreasonable Stipulations and Discussion Paper*.

292 See par 9.2.6.4 *supra* and Van der Walt 1991 *THRHR* 367; 1993 *THRHR* 65.

into account when adjudicating policy aspects, such as the protection of the sanctity of contract, prevention of an abuse of right, prevention of an abuse of superior bargaining power and the protection of the public interest.²⁹³

It is submitted that good faith is one of these standards, namely that standard which imports into contractual dealings the requirement that the parties should take into account the legitimate interests of one another. Furthermore, good faith serves as a technique to fend off bad faith in contractual dealings. It is submitted that, if European and American trends are anything to go by, the concept of good faith will play a decisive role in the future of South African contract law.²⁹⁴ It may also be the ideal vehicle by which to import the spirit of constitutionality²⁹⁵ and affirmative action into contract law.²⁹⁶

9.6.4.4 Consumer protection

Bankers should understand that certain sureties may deserve special protection. A distinction will have to be made between "consumers" as a class deserving protection, and "non-consumers".²⁹⁷ It is clear that no longer will we have a law of contract, but a "law of contracts".

9.6.4.5 General fairness provisions and duties of disclosure

After surveying the South African law, it is concluded that there is no general duty of disclosure of material facts in a contractual relationship. The legal convictions of the community may determine the existence of such a duty, depending on the facts, circumstances and relationships involved. An important standard used in the determination of a duty of disclosure is the concept of good faith.²⁹⁸

Our law, in the form of the *boni mores*, has a general principle of fairness in contract. It is

293 See par 9.2.6.4 *supra*.

294 *Ibid.*

295 See *Mort NO v Chiat* [2000] 2 All SA 515 (K).

296 It has been said that good faith serves to dispel the creeping danger of fossilization to which the law is always vulnerable. Teubner 1982 *ZHR* 625.

297 See par 2.4 *supra* (England); par 3.5.4.4 *supra* (Australia); par 6.4 *supra* (Germany); par 7.2.8 *supra* (the Netherlands); par 8.5 *supra* (South Africa); and generally par 9.2.3 *supra*.

298 See par 9.4.3.3.3 *supra*.

recommended that bankers realise and accept that a more altruistic, moralistic approach to fairness in contract is expected rather than the conservative individualistic approach used up to the present. General standards of honesty, good faith, morality, and fair dealing will to a greater extent underlie the norm of legality, as constituted by public policy.²⁹⁹ It is submitted that the principle that contracts wilfully entered into by the parties are to be recognized and accepted in law, will remain a primary standard in the determination of public policy.

Most importantly, it is recommended that a bank's dealings and relationships with customers and sureties should be imbued with the spirit of the new Constitution.³⁰⁰

In a very recent contract-law case, *Mort NO v Chiat*³⁰¹ the Court stated:

"[I]t is clear that our highest Court has given the green light in the direction of the development of a concept of good faith in our law of contract which would render the body of contract law congruent with the values of our constitutional community".

It is recommended that once a banker has complied with his duty of disclosure and it is clear that the surety does not understand the transaction or is one of a "high-risk" group which the law has already indicated may need advice, he should refer the surety to an appropriate person to obtain independent advice, in the sense of a clear explanation of the terms of the documents, the effects of the transaction on the surety and the propriety of the surety's entering into the suretyship transaction.³⁰²

9.6.5 Self-regulation or regulation?

Banks realise the importance of suretyship as a form of debt security particularly in respect of smaller loans. Suretyship plays a most important part in commercial life today. As an example, "personal loans", especially of small sums, by banks or other institutions will often have to be so secured. Where a loan is made to a woman, the suretyship of the husband would well be

299 See par 8.4.3 *supra*.

300 Constitution of the Republic of South Africa Act 108 of 1996. The Constitution does not replace the common law, but enhances it. See Malan & Pretorius 2001 *THRHR* 268 at 277.

301 [2000] 2 All SA 515 (K) at 526.

302 See ch 5 *supra*; pars 9.4.4 and 9.4.5 *supra*.

required by the lender. When credit or a credit facility or a loan is given to a private company the creditor would normally insist on the suretyship of the directors and possibly certain shareholders so as to protect himself or itself against the limited liability of the shareholders³⁰³ and also the competing claims of the directors as creditors.³⁰⁴

Banks are painfully aware of the attacks on their suretyship contracts or certain clauses contained therein. It has been recommended in this thesis that banks take certain pro-active steps to avoid findings of unconscionability.³⁰⁵

In all the legal systems analysed in this thesis, banks have accepted a code of conduct in respect of their dealings with customers. The purpose of these codes is, briefly to maintain standards of fairness in the banker-customer relationship.³⁰⁶

The Banking Council of South Africa has also accepted a Code of Banking Practice. The Code professes to deal with the banks' relationship with personal and small business customers. What is immediately striking is the fact that the Code's preamble³⁰⁷ specifically states that none of its provisions:

- will be justiciable in a court of law; or

303 In *Standard Bank of SA Ltd v Wilkinson* 1993 (3) SA 822 at 829 the Court stated that:

"It must furthermore be kept in mind that in modern society suretyships have become important because they are frequently linked to joint stock companies. A company that 'has no soul to be saved or body to be kicked' (*per Greer LJ in Stepney Corporation v Ososky* [1937] 3 All ER 289 (CA) at 291H) is often merely a vehicle with which the debtor seeks to borrow money. He creates a company with the least share capital permitted by law of which he is the sole shareholder and director and then seeks to borrow money for this newly-formed company which has few, if any, assets."

304 See *Kahn Cases* 770

305 Such as the creation of a banking industry ombudsman and a code of conduct to maintain standards of fairness in the banker-customer relationship. Other steps recommended include the ensuring of procedural fairness, substantive fairness, and the assumption of duties to disclose information. See pars 9.4.1 to 9.4.3.3 *supra*. Bankers should furthermore insist upon the surety's obtaining independent advice, in certain circumstances. See ch 5 and par 9.4.4.2 *supra*. Suitably trained compliance staff must be employed to supervise these issues. See pars 9.4.3.1; 9.4.3.2 and 9.4.3.3 *supra*.

306 See par 2.4.4 *supra* (England); par 3.5.4.3 *supra* (Australia); par 6.2.3 *supra* (Germany); par 7.2.3 *supra* (the Netherlands).

307 Code of Banking Practice 1.

- may be used to influence the interpretation of the legal relationship between a customer and the bank; or
- will give rise to a trade custom or tacit contract or otherwise between a customer and the bank.

This preamble creates a problem. As Pretorius³⁰⁸ points out, although Codes of Conduct are used in many countries, the main challenge is to devise an effective method of ensuring and enforcing compliance with such a code. "A supposed legal duty which is not matched by a remedy is a nonsense."³⁰⁹ It is recommended that the Banking Council should adopt its stated principles unequivocally or not bother at all.

A surety has a vast array of defences and benefits available.³¹⁰ As far as defences based on public policy are concerned, South African courts exercise the right to set aside a contract on the grounds of public policy, sparingly, and only in cases where the impropriety of the transaction and the element of public harm are manifest. In assessing the impropriety of the transaction and the element of public harm our courts have taken a conservative stance.³¹¹

If it is the perception of the legislature that sureties need more protection against unfair contract terms, it should legislate against such terms.³¹² Some of the legal systems analysed in this thesis have enacted legislation against unfair contract terms specifically.³¹³ Many modern, unfair contract term statutes do contain (apart from a general clause) a list of terms which aims at giving

308 See JT Pretorius in 1995 *ABLU* 1 at 11-12. See, also, McKay 1994 *IBL* 507 at 511.

309 Quoted from Sealy 1987 *Monash University LR* 164 at 177.

310 See pars 8.3.3 and 8.5.3 *supra*.

311 See par 9.6.3 *supra*.

312 The investigation team of the SA Law Commission *Unreasonable Stipulations* 29-31 has proposed that specific guidelines must be laid down which would supplement a general provision of fairness. See, also, SA Law Commission *Discussion Paper* 4-6 in which a research team under the guidance of Prof CFC van der Walt identified a number of common provisions which could and should receive the critical attention of the legislature.

313 See par 9.2.4 *supra*. In Dutch law the problem of unlimited suretyships has been addressed in Art 7:858. This article provides that suretyships entered into by a surety, not related to his profession or business, are only valid if the maximum amount of the surety's liability has been stated in the suretyship.

the general clause some clarification.³¹⁴

It is submitted that the publication of lists of *prima facie* unfair terms can certainly assist in obtaining legal certainty. It is imperative that banks (indeed all contracting parties) must be able to determine the legal consequences of its contracts and not be at the mercy of vague standards.

9.6.6 The future of suretyship

Whilst it is submitted that the publication of a list of *prima facie* unfair terms can assist to a large extent in creating legal certainty in respect of a bank's contracts, and in particular its suretyships, a warning must be issued against over-regulation. Most of the terms contained in a standard banker's suretyship have been inserted as a result of a lesson learnt some time in the past. Should certain terms which a banker considers essential, in his assessment of risk, be banned, or the cost of negotiating each suretyship become too costly, the natural result would be that suretyship will not be accepted as security.³¹⁵ If our law adopts such stringent protection measures, as is the case in Australia, for example, banks, particularly those who deal mostly with consumers, may wish to reconsider whether suretyship is in fact security, or an invitation to litigation.³¹⁶

314 See, eg, in Germany s 9 AGBG. German legislation contains two sets of guidelines on standard terms, namely, a so-called blacklist of terms (which simply nullifies those terms) and a grey list of terms (rendering those terms assailable). See ss 11 and 10 AGBG; par 9.2.4; par 6.2.1; par 6.2.3 and par 6.4 *supra*. See, also, the EC Directive on Unfair Contract Terms, discussed in par 9.6.4.2 *supra*, which contains a schedule, consisting of two parts, in which unfair terms are set forth. The first list contains seventeen terms that are regarded as unfair, and the criterion used is whether those terms have a certain aim or effect. The second list contains five exceptions to this rule.

315 Certain clauses which at first blush may seem to be somewhat oppressive are, in the context of the realities of commercial life, natural consequences of loans to sureties. See *Standard Bank of SA Ltd v Wilkinson* 1993 (3) SA 822 at 829. These clauses should not be attacked.

316 See par 9.5 *supra*.

TABLE OF STATUTES

SOUTH AFRICA

Alienation of Land Act 68 of 1981

Attorneys Act 53 of 1979

Banks Act 94 of 1990

Bills of Exchange Act 34 of 1964

Bills of Exchange Amendment Act 25 of 1943

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Companies Act 61 of 1973

Constitution of the Republic of South Africa Act 200 of 1993

Constitution of the Republic of South Africa Act 108 of 1996

Consumer Affairs (Unfair Business Practices) Act 7 of 1996 (Gauteng)

Consumer Affairs (Unfair Business Practices) Act 71 of 1988

Conventional Penalties Act 15 of 1962

Credit Agreements Act 75 of 1980

Criminal Procedure Act 51 of 1977

Currency and Exchanges Act 9 of 1933

Drugs and Drug Trafficking Act 140 of 1992

Fertilizers, Farm Feeds, Agricultural Remedies and Stock Remedies Act 54 of 1972

Financial Institutions (Investment of Funds) Act 39 of 1984

Financial Markets Control Act 55 of 1990

General Law Amendment Act 32 of 1952

General Law Amendment Act 50 of 1956

General Law Amendment Act 80 of 1964

Income Tax Act 58 of 1962
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Trade Practices Act 76 of 1976
Trade Practices Act Regulations *Government Gazette* 6880 14 March 1980
Usury Act 73 of 1968
Water Act 54 of 1956

SWEDEN

Act to Prohibit Improper Contract Terms of 1971

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Standard Contracts Act of 1982

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Bank Integration Act of 1991(Cth)
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 s 221 of 12 CFR
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 ss 300, 1100 *et seq* of 40 CFR
Community Reinvestment Act of 1977 (s 2901 *et seq* of 12 USC)

Competitive Equality Banking Act of 1987 (101 Stat 552 (1987))

Comprehensive Environmental Response Compensation and Liability Act of 1980 (s 9601 *et seq* of 42 USC)

Consumer Credit Protection Act (s 1601 *et seq* of 15 USC)

Douglas Amendment Act of 1970 (s 1842 of 12 USC)

Electronic Fund Transfer Act (s 1693 *et seq* of 15 USC)

Equal Credit Opportunity Act (s 1691 of 15 USC)

Federal Bankruptcy Code (11 USC)

Federal Deposit Insurance Act of 1950 (s 1811 of 12 USC)

Federal Deposit Insurance Corporation Improvement Act of 1991 (105 Stat 2236 (1991))

Federal Regulations

57 Fed Reg 62 890 (1992)

58 Fed Reg 4460 (1993)

59 Fed Reg 18266 (1994) (Fair Lending Initiative)

Federal Reserve Board (FRB)

Regulation D (s 204 of 12 CFR)

Regulation L (s 212 of 12 CFR)

Regulation 2 (s 226 of 12 CFR)

Regulation Service Locator No 3-1501 of 1979

Financial Institutions Reform Recovery and Enforcement Act of 1989 (103 Stat 183 (1989))

Financial Institutions Regulatory and Interest Rate Control Act of 1978 (92 Stat 3641 (1978))

Foreign Bank Supervision Enhancement Act of 1991(105 Stat 2286 (1991))

Foreign Transactions Reporting Act of 1970 (84 Stat 1118 (1970))

Garn-St Germain Depository Institutions Act of 1982 (96 Stat 1469 (1982))

Internal Revenue Code (s 1 *et seq* of 26 USC)

Interstate Land Sales Full Disclosure Act (s 1701 of 15 USC)

Investment Company Act of 1940 (s 80 of 15 USC)

McFadden Act of 1927 (s 36 of 12 USC)

Monetary Control Act of 1980 (94 Stat 132 (1980))

National Bank Act (s 1 *et seq* of 12 USC)

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (108 Stat 2338 (1994))

Right to Financial Privacy Act of 1978 (s 3401 of 12 USC)

Securities Act of 1933 (s 77 of 15 USC)

Securities Exchange Act of 1934 (s 78 of 15 USC)

Truth in Negotiations Act (s 2304 of 10 USC)

Uniform Commercial Code (DC) (77 Stat 630 (1963))

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Banker's Book Evidence Act of 1879

Bank of England Act of 1998

Banking Act of 1987

Companies Act of 1985

Company Securities (Insider Dealing) Act of 1985

Consumer Credit Act of 1974

Consumer Protection Act of 1987

Consumer Protection (Code of Practice for Traders on Price Indication) Approval Order of 1988

Contracts (Applicable Law) Act of 1990

Criminal Justice Act of 1988

Criminal Justice Act of 1993

Drug Trafficking Act of 1994

Drug Trafficking Offences Act of 1986

Fair Trading Act of 1973

Financial Services Act of 1986

Judicature Act of 1873

Marine Insurance Act of 1906
 Misrepresentation Act of 1967
 Money Laundering Regulations of 1993
 Moneylenders Act of 1900
 Police and Criminal Evidence Act of 1984
 Road Traffic Act of 1934
 Sale of Goods Act of 1979
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