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Risky Business: Financial Certificate Claims and Professional Indemnity Insurance

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In the 1990s particularly, following a number of high profile cases, there was considerable concern expressed about the potential liability risks associated with lawyers providing advice to clients or certification to lenders about guarantees and other securities. The heat may have gone out of the issue in recent times, and as a result some practitioners may not be fully aware of the risks, or may not have given the issue as much thought as previously. However the professional indemnity insurance scheme which covers all practitioners¹ has special provisions which reflect the risks associated with this area of practice.

Excess payable under Professional Indemnity Insurance Scheme

The insurance scheme deals with this through 'Financial Certificate' claims² attracting a much higher excess (payable by the practitioner) when a claim of this type is made against the practitioner and the practitioner relies on the insurance. Under the 2009-2010 scheme the basic excess per claim is \$3,000 or a multiple of \$3,000 per person liable to compensate a claimant up to a maximum of \$50,000. The basic excess payable will be between \$3,000 and \$50,000 depending on the number of partners of the firm, or number of directors of the company practitioner or persons held out on the company practitioner's letterhead as legal practitioners at the relevant date.

Most 'Financial Certificate' claims now attract an increase in excess of 300%. Claims where the insured practitioner was first retained after 1 January 1994 and before 31 December 1998 attract a 50% excess. Where the insured was first retained after 1 January 1999 there is an excess of 300%.

The practical effect is that if the practitioner or his or her firm does this type of work and it results in a claim the excess payable, which the practitioner will have to bear, will be between \$9,000 and \$150,000. Practitioners who do this type of work need to ask themselves: 'Is it worth the risk, do I know my risks, and am I managing my risks effectively?'

What are 'Financial Certificate' claims?

'Financial Certificate' claims are defined widely. The increased excess is payable where a claim: 'arises out of or is contributed to by any matter or transaction in relation to which the insured was retained to provide any advice to or any certification in respect of, a proposed guarantor, indemnifier, surety, mortgagor, or co-borrower who was not to derive substantial new financial benefit from or in respect of the said transaction of guarantee, indemnity, surety, mortgage or contract of loan respectively'.

Financial Certificate claims will cover the situation where the lawyer is retained to act for the lender to provide certification to the lender, as well as when acting for the person who is giving the security. For convenience the types of dealings between the lender and third party covered by the 'Financial Certificate' definition are referred to in this article as third party securities.

¹ Legal Practitioners Professional Indemnity Insurance Scheme under section 52 of the Legal Practitioners Act 1981.

² See definition of 'Financial Certificate' claims in clause 2.6 of Schedule 2 of Certificate of Insurance.

Reasons for seeking financial certification

Lenders seek securities from third parties as a means of managing their credit risk in lending to the borrower. Lenders seek certification from lawyers in relation to third party securities, or require borrowers and third parties to obtain such certification and provide it to the lender as a condition of extending credit to the borrower, for reasons which include:

- Because it is a means of the lender discharging its own duty of explanation;
- As a risk minimisation measure for the lender: with the aim of maximising the chance that the third party securities will be held valid and enforceable if challenged; and
- As a risk or loss shifting or sharing measure so that the lawyer who provides the certification bears some of the liability risk for the loss if things go wrong.

What are the risks to lenders?

Lenders bear the risk of having their third party securities set aside for reasons for reasons associated with the unfairness of the circumstances in which the securities were obtained or relating to the personal circumstances of the third party giving the security (e.g. special disadvantage).

This may take many forms. Examples include:

- unconscionable transactions where the third party is at a special disadvantage and the lender takes unconscientious advantage of that special disadvantage³; and
- the special equity which a married woman has to set aside a third party security given by her to the lender in respect of her husband's debts where the security has been given as a result of the husband's undue influence or if at the time of giving the security she did not understand its effect⁴.

What are the risks to lawyers who advise in relation to 'Financial Certificate' matters?

Lawyers who work in this area are exposed to legal liability risk on a number of fronts.

If a lender cannot recover under its third party securities, or from the borrower, it will likely look to see whether it has grounds to claim against a lawyer who provided certification. Conversely the third party client who is liable to the lender under the third party security may wish to claim against the lawyer alleging inadequate advice in relation to the transaction.

The potential liability risk which the lawyer bears is not limited to contractual liability under the terms of the retainer with the client. The lawyer may owe a duty of care to the lender or the third party, and have liability in negligence. The duty of care in tort a lawyer owes may in some cases exceed the duty owed under the retainer⁵. The lawyer could also have statutory liability, for example under the 'misleading and deceptive conduct' provisions of the Trade Practices Act and State Fair Trading Acts. Even if in fact not found liable lawyers still end up getting sued relatively frequently. The standard of care which a lawyer owes to the client to provide advice in relation to the third party securities and associated transactions can be high.

The practical risk the lawyer runs in advising about 'Financial Certificate' matters may also vary with the circumstances of the person to whom advice is given. Higher risk situations may include third parties who are elderly, not fluent in English, guaranteeing debts of children where no tangible benefit is received for this, third parties putting most of their assets at risk, or third parties with little business experience.

The lawyer has an obligation to summarise to the third party the important features of the third party securities⁶. In the context of a guarantee given under consumer credit legislation the SA Full Court has held that the lawyer has a duty to summarise the obligations of the guarantor and to ensure, through enquiries, that the guarantor is not acting under undue influence of the borrower⁷.

³ E.g. *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447

⁴ *Yerkey v Jones* (1939) 63 CLR 649; reaffirmed in *Garcia v National Australia Bank* (1998) 194 CLR 395

⁵ *Riz v Perpetual Trustee Australia Ltd* [2007] NSWSC 1153

⁶ *Citibank Savings Ltd v Nicholson* (1997) 70 SASR 206; *Pirotta v Citibank Ltd* (1998) 72 SASR 259.

⁷ *Micarone v Perpetual Trustees Australia Ltd* (1999) 75 SASR 1

In order to discharge adequately these obligations, the lawyer may need to outline and discuss a wide range of matters with the third party. A 'standard form' explanation will usually not suffice. Depending on the circumstances these may include, without limitation:

- the effect of the third party securities in the context of the overall transactions;
- the rights of the lender under the third party securities;
- rights of the third party against the borrower;
- question of contribution, marshalling of securities, set-off, exoneration and the like.

Although some cases have suggested that, unless the retainer either expressly or by implication requires the lawyer to do so, the lawyer is not expected nor required to advise the third party about financial or commercial wisdom of giving the security⁸, it has also been pointed out that in some cases there may be no bright line of distinction between legal and commercial advice⁹.

The potential pitfalls for lawyers in advising about 'Financial Certificate' matters are many and varied. A few examples follow. Failure to advise correctly about the dollar value of liability under the third party security can lead to liability¹⁰. Giving advice to the third party in the presence of the borrower can create a liability risk¹¹. Allowing the borrower to translate for the third party the advice given by the lawyer, given the risk that the advice may not be relayed correctly, can lead to liability¹². The identity of the client is a risk issue for the lawyer. Advising both husband and wife can lead to problems if the lawyer wrongly thinks that he or she is only advising one party¹³.

Even if you have done everything correctly, and have exercised reasonable care and skill in the circumstances, will you be able to prove this if a claim is made. Risk issues also relate to documentation and evidencing of the advice a lawyer has given.

Advising in relation to 'Financial Certificate' transactions: are you up the requirements? Are the risks worth it given the terms of your insurance cover?

For any queries about this, or other Risk Management Services offered by Law Claims, please contact the PI Risk Manager, Gianna Di Stefano on 8410 7677.

⁸ *Citicorp Australia Ltd v O'Brien* (1996) 40 NSWLR 398; *Micarone v Perpetual Trustees Australia Ltd* (1999) 75 SASR 1 at 142

⁹ *Spiteri v Roccisano* [2009] VSC 132 at [51]

¹⁰ *Esanda Finance Corporation v Tong* (1997) 41 NSWLR 482

¹¹ *McNamara v Commonwealth Trading Bank* (1984) 37 SASR 232, 241

¹² *Roberts v Goldenberg* [1997] ANZ ConvR 405

¹³ *Major v Wakeling* [2000] NSWCA 370