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SOUTH AUSTRALIA

THIRTY-NINTH REPORT

of the

LAW REFORM COMMITTEE

of

SOUTH AUSTRALIA

to

THE ATTORNEY-GENERAL

RELATING TO THE REFORM OF THE LAW OF SURETYSHIP

1977

The Law Reform Committee of South Australia was established by Proclamation which appeared in the *South Australian Government Gazette* of 19th September, 1968. The Members are:

THE HONOURABLE MR. JUSTICE ZELLING, C.B.E., *Chairman.*

THE HONOURABLE MR. JUSTICE JACOBS, *Deputy Chairman.*

THE HONOURABLE MR. JUSTICE KING, *Deputy Chairman.*

B. R. COX, Q.C., S.G.

D. W. BOLLEN, Q.C.

J. F. KEELER.

K. T. GRIFFIN.

The Secretary of the Committee is Miss J. L. Hill, c/o Supreme Court, Adelaide, South Australia 5000.

THIRTY-NINTH REPORT OF THE LAW REFORM COMMITTEE OF SOUTH AUSTRALIA RELATING TO THE REFORM OF THE LAW OF SURETYSHIP

To:

The Honourable Peter Duncan, M.P.,
Attorney-General of South Australia.

Sir,

Your predecessor referred to this Committee the consideration of the reform of the law relating to suretyship. There are many men who have found out by bitter experience the wisdom of the admonition of that wisest of men, King Solomon—"Be not thou one of them that strike hands, or of them that are sureties for debts": Proverbs 22:26.

It is probably impossible to save fools entirely from their folly but it is another thing, as Courts have done, to weigh heavily the law in favour of creditors, particularly banks, with no thought of the competing interests of the surety. The law has frequently made sureties liable in circumstances which were totally unenvisaged when the contract of suretyship was made and have stretched the law as far as possible in favour of the creditor and against the surety. In our opinion it is high time that the balance was redressed. We do not wish to impede legitimate commercial transactions in which suretyship forms and has for long formed as essential part, but we think that because a man becomes surety for another, it is not necessary for the Courts to take heed of another proverb of the same learned monarch and "answer a fool according to his folly lest he be wise in his own conceit" (26:5).

For these reasons we have not essayed a general review of the law of suretyship. We have preferred to deal with the cases in which, as the law stands at present, the scales are not held evenly between the creditor and the surety and have made suggestions for the reform of the law so that it might operate more equitably between the parties.

As to the definition of "suretyship" itself, this is usually taken from the speech of Lord Selborne in *Lakeman* v. *Mount Stephen L.R.* 7 *E & I.* 17 *at* 24-25 where His Lordship says:—

> "There can be no suretyship unless there be a principal debtor, who of course may be constituted in the course of the transaction by matters *ex post facto*, and need not be so at the time, but until there is a principal debtor there can be no suretyship. Nor can a man guarantee anybody else's debt unless there is a debt of some other person to be guaranteed."

We have not in this report distinguished between indemnity and guarantee. We have already in the Thirty-Fourth Report of this Committee recommended the repeal of Section 4 of the Statute of Frauds in relation to South Australia. It seems to us that in all circumstances the same rule should apply whether the contract be strictly one of guarantee, i.e. that recourse must first be had to the principal debtor and then to the surety, or a contract of indemnity where both are principal debtors and the amendments we recommend in this report should apply equally to both classes of contract of suretyship. For a good description of contracts of indemnity *stricto sensu* see *Bullen & Leake and Jacobs* (as it now is) *Precedents of Pleadings 12th Edition, pages* 495-497.

Turning now to the cases in which we think there should be amendments of the law they are as follows:—

1. Guarantees given in relation to a customer's account with a bank. This was the case which caused the original reference by your predecessor as the law, as presently constituted, is so manifestly unjust to the surety as to cry out for some redress for the surety. As the law stands at present, a bank is not required to disclose to a surety matters which any person entering into a contract of this kind would regard as material in deciding whether or not to act as surety unless there are "some unusual features in the particular case relating to the particular account which is to be guaranteed": see the judgment of the High Court of Australia in *Goodwin* v. *The National Bank of Australasia Limited* (1968) 117 *C.L.R.* 173. In that case an eighty-two-year-old woman was prepared to guarantee the account of her son and daughter-in-law with the respondent bank. However a week before the execution of the suretyship document the son had become surety to the bank for the account of a third person named Cavendish. This was not disclosed to this elderly woman and she became liable for a large sum of money on an account of which she knew nothing and had been told nothing. The contrary of the decision in Goodwin would appear to have been decided by Gordon J. in the Full Court of this State in *Chambers* v. *Rankine* 1910 *S.A.L.R.* 73. The other two Judges of the Court, Way, C. J. and Homburg, J., construed the guarantee in question there in a different manner and the point did not arise in their judgments. Insofar as Gordon, J.'s judgment is to the contrary of Goodwin's case it must be taken of course to be over-ruled *sub silentio* by the High Court's decision in Goodwin even though Gordon J.'s judgment is good sense and good commercial morality. The leading case is the decision of the House of Lords in *Hamilton v. Watson* (1845) 12 *Clark & Finelly* 109; 8 *E.R.* 1339. The effect of their Lordships' decision in that case is that a surety should in effect administer a whole series of interrogatories to a bank before entering into a contract of suretyship. How the surety is supposed to draw this hypothetical set of interrogatories, when the bank has all the knowledge and the surety has none, is a matter left unexplained by the eminent gentlemen who constituted the tribunal in question. Lord Campbell at pages 118-119 of the report in Clark & Finelly (at page 1343 of the English Reports) shows clearly the policy behind their Lordships' decision, which is that bankers would never get sureties or would get them much more rarely, if they had to make full disclosure before entering into contracts of suretyship. That might have been a sufficient commercial morality in the *laissez faire* era of 1845. It is an intolerable situation in 1976. We have no hesitation in recommending that the law be altered and that the person seeking the guarantee should be required by law to disclose to the surety all matters material to the decision of the proposed guarantor as to whether or not to enter into the proposed contract of suretyship before he enters into it. This recommendation should apply to all contracts of suretyship and not only those guaranteeing contracts made with banks.

The matter came to the attention of the then Attorney-General because the Australian and New Zealand Bank Limited raised the same defence in *O'Brien* v. *The Australian & New Zealand Bank Limited* (1971) 5 *S.A.S.R.* 347 *at page* 355. The defence did not prevail in that case because an actual untruth was told when a question was asked, but it is clear that even in this decade banks are still prepared to rely on the sort of commercial morality which would have been doubtful in 1845 and intolerable in our present consumer oriented society today.

2. We have not dealt in this paper with guarantees of contracts made by infants although these are themselves unsatisfactory: see a note in 35 *A.L.J. at* 357-8, articles by the then Mr. Else-Mitchell in 63 *L.Q.R.* 255 and by Stein in 90 *L.Q.R.* 258 and the decisions in *Coutts & Company* v. *Browne-Lecky* [1947] *K.B.* 104 and *Yeoman Credit Ltd.* v. *Latter* [1961] 1 *W.L.R.* 828, because we are dealing with the subject of infants' contracts generally in another report which is yet to be submitted to you. If the topic of guarantees given by infants is not dealt with in that report, we shall forward to you a supplementary report to this Thirty-Ninth Report of the Committee to cover that particular topic. We draw attention in this report to the defects in this branch of the law in case you prefer to deal with this particular aspect of it under suretyship and not under infants' contracts generally.

3. As the law stands at present a surety may restrict his liability under the contract of suretyship to a certain fixed amount but the creditor can still lend up to any amount and thereby bring into existence other debts which will compete with that of the surety and may well force the principal debtor into bankruptcy and therefore produce a liability on the surety quite unintended by the surety. As was said by the Court of Appeals of New South Wales in *Total Oil Products (Australia) Pty. Ltd.* v. *Robinson* (1970) 1 *N.S.W.L.R.* 701 unless the terms of the promise otherwise clearly show it, a guarantee for a stated amount merely limits the maximum liability of the guarantor and does not make the guarantor's liability conditional upon the principal debtor's liability remaining beneath that sum. Yet that is a reason why the average man puts in a limiting figure of that kind: to make sure that the principal debtor cannot get credit beyond that figure. In fact the limitation is nugatory. See also the decision of the Full Supreme Court of Queensland in *Queensland National Bank Ltd.* v. *Queensland Trustees Ltd.* (1899) 9 *Q.L.J.* 282. The law should be amended to provide that where an upper limit is specifically placed on a surety's liability in relation to a particular creditor, and that creditor advances moneys to the debtor beyond the limit of liability so imposed and accepted by the creditor without first obtaining the consent of the surety, the surety's liability should be diminished to the extent of those further advances.

4. So, too, as the law stands at present, a creditor can appropriate moneys paid by the debtor so as to defeat rights of the surety: see the judgment of the Privy Council in *Fahey v. M. S. D. Spiers Limited* [1975] 1 *N.Z.L.R.* 240 and *Rowlatt on the Law of Principal and Surety 3rd Edition, pages* 126-127. As is said in Rowlatt at page 126:—

> "If he (i.e. the debtor) makes no appropriation, the creditor can either then or at any time afterwards appropriate the moneys he pleases, even to a debt statute barred, though not a debt incurred during infancy; and the payment will not be presumed, as in the Civil law, to have been appropriated by the debtor to the more burdensome debt."

In other words the matter of appropriation goes on solely as between creditor and debtor. It is a matter of which the surety knows nothing and yet it enures to the disadvantage of the surety. That the creditor and debtor may so appropriate moneys as between themselves is well established. That the creditor should be able to do so to the disadvantage of the surety where there is a surety and without informing the surety thereof is wrong and that power should be taken away by

statute. The creditor can retain his power to appropriate payments as he pleases, or he may secure himself by obtaining a surety to the debt, but he should not be able to do both things. The unreasonableness in any event of granting this power of appropriation to the creditor in these circumstances is shown by *Rowlatt* (*op. cit.*) at page 134, quoting with approval a decision of the Supreme Court of Massachusetts that where money is obtained not by voluntary payment by the debtor but by execution levied, the proceeds of the execution cannot be appropriated by the creditor to those debts which are not guaranteed but must be apportioned ratably between all the debts included in the judgment. There should not be one rule for executions and another for voluntary payments. The rule propounded by the Supreme Court of Massachusetts in relation to execution is equitable, reasonable and proper and it should apply in both sets of circumstances.

Our recommendation is that the law should provide that irrespective of any appropriation as between debtor and creditor all payments by the debtor should operate to relieve the guarantor *pro tanto* of his obligation to the creditor in the absence of agreement to the contrary by the guarantor at the time of the appropriation.

5. Again, as the law now stands, the creditor can circumvent any limitation imposed pursuant to the suretyship agreement simply by entering into a new agreement with the debtor leaving the surety's contract intact and without notifying the surety of what he is doing: see the decision of the British Columbia Court of Appeal in *Bank of Nova Scotia* v. *Neil* (1968) 69 *D.L.R. 2d.* 357. In that case the guarantee was for two thousand dollars. The bank then went ahead and entered into fresh agreements with the debtor, unknown to the surety, totalling eight thousand dollars. They collected that latter amount in full and were held to be still entitled to recover the two thousand dollars from the surety. Again this result comes, to a certain extent, not only from the freedom of agreement accorded to creditors but also to the rule as to appropriation which we have dealt with under the preceding clause. Norris, J. A., says at page 358:

> "Where the guarantee is a continuing one, the surety has no right to control the appropriation of payments in, so long as (in this case) the banker deals with the accounts in the ordinary way of business: *Deeley* v. *Lloyds Bank Limited* [1912] *A.C.* 756 *at* 768."

We do not regard that in the 1970's as an acceptable way of carrying on business. It is a deceitful transaction carried on behind the back of the surety.

6. Similarly where a surety has joined in a bond for a thousand pounds and the creditor subsequently agrees with the debtor that the debt shall be only five hundred pounds, that does not discharge the surety and he is still liable for the full thousand pounds: see *Croydon Gas Company* v. *Dickinson* (1876) 2 *C.P.D.* 46 *at* 51. It is only the debtor's liability that the surety is guaranteeing and that should be the limit of the surety's liability.

7. So, too, it is not necessary for a creditor to resort to securities for the guaranteed debt received by the creditor from the principal debtor before proceeding against the surety. The distance to which this has been carried can well be seen in *Halsbury 3rd Edition Volume* 18 *"Guarantee and Indemnity" page* 450 *note* (*K*) where it is said—

"Even where the guarantee expressly stipulated that, before the surety could be called upon to pay, the creditor must have availed himself to the utmost of any *bona fide* securities which he held on the principal debtor, and it was proved that the creditor had neglected to adopt means to enforce payment of a bill by a party who was shown to be totally insolvent, it was held that the surety was not relieved from liability. *Musket* v. *Rogers* (1839) 8 *Scott* 51. A similar decision is *Lancaster* v. *Harrison* (1830) 6 *Bing*. 726."

In our opinion the law ought to be that if the creditor has securities which will either extinguish or reduce the amount of the surety's liability, he should in all honesty be compelled to realise them before proceeding against the surety. So too the creditor should owe a duty to the guarantor to exercise due diligence in preserving and enforcing securities applicable to the debt guaranteed: see *Provincial Bank of Canada* v. *Prince Edward Island Lending Authority* (1975) 59 *D.L.R.* 3*d*. 446.

8. The next matter in which the law of suretyship is at present defective is contained in *Halsbury* (*op. cit.*) *at page* 519—

"Paragraph 954. When the release of the principal debtor by the creditor is accomplished by means of a fraud on the part of the former the surety, if he has given no consideration, is not discharged even though he is no party to the fraud, upon the general principal (*sic*) that a volunteer cannot avail himself of what has been obtained by the fraud of another."

The cases which are cited for this principle do not in fact bear it out, as only one of the three cases really turns on the point and that is *Scholefield* v. *Templer* decided at first instance by Page-Wood V.-C. (as he then was) in 28 *L.J. Ch.* 452 and affirmed on appeal by the Lord Chancellor and the Lords Justices in 4 *DeG and J*. 429; 45 *E.R.* 166. However a perusal of the judgments on appeal show that the real ground of that decision was not so much the volunteer principle referred to in the text but rather that the surety concurred in the representations on the faith of which the release was given and was therefore estopped. There was a volunteer case on the other side of the line, a decision of Lord Eldon in *Ex parte Wilson* 11 *Ves*. 410 where it is clear that that eminent master of equity did not regard voluntariness as in itself an answer in these circumstances. In any case the whole reference to voluntariness is misplaced. The rule is "equity will not assist a volunteer". The surety is not asking for equity to assist him. The surety is saying "the principal obligation is gone, therefore on the principle propounded by Scrutton, L. J. in *Eldridge* v. *Morris and Taylor* [1931] 2 *K.B*. 416 *at* 420: "If the debt of the principal is gone, the surety is also discharged, my liability has gone. I am not seeking any help from equity at all." It is therefore possible that the text of Halsbury is wrong on the point but so that there can be no doubt for the future, it should be enacted that if the principal's liability has gone by reason of fraud, as to which fraud the surety was not a party neither did he make any representation in relation to which he should be estopped, the surety is discharged.

These deal with the specific instances in which the law ought to be amended. It would, however, in our opinion, be a good amendment to the law if in all cases a surety had to be given notice when the

principal debtor defaulted. It is necessary to give notice now in some cases but not in others as is explained by the High Court of Australia in *The Commercial Bank of Australia Limited* v. *The Colonial Finance Mortgage Investment & Guarantee Corporation Limited and Others* (1906) 4 *C.L.R.* 57. Indeed *Halsbury* (*op. cit.*) at page 449 states the obligation to give notice in even less satisfactory terms than the High Court did in *The Commercial Bank case*: see paragraph 826. The giving of notice to the surety immediately on the default of the debtor would alert him to the situation as between himself and the principal debtor. In many cases, he could call on the principal debtor to pay, with some hope at that stage of getting payment by the debtor in whole or in part and if he could do that then he would be able to help himself: see the recent decision of *Thomas* v. *The Nottingham Incorporated Football Club Limited* 1972 *Ch.* 596 and an article in 117 *Sol. Jo. page* 65.

However the major remedy which we recommend for improving the law of suretyship in general, as distinct from the particular improvements which we have recommended, is an enactment that no contract of suretyship shall be valid unless the contract has first been explained to the proposed surety by a solicitor independent of those acting for any other party to the transaction. A contract of suretyship is in fact not a simple contract at all, as most people blithely think when they are entering into one. It is a very complex transaction and will remain so even if the reforms which we have proposed become law, and the only way to ensure that a man knows what he is entering into and does not go blindfold into something which may bankrupt him, is to have the contract properly explained to him by obtaining independent legal advice before the contract is entered into at all.

However the Committee is of opinion that to add the cost of obtaining the advice of an independent solicitor on to the general costs of the transaction of quarantee would be oppressive in the case of small contracts. We therefore recommend that it be enacted that the necessity for independent advice shall not apply to contracts guaranteeing a total amount of $1 000 or any less sum. In such cases there should be a form of advice in writing, prescribed by regulation, which must be handed to the guarantor prior to his entering into the guarantee as a condition of the enforceability of the guarantee.

To prevent evasion of the general principle by splitting what is really one contract of guarantee into several each of which does not exceed $1 000, a section should be inserted in the proposed legislation prohibiting any such evasion. Where advice is required to be given by an independent solicitor, it should be provided that the surety cannot by contract deprive himself of this protection. Further the legislation should provide, as the Chief Justice has pointed out in his valuable memorandum on this paper that any provision of a contract of guarantee to the effect that any variation of the contract between the creditor and the debtor, or the giving of time or other indulgence to the debtor, should not release the surety, should be void, either unconditionally or unless the effect of the particular provision has been expressly drawn to the attention of and explained to the surety. Roman law required specific renunciation by name of protective legislation of this kind: see for example *Bank of Africa Ltd. v. Cohen* [1909] 2 *Ch.* 129.

We express our appreciation to the Chief Justice the Honourable Dr. J. J. Bray for his commentary upon the draft report.

We have the honour to be

HOWARD ZELLING
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Law Reform Committee of South Australia

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