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Solicitors Under Fire: Economic Impact on Negligence Claims

Intro

Over the past 14 months, there have been 12 interest rate rises, surges in inflation and escalating costs of living. Host Julian Morrow chats with Malcolm Cameron, National Practice Group Leader at Sparke Helmore about our rapidly changing economy, the impact this has on solicitors and how economic pressures can increase the likelihood of professional negligence claims occurring.

Julian: Welcome to Risk on Air. I'm Julian Morrow, and today I'm speaking with Malcolm Cameron. Malcolm, our topic today is *Interest rates, property prices and macroeconomics: impact on claims against solicitors*. Now, I've got to say I've never had a conversation in a CPD or Lawcover context about macroeconomics. It's an interesting topic that we've come to. Could you tell us to begin with, how is it that you came to thinking about this topic?

Malcolm: I was lucky enough earlier in the year to go to the opening of the Law Term Dinner, which the Law Society hosts every year. And the Chief Justice, Justice Bell, gave a speech at the dinner. One of the things he said in terms of looking forward to 2023 and the court's agenda was, he talked about an expected increase in volume. And this is what he said, "We unfortunately also anticipate a very significant growth of work in the possession list this year with the likely continued rise in interest rates likely to be productive of extreme mortgage stress exacerbated by the end of COVID related moratorium on actions for possession and as borrowers come to the end of locked in historically low fixed interest rates." So, hearing that from the Chief Justice, just in terms of looking forward to the year, just got me thinking about economics, got me thinking about the impact on litigation generally and obviously, because of what I do for a living, it got me interested in claims against solicitors. So that's where the idea came from.

Julian: It's worth recapping that we are speaking at a time when the Reserve Bank has raised the cash rate target interest rates 12 times since May 2022. Before that, the last official time rates went up was November 2020. By the time people are listening to this we might be looking back on the time that there had only been 12 interest rate increases with nostalgia! And then, of course, there's the pandemic as the Chief Justice mentioned, Russia's invasion of Ukraine, profound effects on the global economy that are working their way out. It makes sense that that's going to impact on the sorts of issues that solicitors are facing. And I suppose in particular because of where most solicitors' work occurs, what are the main areas of practice?

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Malcolm: Well, as I said, it's all related to property one way or another. I mean, I'm not an economist; I should make that clear so that people don't get the wrong idea.

Julian: Disclaimer noted.

Malcolm: But some of the economics is pretty basic. So a lot of what you see across Sydney in the development space of people buying land to build apartments, those are slow burn projects. People will buy land in a particular environment, with particular interest rates, and they'll have to do a construction, then they'll have to sell the properties at the end. If the world changes dramatically in the meantime, that's going to impact on those sorts of development deals. And that has flow on effects to lawyers because lawyers are involved usually at every stage of those processes, from acquiring the site at the beginning, to dealing with the finance, to selling the completed units at the end, and there's lots of different ways that things can go wrong. And when you've got a bit of a squeeze, if you like, by higher interest rates and lower property prices, that can be a real problem for people out there in the real world. And that can then reflect into claims against solicitors.

Julian: And I think if you combine sort of general commercial law with the nuts and bolts of conveyancing, that's more than 50% of the work that solicitors are doing.

Malcolm: I think that's right. I think it's something like 30% in sort of commercial work and 28 or 29% in property. So, it's a significant part of what the profession does. Those of us that are litigators get a bit shielded from that. I don't do that sort of front end transactional work myself, but a lot of people in the profession do and mostly do a good job of it. But it's when you've got clients in distress, it can reflect into what they look to their solicitors for.

Julian: So when we think about the prospect of an increase in, as you've said, clients in distress, what would you say are the key risks or increased risks that solicitors should be aware of when engaging with clients going through that sort of thing?

Malcolm: Yeah, so there's a few different ways you can answer that. I mean, there's sort of a technical response, which is that from a legal point of view, those economic matters don't change the legal landscape. The documents mean what they mean; the legal relationships between the parties are what they are. So in a technical sense, the practitioners in the area, the sort of detailed way they do their job won't necessarily change. But in terms of the risks that it presents, it seems to me that there's a much higher risk of transactions turning out to be a bad idea for the client. Now, our job as lawyers is not to necessarily predict whether something's going to be a bad idea or a good idea for a client, but if clients are getting themselves into situations which ultimately prove to be untenable, that seems to me to be a significant real world risk for lawyers. Because if your client ends up in a deal where they lose money or where they are in a situation which they can't afford to be in, they become unhappy and that unhappiness can feed into risk for the profession.

Julian: Yeah, they become unhappy. They're probably under pressure as well. They might also be less inclined to spend time with their lawyer because it's costing them money.

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Malcolm: Yeah, that's right. And that's a conundrum in practice generally where you've got low margin work for professionals where, you know, to do a proper job, you need to spend hours, possibly even days on a matter. Clients only want to spend a few hundred dollars or maybe a couple of thousand dollars to get the advice. So the pressure is on them. And it sort of almost invites a situation where the profession has to almost make a choice between doing the job properly and maybe having to rush something through to keep the client happy.

Julian: Is it likely that there will be an increase in professional negligence claims because of these broader adverse economic circumstances?

Malcolm: Well, getting my crystal ball out, I would say yes. I mean I've been doing this sort of work for quite a while and I can remember when I first started in the profession; it was the second half of the 1990s, sort of in the wake of the big interest rate rises in the J curve recession of '89 – '90. And a lot of cases I saw as a young lawyer involved property development cases gone wrong, developers who'd over geared, didn't have enough money, got everybody under the sun to guarantee their loans, and that turned into quite a few claims at that time. The GFC, when that happened, produced a huge raft of professional negligence claims against all sorts of professionals, from lawyers, to financial planners, to accountants. Those are sort of my experiences. It's not kind of an empirical piece of evidence but from my perspective, I think absolutely, when you have an economic squeeze, you end up with more litigation.

Julian: In terms of situations of borrowers and guarantors, could you give us your overview of the sorts of professional negligence claims that tends to arise and what that means for practitioners thinking about their clients who might be in that situation?

Malcolm: The most fertile area for claims arising out of borrowing and guarantees are situations where there's a third party guarantor. And so a typical case might be a son or a daughter, or a sister or a brother, as a business; they need to borrow some money to fund that business. They don't have the assets themselves to support the loan. So the lender will want a third party guarantor, so that might be Mum, might be Dad, might be the wife, might be the husband. And the lender will also want certainty that the guarantor is getting advice, independent advice, from a solicitor. And in fact, a lot of lenders will have a requirement that any guarantor gets independent legal advice. The problem with those transactions is really that the guarantor gets nothing. They get the warm fuzzy feeling of having helped their relative, but they get nothing out of the transaction themselves. I mean, there's lots of reported cases on that sort of situation, but in my own practice I've seen multiple cases where that's exactly the situation. So, the borrower defaults; the lender seeks to enforce against the guarantors; the guarantors sue their solicitor and say, "You never explained this to me. I didn't know what I was getting into".

Julian: And I suppose that's why there are some formal rules about what you need to do. And that brings us to Rule 11 of the Legal Profession Uniform Legal Practice Rules. Could you talk to us a little bit about Rule 11 and I suppose the formalities of that rule, but then maybe stepping back a little bit more broadly and some of the practicalities that apply and not just a sort of box ticking exercise?

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Malcolm: Yeah, so that's something I'm quite interested in, the practical side of it. For most practitioners they'll know there is a rule and the rule, as you say, Julian, it's Rule 11, and it sets out a series of musts. So, when giving advice to a guarantor or to a borrower, thou shalt do the following things. And there are prescribed forms. A declaration by the borrower, declaration by the guarantor, for example, it requires a guarantor to give a stat deck saying that they've been advised about the fact that if the loan isn't repaid, the lender can come against them; that if they're giving a mortgage, that the lender can take their home. All of which is true and clear and sort of straightforward but all of it focuses on what I think of as the mechanics of the transaction. And so a practitioner can comply with that rule and the client can go ahead and enter the transaction. But if that's all that happens, what the client will have heard is really, if you like, the way the transaction functions in a technical, logical sense. It doesn't tell them anything about the substance of it. And that, to me, is not unhelpful but it doesn't necessarily get the client to where they may need to be, if that's all that's done.

Julian: So what I'm hearing you say is that narrow technical compliance with rules that are designed to limit the risk might not actually be enough to genuinely limit the risk. How do you bridge that gap and go the extra step?

Malcolm: Yeah, where do you sort of draw the line between doing what the rules require and doing what practical common sense may require? Well, firstly, like everything in the law, it depends. So there isn't sort of a simple answer unfortunately. But when you look at the cases on this area, what you see are statements from judges that talk about how far the solicitor needs to go depends very much on the facts of the case. And so there was a case of *Dominic v Riz* back in 2009, where a couple had mortgaged their home and borrowed \$150,000 to invest in Karl Suleman Enterprises, which was I think froggy.com, I think it was at the time. And they were promised fantastic returns and they were going to make heaps of money, which turned out not to be the case. They sued their solicitor and the solicitor had given them, what you might call, the right technical advice, had been through the documents, explained what they were doing, but didn't say anything to them about the investment in Karl Suleman Enterprises or explain anything about the transaction. The Court of Appeal said that was okay in that case because the lawyer didn't know anything really about the transaction. So there was nothing about it that stuck out to them.

So it depends. But there's been other cases where the nature of the transaction is so obviously problematic that I think the lawyer needs to go further. I might, if I may Julian give an example on a no-names basis of a case that I worked on some years ago, an old lady who was, I think she was in her seventies at the time, was approached by somebody who she trusted with what he described as an investment opportunity. And she did exactly what the people had done in the froggy.com case: she went to a solicitor, she was asked to give a mortgage over her home and to invest in this venture. The interest rates on the loan were 8% per month. I think that's 96% per year. That's if she wasn't in default. If she was in default it was 15% per month, which is 180% a year. And the solicitor she went to, who I acted for in that case, which we ended up settling, had given absolutely technically correct advice about the nature of the document, the mortgage, etc. But to me, when I saw it, it was such an obviously dodgy proposition that I think the solicitor needed to do more. I think she really needed to say, "How do you understand this? How do you think you're going to make money out of this?" Try to get the client to explain to her, as the solicitor, what she was doing. Not because the solicitor needed to give financial advice, but just because, to protect the client from herself really, I thought she needed to satisfy herself as the practitioner that the client really understood, I guess in an economic sense, what she was getting herself in for, which she didn't.

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- Julian:** And that's really interesting because on one level there is the scope of the retainer and what that inherently requires, but there certainly are other examples and other cases where judges have talked about the need to address the financial and practical consequences of a transaction even though you're not the financial advisor. That's a grey area, dare I say it, Malcolm, is it a penumbral area?
- Malcolm:** Oh, that's one of my favourite words. We love talking about penumbral duties.
- Julian:** Just in case there aren't people here who just immediately know exactly what we're talking about when we're talking about penumbral duties, what are they, and why should we be talking about them now?
- Malcolm:** Well in some cases it's been suggested that lawyers in effect have a duty at large to look after their clients' interests, whatever that may mean. And that's been described as a penumbral duty-
- Julian:** Kind of shadow duty type thing.
- Malcolm:** I'm not a linguist, so I can't speak to the derivations of the word. And the authorities say that there isn't such a penumbral duty - but! And the 'but' goes something like this. So essentially your duty as a practitioner is to competently carry out your retainer and not to do other stuff. So if you're retained to do one thing, you can do that one thing. However, if you become aware, in the course of doing that one thing, of something which suggests to you that your client's interests are endangered, then you've got an obligation to warn the client about that. Now the problem with the real world is it's very complex and lots of different situations can come up.
- Julian:** It's full of penumbra.
- Malcolm:** It's full of penumbra. And so working out in a particular case whether the thing that you've just learned of is enough to trigger that obligation to warn, is actually not that easy. But I don't know, I said it's not that easy but, for me, it's not that hard either, because lawyers are usually pretty smart people. They know when something looks not right. And so it's sort of a version to me of 'if you see something, say something'. And so going back to my old lady case, this was an old lady who'd lived in the one house for 50 or 60 years, she was on a fixed income and she was being asked to give a mortgage over her house to basically put the whole of her life savings and her home at risk to invest in something which, frankly, I didn't understand as the practitioner looking at this after the event; there was no way she understood it. So, to me that sort of, 'if you see something, say something' idea made it obvious in that case that the lawyer needed to steer her away from that decision. Does that cross the line into financial advice? I don't think it does. I think it's really just protecting the client from a danger that you can see in a way that she probably couldn't see.
- Now not every practitioner would agree with me, by the way. There'd probably be some people who would've said that that was fine, but that's not the view I formed at the time.

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Julian: Yeah, there are penumbras in the penumbra debate. But it's the case of Australian Executor Trustees (SA) Limited v Kerr, which is New South Wales Court of Appeal case. Justice Gleeson, I suppose, deals with the penumbra debate by saying it's not a penumbral duty, but the real question is, what does reasonable care in the particular circumstances of the case require? And there's more than one case where the failure to address the financial and practical consequences can tip over into that failure to take reasonable care.

Malcolm: That's a good example, that case. It's a case that my firm had the misfortune to be involved in but we were successful in the end. In a way it's sort of the diametric opposite of the little old lady mortgaging her house for the strange investment. So, the client was a sophisticated trustee company. It had designed a particular transaction that it wanted to enter into. It approached the solicitors for advice on a very narrow question which, from memory, was whether or not the trustee permitted the transaction to be carried out. And, in fact, I think there was even a draft form of sign off provided by the client to the law firm. So the law firm gives the advice entirely within the scope of what it had been asked to do. It doesn't look at the wisdom of the transaction; it doesn't look beyond the very narrow scope of what it's being asked to look at. And, both at first instance and on an appeal, that was held to be sufficient and coming back to the reasonable care in the circumstances of the case, when you look at the circumstances there, it was a client who knew what it was doing. It was a client who was capable of making decisions about investments, understanding economic risk, in effect, understanding the things that could go wrong. And it was looking for a lawyer to tick a box, and the lawyers tick the box, and the Court of Appeal said that was sufficient.

And so that to me is quite a useful case because it shows that it's not completely open slather. The penumbra duty doesn't mean you've got to hold every client's hand through every single transaction, but you've got to understand your client, I think, sufficiently to know how much is enough in the particular case.

Julian: Yeah. So the sophistication and knowledge of the client is going to be one, but not the only factor that really needs to be taken into account. So Malcolm, we're in this situation where interest rates are rising, experience suggests that that means that there are going to be clients in distress. So what are the practical risk management tips that the practitioners listening now should be bearing in mind when those sorts of clients are across the desk, or on the phone, in the Zoom call or whatever it is?

Malcolm: There's a few practical things, some of which are obvious, maybe others not quite so obvious. The first is one of the basic rules; work out who your client is. It's not uncommon for two people to turn up at the solicitor's office, one of whom is the borrower or a director of the borrower and the other of whom is their mother, their wife, their cousin, whoever it might be that they're asking to guarantee the loan. So who is the client in that situation? Most solicitors will take a practical view of conflict. So, if there are two clients who turn up, they'll form a practical view about whether there's an actual conflict between their interests. So, if it's husband and wife buying a house together, two people, sure, but not really a conflict there. But in that situation I just sort of posited where it's a borrower and a guarantor, don't act for both of them. And there's almost nothing you can do if you decide to act for both, that's going to ultimately protect you because there's an inherent conflict between them, which of course the clients do not see because it's mum with her son, you know?

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Julian: Exactly and that's the awkward situation for the solicitor because you might all be sitting in the same room or the same call and there may well be circumstances where one of the things you need to be able to do is to talk to the person who is your client, and only them.

Malcolm: So that, that's absolutely my number one tip in guarantee cases in particular is to figure out who your client is and only act for that person. I know that that is actually not easy and it seems to me that there's sort of ways to sort of solve for that. Practitioners need to have a network around them. You don't just say no to Mum in the situation; you say, I can't help you but my colleague down the road can help you.

Julian: So a referral network to not just provide the problem for the other person in the room, but a helpful way to solve that problem as well.

Malcolm: There'll be resistance to that at times because people won't want to spend money on a second lawyer. There'll be pressure put on the practitioner to just do it because really, from the client's point of view, the borrower's point of view particularly, they are just trying to get a signature on a page. They want the money, they want the signature. If that means they've got to go to a solicitor as a box to tick, that's what they're doing. So resist that to the extent you can.

I guess my second practical tip, if you get past that hurdle and you're actually dealing with someone who's a guarantor, for example, is the best thing is to firstly speak to them alone. Secondly, get them, as the guarantor, to describe to you, as the practitioner, what they're doing. What is this transaction; what are the risks of it? How do you see it? Why are you doing this? Because what you typically see when the litigation comes later is the guarantor says, "I've got no idea. I didn't understand any of this". So just ask them, can they explain what they're doing and why? And a mum saying, "I'm doing this to help my son" is probably not enough. So that's my second practical tip. Try to get the client to tell you what they're doing.

Julian: And I think that's really worth dwelling on because a lot of the time for lawyers, it's thinking about, "Well what have I said to the client so that I can be comfortable that it's been said?" But what you're alluding to there is how you satisfy yourself that it's been understood.

Malcolm: Yes, exactly. That's exactly right.

Julian: And hearing it from the client. And that doesn't involve them saying, "I now understand that the legal test for informed consent is this", but actually you're satisfying yourself about their understanding of the financial and practical consequences. You're satisfying yourself by asking them to actually explain it to you.

Malcolm: Yeah, that's right. And it also feeds into the point I made earlier about fulfilling the Rule 11 requirements is good but may not be enough. You can always get to that at the end of the session, not at the beginning of the session. If you start with that, you end up with, I think, a very narrow base. So, that's my second practical tip is to ask the client to explain to you what they think they're doing.

I think the third tip, and this relates again to guarantors, is to ask the guarantor client what they know about the financial affairs of the thing that they're guaranteeing. So, if it's a relative's business, if it's a relative's loan for some other purpose, what do they know about that business? What do they know about the financials? I think if you step out of this context for a minute, and imagine this as a corporate deal where everyone's sophisticated, the lawyers acting for a large lending company who's wanting to lend into some corporate

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deal, they'll advise their client to do due diligence. You know, here's what you need to ask the counterparty. Here's the data room that needs to be set up, here's the documents you need to look at. Now, obviously in a domestic context or smaller context, you're not going to have a data room, but the concept's the same. What you're really doing is advising the client to do some due diligence. I don't suggest people use that expression when they're talking to a person in this situation but, again, by inviting them to explain what they know about the thing they're guaranteeing and maybe counselling them to see what they can find out if they turn out not to know anything. So that's really the third thing, is to try to get the client to get information so they can assess it.

Julian: And from a risk management point of view for solicitors, what would you advise about record keeping on this sort of stuff?

Malcolm: Well, this is the usual advice...

Julian: Just trust, would that be where we'd start?

Malcolm: So, the obvious answer is anything in writing is better than anything that's retained only in your memory. I've had lots of cases over the years where the solicitor has given me a very thorough account of exactly what transpired in a conference with a client. And when I ask for the documents that demonstrate that, they don't exist, and the problem that that presents when you're defending a piece of litigation is just purely an evidentiary problem. I can sit a witness in the witness box and they can give their evidence and they may be accepted, but if there's nothing in writing, it's much harder for that to happen. I should say, solicitors do get believed at times when they give evidence. It's not that it doesn't happen. File notes are not something which you get punished for not having but, from a litigator's point of view, please create a document that I can use.

Julian: And there's certainly some cases where record keeping and file noting has made a critical difference. The case of Secured Lending 1 Pty Ltd v Mahmassani which is a New South Wales Supreme Court case from 2021. And that's got a critical passage. Now, of course you've referred to Rule 11, and there's no doubt the advice is comply with Rule 11 in full.

Malcolm: Absolutely, yeah.

Julian: But that was a case where the judge noted it would've been far preferable for the solicitor, and the solicitor could have avoided a claim, if the advice had been confirmed by way of a letter that was written soon after a critical conference. But actually, in that case, it was a file note that made a difference. Is that right?

Malcolm: Yeah, that's right. So it's a good example of evidentiary uncertainty. So there were multiple people at meetings, as I understand it in that case; there were multiple versions of events about what had been discussed. And ultimately the judge in the case had to make a decision about what had occurred at the meeting. And the best evidence that was available were the solicitor's notes. And that ultimately helped the solicitor successfully defend the case. So that absolutely it's an evidentiary question. So from a risk management point of view, as I say, help those who are going to defend you to help you by keeping a good note. Now, some people will say, confirm everything in writing, and there is some merit in that. But I also think that if you write a client a six page letter that recites multiple slabs of the guarantee and mortgage documents that you've just witnessed them sign, that letter may or may not be an especially helpful document.

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So to me it depends a bit on your audience. I mean, writing a six page letter to a client whose first language may not be English, that may be of limited sophistication, is probably not going to help that client very much. Much more important is, and this is the point you made earlier, is working out in the situation what is best to make sure that the particular client actually understands. So there's an evidentiary side to that, which is the file note, maybe putting something in writing if it's done in a way that is capable of being understood, which some solicitors are very good at. But you don't have to put everything in writing and in a practical world, you just can't. I mean, often solicitors don't get paid very much for these guarantee advices. And having to write somebody a six page letter or a two page letter after the event might be not very practical.

Julian: And for what we've discussed, Malcolm, it seems to me that we're talking about situations where clients are coming to you for help and they might have a particular end in mind, but what's required professionally might be a little bit different from the specific help that the client's actually looking for.

Malcolm: Yeah, that's true, Julian. In fact, the former Chief Executive of Lawcover had a little expression, which I sometimes steal, which is this, "Don't be helpful, do your job." Because you're right. The reason that a client comes to you to get advice about a mortgage or a guarantee is not because they actually want advice about the mortgage and the guarantee. It may not be always true, but it's almost always true. The reason they come to you is because their lender has said, "You need to see a solicitor about this". So, if you restrict yourself to being helpful, the most helpful thing you could do for the client is to just sign the documents; not say a word to them. They'd go away happy because they ticked the box they needed to tick. But in my view, that isn't doing your job. Your job is to give clients the benefit of something that you have, which is unique to the profession, which is the ability to understand these transactions in a way that unsophisticated clients can't. So that's actually our job, it seems to me. And the way you make that happen, regrettably, is dependent on the situation, on the person in front of you, on the nature of the deal, which is why the cases use general words. It's fact dependent, what is the scope of the duty. But to do your job, if you haven't brought the client to a position where they actually understand what they're doing and are making a decision for good or for ill with the full picture in front of them, then I don't think you've done your job.

Julian: Well, there may be penumbra in this area, Malcolm, but I'm just relieved to know that there's a line between being able to address the financial and practical consequences of a particular transaction and having to have a more detailed understanding of macroeconomics. And I'm sure there are plenty of listeners out there who think that too. So before we all go off and get extra tertiary qualifications, focus on the specifics of the event and keep appropriate records. And Malcolm, thanks very much for speaking with us on Risk on Air.

Malcolm: Thanks, Julian. It's been a pleasure.

Outro

Thanks for listening to Risk on Air by Lawcover. Join us for the next episode on current risks in legal practice to stay up to date.