SINS OF THE FATHER: CAN A GUARANTOR AVOID LIABILITY BY CLAIMING TO HAVE BEEN UNDER 'UNDUE INFLUENCE' OF A FAMILY MEMBER?

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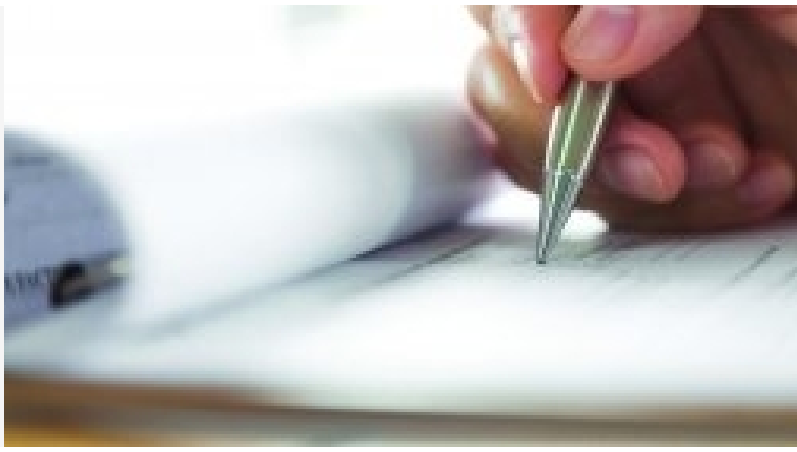

INTRODUCTION

"This case illustrates the importance of giving consideration to the Etridge guidelines when seeking guarantees from parents, spouses and their (adult) children or other family members."

In an important recent judgment[1], in which this firm acted for the successful claimant lenders, the Commercial Court in London has comprehensively rejected arguments advanced by two sons of a shipping magnate – who, together with their father, had given the claimants a number of personal guarantees of a series of shipping loans – that (i) they had acted under their father's undue influence; and (ii) the claimants had been put on inquiry of this. In giving judgment, the Judge (Jacobs J) reviewed the authorities and helpfully clarified a number of aspects of the law of undue influence, which will be of interest both to legal practitioners advising on personal guarantees and related security and to lenders seeking to obtain such security.

BACKGROUND

The claim was brought by a number of companies managed by Yield Street Management, LLC, a US online investment platform, for recovery of some US$76.7m owed under various loans to ship-owning corporate borrowers, advanced to finance the acquisition of end-of-life vessels for demolition, that three members of the Dubai-based Lakhani family had personally guaranteed. The claimants had, as they were entitled[2], chosen not to wait for defences to be filed before applying for summary judgment. One of the guarantors, Tahir Lakhani, did not contest the claim for judgment but his two sons, Ali and Hasan, filed witness statements in which they maintained that their father had 'instructed' them to sign their guarantees, and that they had understood neither the nature of the loan transactions nor the risks involved.

UNDUE INFLUENCE: THE LAW

Under English law (which was the governing law of the guarantees), a party may avoid liability for a transaction (including a guarantee, loan or mortgage) by showing that he or she was 'unduly influenced' to enter the transaction and that the other party (usually a lender) was put on inquiry as to some equitable wrong but failed to take reasonable steps to satisfy itself that the party influenced has been made aware of the risks. The risk of a guarantee being set aside for undue influence is well-known to UK lenders and their legal advisers in the context of business loans secured over English matrimonial homes. It is standard practice for such lenders to require spouses to take independent legal advice and for the solicitor advising them to confirm this to the lender, the so-called *Etridge* guidelines, named after the House of Lords decision in the case of that name[3]. This risk is somewhat less familiar to commercial lenders active outside the UK residential market. However, it is one that clearly exists and should not be ignored.

THE PARTIES' ARGUMENTS

In this case, both sons were joint shareholders and co-directors of the borrowers' parent, North Star Maritime Holdings Limited, which had given corporate guarantees of the loans. However, their case was that the claimants were nevertheless put on inquiry as to the influence they alleged their father exerted over them. They relied on the fact that the claimants had dealt primarily with their father, who had worked for over 40 years in the industry. They also relied on an email sent to their father by GMTC LLC, a Greek based advisory boutique that had sourced the transaction for the claimants. In the email, GMTC had made known the claimants' requirement for the sons to give guarantees in view of their co-ownership of the holding company, although the email commented that the father would say that the borrowers' business was 'ultimately all him'. The claimants had not been made aware of this email at the time, but had to accept, for the purposes of the summary judgment application, that GMTC had sent it as their agent.

"The claimants submitted that they were nevertheless not put on inquiry as to potential undue influence and, further, that there was no actual undue influence."

The claimants submitted that they were nevertheless not put on inquiry as to potential undue influence and, further, that there was no actual undue influence. The claimants argued that they were not put on inquiry as it was entirely natural for the sons, as owners and directors of North Star, to give guarantees of loans advanced, initially, to refinance other loans from different lenders of which they had also provided personal guarantees. As such, it could not be said that the relationship between the debtors (the borrowers) and the sureties (the sons) was not commercial. Nor could it be said that the transaction was not to the sons' financial advantage. Having failed to advance a case of any overt acts of improper pressure or coercion by their father, the sons could not show actual undue influence, and the fact that Tahir wielded considerable influence over his sons did not suffice. In short, the sons were not alleging any 'conscious act of wrongdoing'[4] by their father.

The sons contended that the fact the loans were for significant sums which, they claimed, substantially exceeded their assets 'and so could ruin them' sufficed to put the claimants on inquiry. Further, the fact that the sons were the 100% owners and directors of North Star did not, they said, assist the claimants because such interests were "*not a reliable guide to the identity of the persons who actually had the conduct of the company's business*" (per Lord Nicholls of Birkenhead in *Etridge*). They also relied on another authority suggesting that a bank is put on inquiry in a case where the guarantor is a director and/or shareholder but does not have substantial involvement in the business[5]. The fact that their father was, as they described him, an 'aggressive and domineering man', who they alleged 'completely controlled the business' and caused their 'unthinking and unquestioning approach to signing documentation placed in front of them' sufficed to show his undue influence over them.

THE JUDGMENT

"They were not children, but 'well-educated individuals in whom their father 'had sufficient confidence to vest the entire ownership of the ship recycling business in order to accomplish family succession'."

Dismissing the sons' case, the Judge held that the suggestion that they had not understood the nature of their guarantees 'carries no conviction at all'. The Judge noted that both had obtained business degrees and had worked, respectively, in a law firm and a bank before joining the family business. Nor had the claimants been put on inquiry of any potential undue influence. To the contrary, it was 'entirely natural' for the claimants to seek guarantees from individuals who were the borrowers' beneficial owners. Whilst those cases in which a lender is put on inquiry extend beyond the relationship of husband and wife and include that of parent and child, the relationship here was a commercial one, with both sons involved in the borrowing group's business 'who could be regarded as capable of looking after themselves and understanding the risks involved in the giving of guarantees'. They were not children, but 'well-educated individuals in their 20s or 30s' in whom their father 'had sufficient confidence to vest the entire ownership of the ship recycling business in order to accomplish family succession'. They were also the borrowers' beneficial owners, from whom guarantees would ordinarily be expected in a ship finance transaction. Whilst the Judge agreed that the mere fact of a shareholding or directorship interest in a borrowing company is not of itself a reliable guide to whether an individual guarantor has conduct of that company's business, this factor alone is not sufficient to put a lender on inquiry, but rather will depend on the commercial background. This provides helpful clarification of the *dicta* of Lord Nicholls in *Etridge* (quoted above). In this case, the claimants were not put on inquiry when that commercial background was taken together and considered as a whole.

The Judge further held that there was no actual undue influence in this case. For this purpose, mere influence was not sufficient, it had to be 'undue', which connoted impropriety or influence that has been 'misused', for example the case of a husband who prefers his interests to those of his wife and 'makes a choice for both of them on that footing'. By contrast, where a husband had influenced his wife to mortgage the matrimonial home to obtain finance for an advantageous new lease, his influence was not undue as he had not deliberately set out to take unfair advantage of her[6]. The Judge therefore rejected the sons' case that their father's domination over them sufficed to show undue influence. Here, the father's influence could not be said to be unconscionable. This was not, for example, a case in which the sons were claiming that their father had withheld information that the companies were in a parlous financial state.

LESSONS LEARNED

Personal guarantees are not infrequently taken in ship financing transactions, and often are taken from individuals in family-owned businesses. This case illustrates the importance of giving consideration to the *Etridge* guidelines when seeking guarantees from parents, spouses and their (adult) children or other family members, especially where it is unclear whether or to what extent they are actively involved in the business. In this case, in which this firm had not advised on the original loan transactions, the claimants had not been advised of the need to take such protective steps, enabling the sons later to raise undue influence defences, albeit unsuccessfully.

"For a lender to require a personal guarantor to take independent legal advice on their intended guarantee and to have such guarantor's solicitor confirm the giving of such advice is not an onerous step to take."

At the outset of any loan transaction, for a lender to require a personal guarantor to take independent legal advice on their intended guarantee and to have such guarantor's solicitor confirm the giving of such advice is not an onerous step to take and has habitually and routinely been taken in the residential mortgage context for the past 25 years. The alternative would be for the lender to have a private meeting with each such guarantor to warn them of the risks and urge them to take independent legal advice conduct, which most lenders would be loath to do, or to conduct considerable due diligence to satisfy itself that there is no such risk, a process which may be less than fully reliable, in each case with the risk of litigation down the line if the loan goes into default and calls are made on the guarantees.

[1] *YS GM Marfin II LLC and Ors v Muhammad Ali Lakhani and Ors* [2020] EWHC 2629 (Comm).

[2] *Royal Bank of Scotland plc (No. 2) v Etridge* [2002] 2 AC.

[3] Under CPR Part 24.4(1).

[4] Per Patten LJ in *RBS v Chandra* [2011] EWCA Civ 192 at [27].

[5] *Mahon v FBN Bank* [2011] EWHC 1432 Ch.

[6] *Dunbar Bank Plc v Nadeem* [1998] 3 All ER 876.

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