YELDHAM PRICE O'BRIEN LUSK

PENUMBRAL DUTY OVERSHADOWED

Introduction

The New South Wales Court of Appeal[1] has revisited the unsettled legal principle of solicitors' penumbral duty - that is, the principle that solicitors, in certain circumstances, owe duties in tort to take care to avoid foreseeable loss to their clients, even if their contractual duties do not extend that far.[2] The Court of Appeal's decision brings further clarity to this area of law.

Summary of facts

A firm of solicitors were retained by their clients for the limited purpose of documenting a mortgage transaction. The clients borrowed $275,000 from a financial institution on the security of their home (**mortgage transaction**). They intended to use $150,000 of the loan proceeds to invest in Karl Suleman Enterprises Pty Limited (**investment transaction**). The clients believed that they would receive a return of $24,000 per month on their $150,000 investment. They made these bare facts known to the solicitors. Karl Suleman Enterprises Pty Limited made one repayment to the clients and otherwise failed to deliver the promised investment returns. It subsequently went into liquidation. The clients' investment was lost. They were unable to meet their mortgage repayments and subsequently defaulted on their mortgage.

The clients sued the solicitors primarily in negligence, but also for breach of fiduciary duty. This article will focus only on the issues relevant to the solicitors' penumbral duty.

At first instance

At first instance,[3] Justice Brereton found for the clients. He held:

- the solicitors had confirmed to the clients that their retainer was limited to providing legal services with respect to the mortgage transaction and that they would not provide any advice with respect to the investment transaction;
- the solicitors had given advice to the clients to seek independent financial and legal advice in respect to the investment transaction;
- the clients had understood the solicitors' advice;
- the solicitors were not reasonably entitled to be satisfied that the clients would follow-up that advice or that they understood its importance;
- the clients did not seek independent financial and legal advice with respect to the investment transaction;
- the solicitors had not done enough to emphasise to the clients the importance of obtaining independent advice with respect to the investment transaction; and
- the solicitors' omission to emphasise to the clients the importance of obtaining independent advice with respect to the investment transaction caused the clients' loss.

Despite the narrowness of the solicitors' retainer, the trial judge found that the solicitors failed to warn the clients sufficiently that the investment transaction was imprudent. The trial judge found that the solicitors knew that the clients expected a return on their investment in excess of 200%. Justice Brereton thought that it would have been obvious to the solicitors that the

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[1] *Paul Manuelpilai Dominic v Omar Riz* (2009) NSWCA 216 (29 July 2009)

[2] See *Hawkins v Clayton* (1988) 164 CLR 539, *David v David* (2009) NSWCA 8 (February 2009), *Heydon v NRMA Ltd* (2000) NSWCA 374 and *Kowalczuk v Accom Finance* (2008) NSWCA 343

[3] *Riz v Perpetual Trustees Australia Limited* (2007) NSWSC 1153 (18 October 2007) (**Riz**)

clients '... were putting their home at risk for the purpose of raising funds for an investment in respect of which they had expectations that objectively were absurd'.[4] In other words, he considered that the salient factor in this case was that, on its face, the investment transaction was self-evidently improvident and absurd. His Honour distinguished this case from previous authorities as he considered that it was '... plain that the client [was] rushing into an unwise, not to say disastrous adventure...' and that the solicitors' knowledge of this circumstance triggered a penumbral duty. In short, he considered that the solicitors should have formed an opinion of the prudence of the investment transaction despite it being specifically excluded by the retainer.

Justice Brereton considered that a solicitor's duty of care to a client is not confined to the contract of retainer, but may extend in the circumstances of a particular case to require the taking of positive steps, beyond the specifically agreed task or function, if such steps are necessary to avoid a real and foreseeable risk of economic loss being sustained by the client.[5] While he considered that it was not a function of solicitors to give financial advice, he considered that a solicitor is required to address, at a general level, the fairness or reasonableness of a proposed transaction to enable a client to appreciate any disadvantages.

The solicitors appealed.

On appeal

The Court of Appeal found for the solicitors.

The primary issue on appeal was whether the trial judge was correct in ruling that the solicitors were obliged to form and express some view about the fairness or reasonableness of the investment transaction. The Court of Appeal[6] thought that that was going too far. The Court of Appeal considered:

- the solicitors were not retained to advise on the investment transaction;
- for the solicitors to comment, on any informed basis, on the investment transaction required knowledge of it - the solicitors did not have knowledge of it;
- the solicitors were not qualified to give financial advice;
- the clients were told to obtain independent financial advice and that it was necessary for them to do so; and
- the solicitors were entitled to believe that the clients understood the advice that had been given to them.

The primary judge considered that the solicitors were not sufficiently forceful in advising the clients of the need for independent advice because of the apparent improvidence of the investment transaction. However, the Court of Appeal did not consider that the solicitors could have done more than provide the advice that was given.

Lastly, the Court of Appeal considered that, in any event, if the solicitors had been more forceful in providing advice to the clients, the clients would not have acted differently. In short, the clients were aware of the risks involved in the investment transaction, but were prepared to take those risks because of the lure of the high returns on offer.

Observations

Prior to Justice Brereton's judgment, Australian lawyers had understood that they had no duty to provide any financial or commercial advice when documenting transactions such as loans and mortgages.[7] It was generally understood that solicitors could fully discharge their duties to their clients by advising them that they would not be providing financial advice on transactions and that the client should obtain independent financial advice in this respect. The Court of Appeal's decision has now reinforced that understanding.

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[4] *Riz* at 129

[5] His Honour cited the authority of *Waimond Pty Limited v Byrne* (1989) 18 NSWLR 642 in this respect

[6] Allsop P, Hodgson and McColl JJA

[7] See for example *Citicorp v O'Brien* (1996) 40 NSWLR 398

The decision brings certainty to this area of law. The reasoning of the judge at first instance had unsettled the primary risk management tool available to solicitors – that is the tool of specifically limited retainers. The decision has clarified the position that a solicitor's penumbral duty of care will not be extended in its application to situations similar to those found in the *Riz* case.

The Court of Appeal's decision implicitly acknowledges that, in many instances, solicitors are retained to document transactions that are of borderline or dubious commerciality. Further, this decision and the line of authorities that preceded it,[8] acknowledge the practical fact that solicitors are not qualified to give financial or commercial advice and that others are best placed to provide such advice.

This case represents a positive development for solicitors. It rejects the proposition that an objectively improvident transaction undertaken by a client will automatically trigger the penumbral duty of care.

Generally speaking, in cases where a solicitor is on notice that a client's interests are at financial or commercial risk, it should be enough for the solicitor to indentify the risk and advise the client to seek independent advice.

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This article was prepared by Robert Finnigan

For further assistance with professional negligence matters, please contact Simon Lusk, Director (t: 9231 7017, e: slusk@ypol.com.au) or Robert Finnigan, Senior Associate (t: 9231 7018, e: rfinnigan@ypol.com.au)

LEVEL 7, 12 CASTLEREAGH STREET
SYDNEY NSW 2000

DX 162 SYDNEY

T: +61 2 9221 7774
F: +61 2 9221 7775
WWW.YPOL.COM.AU

YPOL PTY LTD TRADING AS
YELDHAM PRICE O'BRIEN LUSK
ACN 109 710 698

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[8] *Citicorp v O'Brien* (1996) 40 NSWLR 398 et al