Comparative Private Law – Contract Law (IV)

Content

Qualified *laesio enormis*

Bundesverfassungsgericht (German Constitutional Court) on surety, 19th October 1993

The constitutional complaints concern the question of how far the civil courts are obliged on constitutional grounds to subject guarantee contracts with banks to control of content when relatives with no income or assets of recipients of credit undertake high liability risks as guarantors. Bank contract law is not regulated by special statutes. It is governed by the contract law of the BGB, and by the AGK (general conditions of contract) in which credit institutions have almost completely and uniformly regulated their services. In granting credit, they use contractual forms which are largely the same. A central credit committee, to which the associations of the credit institutions belong as members, achieves co-ordination. In the security practice of credit institutions, it has become usual in the case of consumer credit and business credit with medium sized undertakings to conclude guarantee contracts with family members. Their income and assets are frequently left uninvestigated. The purpose of such contracts is not exclusively to increase the assets available for liability. It is also to deal with transfers of assets, and to make recipients of credit exercise care in their business dealings by bringing in their relatives (opinion of the Federal Association of German banks). For the last ten years the civil courts have been increasingly concerned with cases in which young adults have become hopelessly overburdened with debt because they had provided guarantees for high bank loans to their partners or parents, even though they only had tiny incomes.

(a) The courts of first instance at first subjected the above contractual practice to extensive content control…

(b) The control of the content of contracts by first instance courts was largely rejected by the ninth civil senate of the *Bundesgerichtshof* [reference omitted]. The third civil senate has agreed with this in substance [reference omitted]. Guarantee contracts could not be regarded as contrary to good morals just because they would probably lead to overburdening with debt. The freedom to formulate contracts included, for everyone of full legal capacity, the legal power to take on obligations which could only be fulfilled under especially favourable conditions. The business inexperience of a guarantor was no ground for imposing duties of explanation and advice on credit institutions. A person of full age knew in general, even without special indication, that the giving of a guarantee declaration represented a risky transaction. The bank could therefore assume that a person who took on a guarantee obligation knew the significance of his action, and assessed his risk on his own responsibility. Different considerations would apply if the bank by its own action (and in a way which it could recognise) caused the guarantor to make a mistake by which the risk of liability was increased. This case law has partly found reserved approval in the academic Literature [references omitted]. But it was predominantly rejected [references omitted]. Even some first instance courts have failed to follow it [references omitted]. The criticism is to the effect that the *Bundesgerichtshof* had carried out the task of judicial control of content in too inflexible and indiscriminatory a manner, and had thereby failed to fulfil the basic decision in the Constitution.
...

The proceedings 1 BvR 567/89: The complainant's father operated at first as a real estate broker; he erected and sold flats for owner occupation. In 1982 he asked the city savings bank C for a doubling of his credit Iimit of DM 50,000 to DM 100,000. When the city savings bank demanded a security, the complainant, who was at that time 21 years old, signed a pre-

printed guarantee document on 29 November 1982 with a maximum sum of DM 100’000, plus additional obligations, which included among other things: ...

The increase in credit was accordingly granted. The complainant received a right of signature for her father's credit account, but had no assets herself. She had no vocational training, was mainly unemployed, and at the time of the guarantee declaration earned DM 1150 net per month in a fish factory. In October 1984, the complainant's father gave up his real property business and operated as a shipowner. The city savings bank financed the purchase of a ship with DM 1.3 million. In December 1986, it terminated the outstanding credit (about 2.4 million DM), and informed the complainant that a claim would be made against her under the guarantee. The complainant at first claimed a declaration that her guarantee was invalid. After the city savings bank had raised a counterclaim for payment of DM 100,000 with interest, the parties to the initial proceedings declared the claim for a declaration to be settled. The *Landgericht* allowed the counterclaim by the judgment which is being challenged. On the complainant's appeal, the *Oberlansdesgericht* changed the decision of the *Landgericht*, and rejected the counterclaim (WM 1988, 1436 (1438)): The city savings bank was obliged on the ground of fault in contractual negotiations to release the complainant from the guarantee, as it had violated its duties of provision of information. It was true that in general the creditor did not have to explain to the guarant or what risk he incurred. But an exception from this principle was required when the creditor's conduct recognisably caused the guarantor to make a mistake. It was equivalent to this when a credit institution trivialised the type and scope of guarantee liability to a guarantor who was obviously unskilled in business, and thereby influenced his decision. This was the case here. It was established by the evidence that the gist of what the representative of the city savings bank had said when the guarantee document was signed was: 'Here, please, just sign this. It doesn't mean you're entering into any big obligation; I just need it for my records.' He had thereby substantially 'glossed over' and trivialised the actual risk for the complainant. It could not be assumed that she would have been prepared, on a realistic assessment, to take on the guarantee. The *Bundesgerichtshof* quashed the decision of the *Oberlandesgericht* by the judgment which is being challenged, and rejected the complainant's appeal against the judgment of the Landgericht (BGH NJW 1989, 1605 = LM § 765 BGB no 67 = ZIP 1989, 629): Guarantees are legal transactions creating one-sided obligations for which the creditor as a rule has neither a duty of explanation nor a duty to obtain information about the state of the guarantor's knowledge. A person who is aged over 18, and therefore of full age according to statute law, knew in general, even without special experience in business matters, that a guarantee declaration gave rise to liability risks. A guarantor's expectation that he would not have a claim made against him could not be the basis of a business transaction. The representative of the city savings bank had done nothing which would have influenced this assessment. At the time of the guarantee declaration, the principal debtor's credit was good, and the information given by the bank employee was therefore correct. The complainant as guarantor should herself have kept an eye on the further development of the father's business affairs and therefore her future liability risk. Express reference had been made in the guarantee form to the possibility of giving notice of termination. The complainant by her constitutional complaint objects to the violation of her basic rights under Art 1 para 1 and Art 2 para 1 of the Basic Law, in combination with the principle of the social state .... At the time of the guarantee declaration her available (*pfändbar*) income consisted of DM 413.70. Since October 1991 she had been the single mother of a son. She lived on social assistance and child benefit (*Erziehungsgeld*). Up to January 1992 a debit balance calculated at DM 160,000 had accumulated. It could not therefore be expected that she could ever pay off an obligation of this kind.

The proceedings 1 BvR 1044/89: The complainant entered into a guarantee in 1979 with the claimant bank which was unconditionally enforceable [i.e., under which the person granting it cannot raise the objection that there has not yet been an unsuccessful execution against the principal debtor] for the securing of a so-called 'insurance loan,' which had been granted to her husband for a total of DM 30,000. At the time of the guarantee declaration she had no income or assets. As a housewife, she cared for her two children born in 1971 and 1978. As her husband fell into delay with interest payments, the bank gave notice terminating the loan in 1988. The debit balance at that time amounted to DM 32,140.31. It was reduced to DM 16,274.02 by realisation of the repurchase value of the life insurance. The bank made a claim against the complainant for this sum. The *Landgericht* allowed the claim by the judgment which is being challenged: No doubts existed about the effectiveness of the guarantee promise. § 310 BGB was not applicable, as obligations which became due in future, however high and unfulfillable, did not represent transfer of future assets. The guarantee contract was also not void under § 138 of the BGB. When the guarantee was taken on, it was possible that the complainant would take up employment before the liquidation of the credit, or would obtain other income. If her husband should become unemployed, he could take over the care of the household and the children. But even longterm inability to perform did not lead to immorality of the guarantee contract. No claim bad been made that the bank was culpable in relation to the giving of advice. The *Oberlandesgericht* rejected the complainant's appeal on the same grounds as the decision of the Landgericht, by a judgment which is also challenged, The complainant by her constitutional complaint objects to the violation of her basic rights under Art. 1 and Art. 2 of the Basic Law. It was known to the bank that as a mother of two small children she would not be able to take up employment in the foreseeable future. With such employment as could at the moment reasonably be expected of her, she would never be in a situation to release herself from the guarantee obligation. In fact, the indebtedness would be bound to increase continually, despite regular payments. The consequent destruction of any prospect for the future resulted in a violation of the Constitution.

House of Lord Royal Bank of Scotland plc v Etridge (No 2):

Judgment: LORD NICHOLLS OF BIRKENHEAD…

[5] My Lords, before your Lordships' House are appeals in eight cases. Each case arises out of a transaction in which a wife charged her interest in her home in favour of a bank as security for her husband 's indebtedness or the indebtedness of a company through which he carried on business. The wife later asserted she signed the charge under the undue influence of her husband. … Seven of the present appeals are of this character. In each case the bank sought to enforce the charge signed by the wife. The bank claimed an order for possession of the matrimonial home. The wife raised a defence that the bank was on notice that her concurrence in the transaction had been procured by her husband's undue influence. The eighth appeal concerns a claim by a wife for damages from a solicitor who advised her before she entered into a guarantee obligation of this character.

UNDUE INFLUENCE

[6] The issues raised by these appeals make it necessary to go back to first principles. Undue influence is one of the grounds of relief developed by the courts of equity as a court of conscience. The objective is to ensure that the influence of one person over another is not abused. In everyday life people constantly seek to influence the decisions of others. They seek to persuade those with whom they are dealing to enter into transactions, whether great or small. The law has set limits to the means properly employable for this purpose. To this

end the common law developed a principle of duress. Originally this was narrow in its scope, restricted to the more blatant forms of physical coercion, such as personal violence.

[7] Here, as elsewhere in the law, equity supplemented the common law. Equity extended the reach of the law to other unacceptable forms of persuasion. The law will investigate the manner in which the intention to enter into the transaction was secured: 'how the intention was produced', in the oft repeated words of Lord Eldon LC, from as long ago as 1807 (*Huguenin v Basely* (1807) 14 Ves Jun 273 at 300). lf the intention was produced by an unacceptable means, the law will not permit the transaction to stand . The means used is regarded as an exercise of improper or 'undue' influence, and hence unacceptable, whenever the consent thus procured ought not fairly to be treated as the expression of a person's free will. lt is impossible to be more precise or definitive. The circumstances in which one person acquires influence over another, and the manner in which influence may be exercised, vary too widely to permit of any more specific criterion.

[8] Equity identified broadly two forms of unacceptable conduct. The first comprises overt acts of improper pressure or coercion such as unlawful threats. Today there I much overlap with the principle of duress as this principle has subsequently developed. The second form arises out of a relationship between two persons where one as acquired over another a measure of influence, or ascendancy, of which the ascendant person then takes unfair advantage.

[9] ln cases of this latter nature the influence o n e person has over another provides scope for misuse without any specific overt acts of persuasion. The relationship between two individuals may be such that, without more, one of them is disposed to agree a course of action proposed by the other. Typically this occurs when one person places trust in another to Iook after his affairs and interests, and the latter betrays this trust by preferring his own interests. He abuses the influence he has acquired.

[10] The law has long recognised the need to prevent abuse of influence in these 'relationship' cases despite the absence of evidence of overt acts of persuasive conduct. The types of relationship, such as parent and child, in which this principle falls to be applied cannot be listed exhaustively. Relationships are infinitely various. Sir Guenter Treitel QC has rightly noted that the question is whether one party has reposed sufficient trust and confidence in the other, rather than whether the relationship between the parties belongs to a particular type (see Treitel, *The Law of Contract* (10th edn, 1999) pp 380-381). For example, the relation of banker and customer will not normally meet this criterion, but exceptionally it may (see National Westminster Bank plc v Morgan [1985] AC 686, at 707-709).

[11] Even this test is not comprehensive. The principle is not confined to cases of abuse of trust and confidence. lt also includes, for instance, cases where a vulnerable person has been exploited. lndeed, there is no single touchstone for determining whether the principle is applicable. Several expressions have been used in an endeavour to encapsulate the essence: trust and confidence, reliance, dependence or vulnerability on the one hand and ascendancy, domination or control on the other. None of these descriptions is perfect. None is all embracing. Each has its proper place.

[12] ln *CIBC Mortgages plc v Pitt* [1994] 1 AC 200 your Lordships' House decided that in cases of undue influence disadvantage is not a necessary ingredient of the cause of action. lt is not essential that the transaction should be disadvantageous to the pressurised or influ-

enced person, either in financial terms or in any other way. However, in the nature of things, questions of undue influence will not usually arise, and the exercise of undue influence is unlikely to occur, where the transaction is innocuous. The issue is likely to arise only when, in some respect, the transaction was disadvantageous either from the outset or as matters turned out.

BURDEN OF PROOF AND PRESUMPTIONS

[13] Whether a transaction was brought about by the exercise of undue influence is a question of fact. Here, as elsewhere, the general principle is that he who asserts a wrong has been committed must prove it. The burden of proving an allegation of undue influence rests upon the person who claims to have been wronged. This is the general rule. The evidence required to discharge the burden of proof depends on the nature of the alleged undue influence, the personality of the parties, their relationship, the extent to which the transaction cannot readily be accounted for by the ordinary motives of ordinary persons in that relationship, and all the circumstances of the case.

[14] Proof that the complainant placed trust and confidence in the other party in relation to the management of the complainant's financial affairs, coupled with a transaction which calls for explanation, will normally be sufficient, failing satisfactory evidence to the contrary, to discharge the burden of proof. On proof of these two matters the stage is set for the court to inter that, in the absence of a satisfactory explanation, the transaction can only have been procured by undue influence. ln other words, proof of these two facts is prima facie evidence that the defendant abused the influence he acquired in the parties' relationship. He preferred his own interests. He did not behave fairly to the other. So the evidential burden then shifts to him. lt is for him to produce evidence to counter the inference which otherwise should be drawn. …

[17] The availability of this forensic tool in cases founded on abuse of influence arising from the parties' relationship has led to this type of case sometimes being labelled 'presumed undue influence'. This is by way of contrast with cases involving actual pressure or the like, which are labelled 'actual undue influence' (see *Bank of Credit and Commerce International SA v Aboody* [1 990] 1 QB 923 at 953 .... This usage can be a little confusing. ln many cases where a plaintiff has claimed that the defendant abused the influence he acquired in a relationship of trust and confidence the plaintiff has succeeded by recourse to the rebuttable evidential presumption. But this need not be so. Such a plaintiff may succeed even where this presumption is not available to him; for instance, where the impugned transaction was not one which called for an explanation.

[18] The evidential presumption discussed above is to be distinguished sharply from a different form of presumption which arises in some cases. The law has adopted a sternly protective attitude towards certain types of relationship in which one party acquires influence over another who is vulnerable and dependent and where, moreover, substantial gifts by the influenced or vulnerable person are not normally to be expected. Examples of relationships within this special class are parent and child, guardian and ward, trustee and beneficiary, solicitor and client, and medical advisor and patient. ln these cases the law presumes, irrebuttably, that one party had influence over the other. The complainant need not prove he actually reposed trust and confidence in the other party. lt is sufficient for him to prove the existence of the type of relationship.

[19] lt is now well established that husband and wife is not one of the relationships to which this latter principle applies ...

INDEPENDENT ADVICE

[20] Proof that the complainant received advice from a third party before entering into the impugned transaction is one of the matters a court takes into account when weighing all the evidence. The weight, or importance, to be attached to such advice depends on all the circumstances. ln the normal course, advice from a solicitor or other outside advisor can be expected to bring home to a complainant a proper understanding of what he or she is about to do. But a person may understand d fully the implications of a proposed transaction, for instance, a substantial gift, and yet still be acting under the undue influence of another. Proof of outside advice does not, of itself, necessarily show that the subsequent completion of the transaction was free from the exercise of undue influence. Whether it will be proper to infer that outside advice had an emancipating effect, so that the transaction was not brought about by the exercise of undue influence, is a question of fact to be decided having regard to a l l the evidence in the case.

MANIFEST DISADVANTAGE

[21] As already noted, there are two prerequisites to the evidential shift in the burden of proof from the complainant to the other party. First, that the complainant reposed trust and confidence in the other party, or the other party acquired ascendancy over the complainant. Second, that the transaction is not readily explicable by the relationship of the parties.

[22] Lindley U summarised this second prerequisite in the leading authority of *Allcard v Skinner*, where the donor parted with almost all her property. Lindley U pointed out that where a gift of a small amount is made to a person standing in a confidential relationship to the donor, some proof of the exercise of the influence of the donee must be given. The mere existence of the influence is not enough. He continued: 'But if the gift is so large as not to be reasonably accounted for on the ground of friendship, relationship, charity, or other ordinary motives on which ordinary men act, the burden is upon the donee to support the gift.' (See (1887) 36 ChD 145 at 185.)

[30] I return to husband and wife cases. I do not think that, in the ordinary course, a guarantee of the character I have mentioned is to be regarded as a transaction which, failing proof to the contrary, is explicable only on the basis that it has been procured by the exercise of undue influence by the husband. Wives frequently enter into such transactions. There are good and sufficient reasons why they are willing to do so, despite the risks involved for them and their families. They may be enthusiastic. They may not. They may be less optimistic than their husbands about the prospects of the husbands' businesses. They may be anxious, perhaps exceedingly so. But this is a far cry from saying that such transactions as a class are to be regarded as prima facie evidence of the exercise of undue influence by husbands.

[31] I have emphasised the phrase ' in the ordinary course'. There will be cases where a wife's signature of a guarantee or a charge of her share in the matrimonial home does call for explanation. Nothing I have said above is directed at such a case.

A CAUTIONARY NOTE

[32] I add a cautionary note, prompted by some of the first instance judgments in the cases currently being considered by the House. It concerns the general approach to be adopted by a court when considering whether a wife's guarantee of her husband's bank overdraft was procured by her husband's undue influence. Undue influence has a connotation of impropriety. In the eye of the law, undue influence means that influence has been misused. Statements or conduct by a husband which do not pass beyond the bounds of what may be expected of a reasonable husband in the circumstances should not, without more, be castigated as undue influence. Similarly, when a husband is forecasting the future of his business, and expressing his hopes or fears, a degree of hyperbole may be only natural. Courts should not too readily treat such exaggerations as misstatements.

[33] Inaccurate explanations of a proposed transaction are a different matter. So are cases where a husband, in whom a wife has reposed trust and confidence for the management of their financial affairs, prefers his interests to hers and makes a choice for both of them on that footing. Such a husband abuses the influence he has. He fails to discharge the obligation of candour and fairness he owes a wife who is looking to him to make the major financial decisions. [Further extracts from this case, dealing with the position of the banks, will be found below.]… [The other Law Lords each. gave a speech. There are some minor differences between them but Lord Bingham said (at [3]) that Lord Nicholls's opinion 'commands the unqualified support of all members of the House.]

Lloyds Bank Ltd v Bundy

Judgment: LORD DENNING MR:…

THE GENERAL RULE

Now let me say at once that in the vast majority of cases a customer who signs a bank guarantee or a charge cannot get out of it. No bargain will be upset which is the result of the ordinary interplay of forces. There are many hard cases which are caught by this rule. Take the case of a poor man who is homeless. He agrees to pay a high rent to a landlord just to get a roof over his head. The common law will not interfere. It is left to Parliament. Next take the case of a borrower in urgent need of money. He borrows it from the bank at high interest and it is guaranteed by a friend. The guarantor gives his bond and gets nothing in return. The common law will not interfere. Parliament has intervened to prevent moneylenders charging excessive interest. But it has never interfered with banks. Yet there are exceptions to this general rule. There are cases in our books in which the court will set aside a contract, or a transfer of property, when the parties have not met on equal terms-when the one is so strong in bargaining power and the other so weak-that, as a matter of common fairness, it is not right that the strong should be allowed to push the weak to the wall. Hitherto those exceptional cases have been treated each as a separate category in itself. But I think the time has come when we should seek to find a principle to unite them. I put on one side contracts or transactions which are voidable for fraud or misrepresentation or mistake. All those are governed by settled principles. I go only to those where there has been inequality of bargaining power, such as to merit the intervention of the court.

THE CATEGORIES

The first category is that of 'duress of goods'. A typical case is when a man is in a strong bargaining position by being in possession of the goods of another by virtue of a legal right, such as by way of pawn or pledge or taken in distress. The owner is in a weak position because

he is in urgent need of the goods. The stronger demands of the weaker more than is justly due: and he pays it in order to get the goods. Such a transaction is voidable. …

The second category is that of the 'unconscionable transaction'. A man is so placed as to be in need of special care and protection and yet his weakness is exploited by another far stronger than himself so as to get his property at a gross undervalue. The typical case is that of the 'expectant heir'. But is applies to all cases where a man comes into property transferred to him: see *Evans v Llewellin* (1957) 1 Cox 333. …

This second category is said to extend to all cases where an unfair advantage has been gained by an unconscientious use of power by a stronger party against a weaker: see the cases cited in *Halsbury's Laws of England*, 3rd ed, vol 17 (1956), p 682 and, in Canada, *Morrison v Coast Finance Ltd* (1965) 55 DLR (2d) 710 and *Knupp v Bell* (1 968) 67 DLR (2d), 256. The third category is that of 'undue influence' usually so called. …

The fourth category is that of 'undue pressure'. The most apposite of that is *Williams v Bayley* (1866) LR 1 HL 200…

Other instances of undue pressure are where one party stipulates for an unfair advantage to which the other has no option but to submit. As where an employer – the stronger party – has employed a builder – the weaker party – to do work for him. When the builder asked for payment of sums properly due (so as to pay his workmen) the employer refused to pay unless he was given some added advantage. Stuart V-C said: 'Where an agreement, hard and inequitable in itself, has been exacted under circumstances of pressure on the part of the person who exacts it, this court will set it aside': see *Ormes v Beadel* (1860) 2 Gift. 166, 174 (reversed on another ground, 2 De GF & J. 333) and *D & C Builders Ltd v Rees* (1966) 2 QB 617, 625.

The fifth category is that of salvage agreements.

THE GENERAL PRINCIPLES

Gathering all together, I would suggest that through all these instances there runs a single thread. They rest on 'inequality of bargaining power'. By virtue of it, the English law gives relief to one who, without independent advice, enters into a contract upon terms which are very unfair or transfers property for a consideration which is grossly inadequate, when his bargaining power is grievously impaired by reason of his own needs or desires, or by his own ignorance or infirmity, coupled with undue influences or pressures brought to bear on him by or for the benefit of the other. When I use the word 'undue' I do not mean to suggest that the principle depends on proof of any wrongdoing. The one who stipulates for an unfair advantage may be moved solely by his own self-interest, unconscious of the distress he is bringing to the other. I have also avoided any reference to the will of the one being dominated' or 'overcome' by the other. One who is in extreme need may knowingly consent to a most improvident bargain, solely to relieve the straits in which he finds himself. Again, I do not mean to suggest that every transaction is saved by independent advice. But the absence of it may be fatal. With these explanations, I hope this principle will be found to reconcile the cases.