MORTGAGE DISPUTES: CONSUMER CLAIMS TO AVOID LIABILITY

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INTRODUCTION

1. In disputed mortgage enforcement proceedings, borrowers and guarantors tend to rely primarily on statutory grounds particularly those in the *Contracts Review Act 1980* **("CRA")**, the *Consumer Credit Code* and now the *National Credit Code.*

2. I will be looking the case law over the last few years relevant to the CRA. I will not be going into an in-depth analysis of each of the factors mentioned in s 9 of the CRA. What I will be looking at, rather, is some of the themes that have arisen in mortgage and guarantee defences in recent years, and how they have been dealt with by the court.

ASSET LENDING

3. The term "asset lending" has probably been raised in most mortgage / guarantee defences - with varying degrees of success - since the decision in *Perpetual Trustee Company v Khoshaba* [2006] NSWCA 41.[2]

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4. But the concept also derives from an earlier case, namely *Elkofairi v Permanent Trustee Co Ltd* [2002] NSWCA 413. I will discuss both of these cases.

***Elkofairi v Permanent Trustee Co Ltd* [2002] NSWCA 413**

5. In *Elkofairi*, the lender ("Permanent") advanced approximately $750,000 to the appellant and her husband. Of that, $469,000 was used to repay an existing mortgagee, which mortgagee had commenced proceedings to enforce its mortgage. Some smaller sums were applied to legal and other expenses, and a sum of approximately $250,000 was advanced by way of a cheque addressed to the appellant and her husband. The appellant did not know what happened to this money, but said that she received no benefit from it.

6. The background was that the appellant and her husband were immigrants from Syria. Over the course of a long marriage her husband, who she described as domineering, non-consultative about family decisions, aggressive and intimidating, had kept her in the dark in relation to financial matters. There had also been marital difficulties. The appellant could not read or write in any language, and could only understand a few simple expressions in English.

7. The husband had engaged in various businesses, and at the time of the refinance with Permanent, he, and the Appellant, owed about $25,000 each to the ATO. The existing mortgagee was pressing for repayment of its debt. The appellant was an invalid pensioner. Her husband was not working and had sold his last business. So, they had a house, with enough equity to support a refinance with a substantial increase in the amount borrowed, but no obvious means to service such increased borrowings.

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1. Nevertheless, it does not seem to be viewed as a negative by all lenders. In an internet search I conducted recently I noticed a large number of lenders who claim to include "asset lending" in the range of services they offer.

8. However, the true position was not known to Permanent. The Appellant's husband had, in his application for finance, stated that the wished to borrow $446,000 to refinance existing debts, and a further $350,000 "for business purposes". The husband left the income section of the application blank. He disclosed assets comprising the house ($1.2 million) and a car. He disclosed the existing bank debt that was to be refinanced, but not the ATO debt.

9. The appellant's signature on the application form was forged.

10. The application was supported by three letters from the husband's accountant, in one of which letters, it was asserted that the husband would be able to repay the loan without hardship - although this opinion was not supported with any details about the husband's financial position. Nothing at all was said about the Appellant.

11. The appellant and her husband signed an acknowledgement as to not receiving legal advice, and their signatures were witnessed by a solicitor who gave evidence that, notwithstanding the election not to receive legal advice, he would have told them various things of a general nature about mortgages.

12. The appellant and her husband failed to make the first payment under the mortgage, and failed to make any payment after that.

13. At first instance both the appellant and her husband failed to obtain any relief from their liability under the mortgage, and the judge awarded to Permanent judgment for possession and for a money sum which by this stage was in excess of $1 million.

14. On appeal the Appellant relied on three grounds. The first was the principle in *Yerkey v Jones* as reaffirmed in *Garcia v National Australia Bank* (1988) 194 CLR 395. This failed, essentially because the lender was not on notice that the Appellant was partially a volunteer.

15. The second ground was the principle in *Commercial Bank of Australia Ltd v Amadio*. It was in connection with this equitable principle that the concept of asset lending was raised.

16. In terms of the *Amadio* principle, the Appellant was under a special disability.

17. But she also needed, in order to succeed within that principle, that this disability was sufficiently evident to Permanent so as to make it prima facie unfair or unconscientious for Permanent to procure the execution of the contract in the circumstances in which it was procured (*Commercial Bank of Australia Limited v Amadio* (1983) 151 CLR 447.

18. Here, the appellant's language and domestic difficulties, and her limited income were not known to Permanent.

19. However, the ground was made out, on the basis of the lack of relevant information that Permanent had about the borrower. Beazley JA (with whom Santow JA and Campbell AJA agreed) said at [56]:

> "Though the full extent of that special position of disadvantage was not known to the respondent, nonetheless the absence of any relevant financial information was sufficient to put the respondent on notice of the appellant's lack of capacity to meet the repayment obligations under the mortgage. That left as the only source of repayment the selling of her only asset, as again the respondent must be taken to have known."

20. So, the lender's lack of relevant financial information in the circumstances amounted to sufficient notice for the purpose of the *Amadio* principle

21. The third ground was the *Contracts Review Act 1980* (NSW), and the appellant succeeeded on this ground also.

22. As regards remedy, the court was guided by the well established approach equity, where a party has received some benefit from a void or voidable transaction, which is to grant relief on terms requiring a payment to take account of the benefit. The benefit in this case was taken to be one half of the $469,000 that was refinanced by Permanent - because that debt had been owed by both the appellant and her husband. The appellant was

required to pay that sum (ie, $234,500) plus simple interest at 7.5% pa from the date of the loan, at which time the mortgage would be set aside as against the appellant only. In the event that the power of sale was exercised, then the appellant was to receive half of the sale proceeds (presumably, net of marketing and sale expenses) less $234,500 plus interest.

Perpetual Trustee Company v Khoshaba **[2006] NSWCA 41**

23. In *Khoshaba* the (simplified) facts were as follows. Mr and Mrs Khoshaba and their daughter borrowed $117,000 (approximately) from Perpetual (acting as trustee of a securitised mortgage programme), of which they paid $100,000 to Karl Suleman Enterprises ("KSE") pursuant to an investment agreement. Purportedly, the funds were to be used for a shopping trolley collection business. The balance of the loan was used for private purposes.

24. The investment was in fact a fraudulent Ponzi scheme.

25. In the District Court the Khoshabas successfully applied under the Contracts Review Act to have their liability to Perpetual reduced from about $88,000 to about $30,000, the latter sum representing the net benefit received by them out of the loan monies (taking into account monies used for private purposes, monies received back from KSE through the operation of the Ponzi scheme, and monies repaid to Perpetual).

26. Mr and Mrs Khoshaba had migrated to Australia from Iran in 1971 and both were pensioners. They, together with their daughter, had been persuaded to invest with KSE through fellow members of the Assyrian community including Mr Suleman himself.

27. Neither Perpetual, nor any entity for whose conduct it was responsible, played any role in persuading the Khoshaba family to invest with KSE, and nor did it know about the investment that was proposed with KSE.

28. There had been some false information provided in the loan application, including a false assertion that Mr Khoshaba was in employment, and as to his income. Mrs Khoshaba's signature was forged. However, the Khoshabas were found to have no knowledge of these things.

29. The trial judge (Rolfe DCJ) had considered a range of factors, but singled out two elements as being decisive:

    (a) The failure by Perpetual to follow its own loan assessment guidelines; and

    (b) The failure by Perpetual to recommend to the Khoshabas that they receive independent legal or accounting advice.

30. As regards the failure to follow guidelines, the various guidelines which were breached included requirements to verify the borrowers' employment and income, as well as to obtain full details of the purpose of the loan.

31. In the Court of Appeal the leading judgment was that of Spigelman CJ, with whom both Handley and Basten JJA largely agreed. The Court was unanimously of the view that the contract was unjust and that the appeal should be dismissed.

32. The Chief Justice thought that, in relation to lending guidelines, the trial judge erred in relying on the guidelines as constituting prudent lending practice. This error related to the way the case was pleaded and run, rather than any assertion that the former cannot constitute evidence of the latter. However, his Honour was also of the view that a failure by a lender to follow its own guidelines may, in appropriate circumstances, be entitled to significant weight in the determination of unjustness (at [80]).

33. The most significant breach of the guidelines, in the view of the Chief Justice, was the fact that the section of the application form that related to the purpose of the loan was left blank. It was here that the "asset lending" issue arose. His Honour referrred to this and said:

> "82 ... This indicates that, as in *Elkofairi* supra at [79], the Appellant “was content to lend on the value of the security”. In my opinion, that

> approach is entitled to significant weight in the determination of unjustness. ....
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> 83 On the information actually available to the Appellant, a husband and wife – one with a $43,000 per annum income and the other a pensioner – borrowed $120,000 for, as far as the Appellant cared to know, immediate expenditure. Enforcing a security against the personal residence of such borrowers should not be treated as if it were the first resort. That is what, on paper, the Appellant can be described as having done.
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> 84 This conclusion is reinforced by the Appellant's concomitant failure to verify or follow up, in the way identified by Rolfe DCJ, other details in the loan application. I do not suggest that the matter can be approached, as his Honour appeared to do, on the basis that the Appellant should be fixed with the knowledge it would or may have acquired if the Guidelines had been observed. However, the other failures, such as not verifying employment and income and not ensuring documents were properly executed, reinforce the conclusion that the Appellant was prepared to act on the basis of adequate security alone.
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> 85 Where the security is the family home of a low income earner and a pensioner, this posture on the part of a lender is entitled to significant weight against the lender in the determination of unjustness."

34. On the other hand, his Honour did not think that the failure to recommend that the Khoshabas obtain legal advice was entitled to significant weight (at [90]), because there was nothing about the loan agreement - as distinct from the investment agreement with KSW - that called for independent advice. His Honour said:

> "90 In a tripartite situation such as this, I do not believe that a failure to recommend that a person obtain advice is entitled to significant weight when the advice is relevant to that part of the transaction which does not involve the rights and obligations or interests of the person who is said to have failed to make the recommendation. Even pensioners must take responsibility for their own actions."

35. His Honour considered that the conflicting considerations were finely balanced and said that, had Perpetual or its representatives made any inquiries about the purpose of the loan, he would have allowed the appeal. His Honour explained (at [92]):

> "I do not mean to suggest that the Appellant had to determine that the proposed investment was reasonable and capable of servicing the loan. It is the indifference, suggesting that the Appellant was content to

> proceed on the basis of enforcing the security, which I find determinative."

36. I have described the reasoning and the facts in both *Elkofairi* and *Khoshaba* at some length so as to show that neither case was just a matter of a lender lending money without knowing or caring whether it could be serviced other than by enforcement against the security property. There were other factors involved so as to make this unconscionable (in *Elkofairi*) or unjust (in *Khoshaba*). In *Khoshaba,* Justice Basten made it clear that something more than asset lending is required for a loan to be attacked successfully. His Honour said:

> "To engage in pure asset lending, namely to lend money without regard to the ability of the borrower to repay by instalments under the contract, in the knowledge that adequate security is available in the event of default, is to engage in a potentially fruitless enterprise, simply because there is no risk of loss. At least where the security is the sole residence of the borrower, there is a public interest in treating such contracts as unjust, at least in circumstances where the borrowers can be said to have demonstrated an inability reasonably to protect their own interests, for the purposes of, for example, s 9(2)(e) or (f). That does not mean that the Act will permit intervention merely where the borrower has been foolish, gullible or greedy. Something more is required: see *Esanda Finance Corp Ltd v Tong* (1997) 41 NSWLR 482 at 491 (Handley JA) cited with approval in *Elkofairi* (supra) at [77] by Beazley JA."

37. So, his Honour's comments, so far as concerns "unjustness", were restricted to cases where (a) the security is the sole residence of the borrower; and (b) the borrower was unable to protects his/her own interests.

38. Since Khoshaba the concept of asset lending has been raised and discussed in numerous cases. I will mention a few of these cases where the judges have had something to say about asset lending.

Kowalczuk v Accom Finance Pty Ltd **[2008] NSWCA 343 ; (2008) 252 ALR 55**

39. This was another case involving monies being borrowed and invested with a fraudster. This case was important for the way in which high interest rates were dealt with, but I will deal with that aspect later.

40. The borrower's case was not as strong as that of the Khoshabas. The borrower could not be described as having a "special disability". Whilst he was relatively uneducated, he had owned various properties over the years, had borrowed money from banks and had developed a property. He worked as a driveway attendant at a service station, earning $14,400 per annum, but he earned another $30,000 in rental income on Berowra as well as interest on invested monies.

41. Nor was this a situation where the lender had no information about serviceability. There were two loans, and the loan application in relation to the first loan contained material misstatements, including that the borrowers' income was $100,000 (when it was less than half that); that the Berowra and Haberfield properties were worth $2.1 million (an overstatement of $600,000) and that Mr Kowalczuk owned two cars worth $30,000 each (whereas he owned one car worth less than $5,000).

42. The application for the first loan stated that the purpose of the loan was "business re investment". It identified the "plan for repayment" as "bank refinance". There was no application in relation to the second loan, but there was a representation by the broker (who also happened to be the fraudster) that a short term loan was needed in relation to "another deal".

43. In the case of both loans, the legal documentation was much better than that in *Khoshaba*. It included a signed declaration by the borrower as to his income and capacity to pay, as well as a signed declaration of having received legal advice from a solicitor, which declaration listed the documents in respect of which advice had been given, as well as some key points of advice, such as the mortgagee's enforcement powers and the applicability of the higher rate of interest. The documentation also included a declaration of business or investment purposes.

44. Various grounds were raised by the borrowers and they failed, except in relation to the question of interest (to which I shall return).

45. The unsuccessful grounds included a ground under the CRA, in connection with the issue of asset lending was raised. The argument here

centred around a passage in the trial judge's reasons, in which he distinguished between two situations in which a borrower has no ability through his own income or assets to repay the loan. The first situation was where the borrower was intending to repay the loan by new borrowings or by selling the property. The second situation was where the lender knew that there would be default in payment of interest or principle so that mortgagee sale would be an inevitable result. The trial judge said that the latter - which he characterised as "pure asset lending" may be unconscionable, where the former is not.

46. The borrower's argument was that there can be unconscionable lending where the mortgagee does not actually know there will be a default; rather, it is enough if the lender knows that there is a high risk that the intended means of payment of the loan will fail.

47. Campbell JA (Hodgson and McColl JJA agreeing) accepted this argument. However, his Honour said, this does not mean that a lender is always bound to carry out a detailed investigation of the practicality of an intended borrower being able to carry through the borrower's plan for repayment.

48. In the instant case, the borrowers had stated that the first loan would be repaid through a bank refinance, and they had stated that the second loan would be refinanced by another financier. The lender had no occasion to doubt this, and so this was just not a case where the lender knew that there was a high risk that the intended means of repayment might fail.

Riz v Perpetual Trustee Australia Ltd **[2007] NSWSC 1153, and on appeal:** ***Dominic v Riz*** **[2009] ANZ ConvR 9-033, [2009] NSW ConvR 56-248, [2009] NSWCA 216**

49. Riz was another case arising from the borrowing of money to invest with a fraudulent scheme operated by KSE. However the case was not on all fours with Khoshaba, because the borrowers were experienced in business; they knew the proposed investment was risky, and spent some time investigating it; their application for finance was supported with false information given on behalf of the borrowers; and the borrowers had

obtained legal advice before entering into the loan. The borrowers failed to avoid liability

50. In the course of his reasons, Brereton J expressed the view (at [70]) that the unfairness in "asset lending" lies in the balance of risk - as the lender can resort to the security in the likely event that the borrower defaults. His Honour continued:

> " Where that is voluntarily accepted, such a transaction may not be unjust. But where in the circumstances in which the transaction is made - particularly where the family home is involved - the borrower has a less than full appreciation of the risks or consequences, or is under some misapprehension or pressure, so as to provide an element of procedural unfairness, such a loan may be unjust. And even apparent comprehension of the transaction and its legal and practical effect and voluntariness is not entirely prophylactic: the purposes of the Contracts Review Act include protection of those who are not able to protect themselves, and while the Act is not a panacea for the greedy, it may come to the aid of the gullible."

51. It should be noted that Riz was also a professional negligence case against the solicitors who advised Mr and Mrs Riz. The judgment against the solicitors was successfully appealed in Dominic v Riz [2009] ANZ ConvR 9-033, [2009] NSW ConvR 56-248, [2009] NSWCA 216, but that appeal did not relate to or affect the judgment below in favour of Perpetual.

Perpetual Trustees Victoria v Longobardi **[2009] NSWSC 654**

52. The borrowers failed to establish asset lending in this case, because the evidence showed that the lender had been given information about serviceability and relied on it. The decision contains a brief discussion by McDougall J of the concept of asset lending. His Honour considered the decisions in *Khoshaba* and *Riz*, and then said:

> "80 It will be seen that employment of the concept of asset lending involves a number of matters, including (and this list may not be exhaustive):
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> > (1) demonstration that the transaction is in fact to be classified as " asset lending ": one in which the lender agrees to

> lend money without troubling itself as to the borrower's ability to repay, and content to rely on the security;
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> (2) the extent to which the imbalance of risk thereby created is understood and, so understood, accepted by the borrower;
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> (3) related to the last matter: the extent to which the borrower really understands the risks and consequences; and
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> (4) another matter related to the two previous matters: whether some pressure operated on the borrower which might have had the effect of impairing the exercise of judgment and the voluntary acceptance of the risk of imbalance."

Ford by his Tutor Beatrice Ann Watkinson v Perpetual Trustees Victoria Limited [2009] NSWCA 186

53. This was a case where the plea of non est factum was made out, and so a claim for relief under the CRA did not need to be determined. However, the court considered the CRA claim and determined that it would have succeeded.

54. As regards asset lending, it should be noted that it appears from what is said in paragraph [111] of the reasons of Allsop and Young JJA that normally, when one intends to raise "asset lending" as an issue, this should be pleaded.

55. Had it been pleaded, it seems that the court would have considered the "asset lending" epithet to be appropriate characterisation of the loan, because the lender took no steps to verify the borrower's income and financial position. This fact, in combination with the fact that the borrower was intellectually impaired and was manipulated by his son to borrow the money for a venture that was in substance for the son's benefit, would have supported a finding of unjustness, had it been necessary.

***Fast Fix Loans Pty Ltd v Samardzic* [2011] NSWCA 260**

56. Here that loan was to a property developer, but the mortgage that was the subject of attack was a mortgage given by the borrower's parents, who were guarantors. The loan was a bridging loan, to enable the son to

exercise an option to purchase a property, with a view to the loan then being refinanced.

57. The parents were elderly migrants from the former Yugoslavia and they were pressured by their son to give the security. They were given legal advice, but they did not appreciate that their obligations did not automatically cease after 3 months, and nor did they appreciate the significance of the high, compounding interest rate.

58. An argument was put that the concept of "asset lending" does not apply to guarantors. After all, the idea should be that the borrower will service, and repay the loan, rather than the guarantor. This argument failed, and a significant matter in that regard was the fact that there was a real risk of default on the part of the principal borrower. Allsop P (Bathurst CJ and Campbell JA agreeing) said:

> The complaint about "asset lending" tended to raise a debate over semantics. "Asset lending" is not a label or a legal frame of reference. It is a convenient expression, used in cases such as *Perpetual Trustee Co Ltd v Khoshaba* [2006] NSWCA 41; 14 BPR 26,639 and *Spina* to describe a form of lending where the lender has little, if any, regard for the capacity of the borrower to repay and rests satisfied with the security to protect itself. As Campbell JA made clear in *Kowalczuk* at [96]-[99], the conclusion of "unjust" for the Act, ss 7 and 9 depends on all the circumstances and not on labels. There is no reason why considerations such as those here cannot lead to the conclusion that a contract of guarantee is unjust if entered into by a lender who is uncaring of a guarantor's capacity to repay where there is a real and significant possibility of default by the borrower and the guarantor takes no benefit under the borrowing. This is particularly so in all the other circumstances of this case - most particularly the recognition by the appellant of the only two likely sources of repayment, one (successful refinancing) having a real risk to it. The appellant lent at a significant interest rate, reflecting the underlying commercial risk, appreciating the position the parents had been placed in, without any basis to consider that the parents appreciated the commercial risk or that they could afford to take that risk.

EXTENT OF LENDER'S KNOWLEDGE

59. An issue that has come up in a number of cases is the extent to which a lender needs to be aware of relevant circumstances involving unjustness before a finding of unjustness will be made.

60. In terms of the various equitable grounds for setting aside transactions, there must always be some element of notice, so that the conscience of the party who seeks to enforce the contract is affected.

61. But the position is not so clear cut under the CRA. Its application is not conditioned on any particular state of notice or knowledge on the part of the stronger party.

62. In *Nguyen v Taylor* (1992) 27 NSWLR 48, the court made a distinction, between a finding of unjustness under s 9 and the exercise of the discretion under s 7. So, the contract in that case was made in circumstances that made it unjust, namely, that the vendor had been misled by his own agent. But the purchaser was not aware of this, so on discretionary grounds no relief was granted.

63. In *Khoshaba*, Basten JA considered the cases of *Beneficial Finance Corp Limited v Karavas* (1991) 23 NSWLR 256 and *St Clair v Petricevic* (1988) ASC ¶55-688, his Honour said:

> "119 Reading *St Clair* and *Karavas* together, the true position may be that a claimant can establish the unjustness of a contract by reliance on factors of which the other party was ignorant when the contract was entered into, but that such ignorance may be relevant in determining whether to grant relief. The fact that the power may be engaged by circumstances which were not known to the other party at the time the contract was made is well-established: see, eg, *St George Bank Ltd v Trimarchi* [2004] NSWCA 120 at [36], Mason P, Sheller JA and Cripps AJA agreeing."

64. The distinction between the finding under s 9 and the discretion under s 7 has been made in numerous other cases, but not always with the consequence that a lender's ignorance entitles it to keep its mortgage.

65. The asset lending cases, for example, show that a lender's ignorance of the borrower's true financial situation will not necessarily be a good

answer to the CRA in circumstances where the lender has not bothered to try to find out what that financial situation is.

66. In the *Fast Fix Loans* case, Allsop P said:

> "50. To a degree, again, the argument of the appellant regarding unjustness was semantic. There is no need, for the purposes of the Act, to find a degree of moral obloquy in the third party. To frame unjustness in terms of the "innocence" (or otherwise) of the third party is to misdirect the enquiry. It is not what is required by the Act, ss 7 and 9 . What is to be undertaken is an overall evaluation in determining both unjustness and the justness of granting relief, which involves a consideration of all the relevant circumstances of the case.
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> ...
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> 51. Meagher JA in Karavas spoke of the injustice in depriving an innocent person of valuable property, including contractual rights (at 277). His Honour was there referring to the jurisdiction to grant relief under the Act against a party who is unaware of the special disability of the party seeking relief. His Honour did, however, state that undoubtedly the jurisdiction to grant relief existed in those circumstances. It may be unjust in all the circumstances to do so. Meagher JA was not, however, laying down a rule, nor can his Honour's statement be seen to import a requirement of mala fides into the Act. As Mason P said in St George Bank Ltd v Trimarchi [2004] NSWCA 120 at [45] (with which Sheller JA and Cripps AJA agreed):
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> > "... s 9 of the Act does not require the party seeking to enforce a contract to be on notice of the circumstances rendering it unfair."
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> Further, here, as found by the primary judge, the lack of knowledge of the appellant of the financial circumstances of the parents was a product of its failure to enquire as to those circumstances.
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> 52. There was no error in the primary judge's approach. It was open to his Honour to consider that the appellant's failure to make enquiries and the knowledge of the appellant about the transaction, its risks and the position of the parents was such as to enable him to conclude that it was just and appropriate to make orders against the appellant."

67. To similar effect, see *Ford v Perpetual Trustees Victoria Limited* [2009] NSWCA 186 at 105-113.

68. What about where the true position is deliberately concealed from the lender by the borrower or the borrower's agent?

69. In both *Kowalczuk* and *Riz*, the lenders relied on false information that had been given to them in relation to the borrower, and this was a factor in favour of the lenders. In *Kowalczuk* the borrower himself was party to the giving of some of the false information, including as to his income and the purpose of the loan. In *Riz*, the false information was provided by a broker without the knowledge of the borrowers. However, this still worked against them, on the basis that the broker was their agent. Brereton J said:

> "76 Moreover, it is clear that parties to a contract are to be treated as responsible for the conduct of those who act on their behalf: thus s 9(2) lists amongst the relevant considerations:
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> (j) whether any undue influence, unfair pressure or unfair tactics were exerted on or used against the party seeking relief under this Act:
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> (i) by any other party to the contract,
>
> (ii) by any person acting or appearing or purporting to act for or on behalf of any other party to the contract, or
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> (iii) by any person to the knowledge (at the time the contract was made) of any other party to the contract or of any person acting or appearing or purporting to act for or on behalf of any other party to the contract, ..."

70. His Honour also said (at [66]):

> "But I do not accept that a lender's failure to detect indicia of a fraud being practiced on behalf of a borrower against the lender, is a circumstance of injustice to the borrower."

71. More recently, in *Azar v Citigroup Pty Ltd* [2011] NSWCA 380 the elderly borrowers were aware, at least, that their son, who they authorised to arrange loans on their behalf, may provide false information in order to obtain the loan, and he did so. This was one of the reasons why the Court of Appeal agreed with the primary judge that the loan was not unjust.

72. In another recent case, *Buccoliero v Commonwealth Bank of Australia* [2011] NSWCA 371, the borrower failed to make out an "asset lending" type argument because the lender relied on fabricated documents provided to it by her co-borrower.

73. In *Tonto Home Loans Australia Pty Ltd v Tavares; FirstMac Ltd v Di Benedetto; FirstMac Ltd v O'Donnell* [2011] NSWCA 389, the broker had

inserted false information into application forms that had been partially filled out by the borrowers. The Court of Appeal overturned a finding at first instance that the relevant finance broker was in fact the agent of the lender rather than the borrowers. However, the Court of Appeal ultimately concluded that the relevant loan contracts were unjust. The lender and the broker had a commercial relationship that was in their mutual interest, which model involved the lender keeping itself out of communications with borrowers until the loan had been consummated.

74. The Court essentially dealt with the issue of broker fraud by saying that it was a risk that the lender took on by adopting its particular business model (a business model which, as Allsop P said at [3], is widespread).

LENDING GUIDELINES

75. It will be recalled that in *Khoshaba* the Court of Appeal held that the trial judge was entitled to take into account the lender's breach of its own guidelines as part of the assessment of whether the contract was unjust.

76. It seems to me that, with the notion that a lender's breach of its own guidelines may help to establish unjustness, comes the risk that lenders with lax guidelines will be rewarded to some extent for their own cavalier approach to lending.

77. Nevertheless, it is a factor that can be taken into consideration, and failure to follow guidelines will carry varying degrees of importance. For example, in *Spina v Permanent Custodians Limited* [2009] NSWCA 206 (to which I shall return), the relevant lending guideline was one that required that a surety provide a certificate of independent advice, and this breach of guidelines was a significant factor in the finding of unjustness. I would suggest, however, that the mortgage would have been set aside in that case regardless of what the guidelines said about legal advice.

78. On the other hand, in *Kowalczuk,* there were some breaches of guidelines relating to "due diligence" steps, and the court did not consider them significant at all. Campbell JA said (at [117]):

> "117 Even accepting that there were some departures from Accom's own lending guidelines and due diligence procedures, the trial judge was well aware of those departures, and did not regard them as enough, even when combined with other factors, to show the loan was either unconscionable or unjust. It needs to be recalled that departure from a lender's own lending guidelines does not in itself establish the injustice of a loan. Rather, those departures need to be part of a process of reasoning, such as that engaged in by Spigelman CJ in Khoshaba, the ultimate outcome of which is that the loans in question are unjust."

79. I would suggest that, in general, one should focus on what the breach of the guidelines was, and in particular what effect (if any) it had - or (to put it another way) what different consequence might be expected if the guideline had been complied with.

INTEREST RATES: HIGH AND LOW

Kowalczuk v Accom Finance Pty Ltd [2008] NSWCA 343 ; (2008) 252 ALR 55

80. In this case, whilst the borrowers' attack on their liability under the mortgage failed, they had some success in relation to interest rates.

81. The interest rate provisions were drafted in a fairly conventional form (particularly for short-term finance), so as to avoid the law of penalties by characterising the higher rate as the usual rate, and the lower rate as a concession that applies in the event of non-default. The Court did not purport to change the common law of penalties, but Campbell JA pointed out (at [172]):

> "In my view, even if as a matter of drafting a mortgage that imposes higher and lower rates of interest is able to avoid the application of the law concerning penalties, by making the lower rate a bonus for compliance rather than a penalty for breach, a mortgage so drafted can still be looked at for its substantial commercial effect when one is considering whether it is unjust within the meaning of the Contracts Review Act."

82. Another point his Honour made was that it is possible for a contractual provision to be unjust even though the contracting parties are aware of it and assent to it. (at [139]).

83. The borrowers complained that both the higher rates and the lower rates were unjust. The interest compounded on a monthly basis, with the consequence that the amount of the debt grew very large, very rapidly.

84. Another matter relevant to whether the interest provisions were just was the fact that the mortgage contained a number of provisions aimed at protecting the lender against the costs of entry into the loan agreement, its administration, breach and enforcement steps. (One of these provisions unquestionably pushed the envelope too far, namely a provision imposing a liability for damages for late payment. This provision was clearly a penalty, as decided in *Guardian Mortgages v Miller* [2004] NSWSC 1236; (2004) 12 BPR 22,833, and was not pressed.)

85. So, in the event of a default, the borrower would be liable for all conceivable expenses occasioned by it, including enforcement, plus a significantly higher rate of interest. Campbell JA (Hodgson and McColl JJA agreeing) was of the view that, where losses and expenses occasioned by default were already provided for, the provision for a higher rate of interest to become payable in the event of a default was not reasonably necessary for the protection of any legitimate interest of any party to the contract (at [166]).

86. The higher rate was accordingly unjust.

87. His Honour went on to say that this reasoning is not limited to situations where the higher rate is itself unconscionable. Rather, the reasoning applies because, in substance, the higher rate is payable in the event of default (even if the law of penalties views the matter differently) (at [171] - [173]).

88. On the other hand, his Honour accepted that differing rates may be justified in some circumstances, although he doubted whether this could

ever be the case where all default-related expenses were recoverable under the mortgage (at [174]).

89. His Honour also said that the provision for compounding of interest was unjust because it applied equally to the higher rate and the lower rate, and raised the question whether it would be appropriate to vary the provision for compounding so that it applied only to the lower rate (at [177]). (It was not necessary to decide this, because the lender had agreed in the course of the appeal to seek only simple interest calculated at the lower rate).

90. I comment that there would normally be no possibility for simple interest to be applicable to the lower rate, because the occasion for compounding is normally a payment falling due without being made. In that event, there is a default, so that the higher rate applies.

91. His Honour also raised, without answering, a public policy issue relevant to remedies: should the court simply take an unjust contract and rewrite it into a contract that would not be unjust? His Honour pointed out that, if courts were to act in that way, there would be no downside for lenders, except in relation to costs, in including unjust provisions in loan documentation, because if challenged they would be rewritten by the court to give the lender the maximum that they could get away with, without contravening the Act.

92. I would comment that this, arguably, is a matter for Parliament. The CRA does not make unjust contracts illegal or require courts to punish lenders.

INTEREST RATES: DISCLOSURE

Fast Fix Loans Pty Ltd v Samardzic [2011] NSWCA 260

93. In this case, Campbell JA pointed the way to a possible future ground of attack on high interest rate mortgages, on the basis of a lack of explanation of the effect of compounding interest. The effect of compounding interest over a period of time can be explained by showing the way in which the compound interest rate translates into a simple

interest rate. When that is done it can be seen that the effective rate in simple interest terms increases with time. His Honour said:

> " The relevance of the calculation is that compounding interest on short rests, even if the rate does not seem alarming when stated in a form like "4% per month" , can be financial dynamite. Many an unsophisticated borrower would not appreciate, unless it was specifically pointed out to them, that a rate of 4% per month, when compounded, can operate to produce simple interest rates like those shown in the table. It could in some circumstances be a significant contributor to the injustice of a loan made to an unsophisticated borrower that the lender has not received a credible assurance that the borrower has received not only information about what the contract of loan says is the rate of interest, but also an explanation that brings home to the borrower the reality of how the rate of interest, including any compounding, actually operates.
>
> Calculators that show the amount that $100 becomes after a particular period of time at compound interest on particular rests, are readily available for purchase, and online calculators that perform that same calculation can be found easily on the Internet. Once that calculation is done, a simple interest rate per annum is readily calculable."

94. This suggests that, at least in the case of high interest rate loans, the documentation should include acknowledgement by the borrower of a table setting out the effective of compound interest in the event of default over a period of years.

POWERS OF ATTORNEY AND ELDER ABUSE

Spina v Permanent Custodians Limited [2009] NSWCA 206

95. This was a classic elder abuse scenario. A mortgage was given over the residence of an elderly woman who lived in a nursing home and had no income. The monies borrowed and secured by the mortgage were used mainly for the benefit of the mortgagor's son. The mortgage was executed by the mortgagor's son under a power of attorney. The mortgagor was not mentally incapacitated. She was not given legal advice, although her son was.

96. The Court of Appeal found that the mortgage was unjust and set aside most of the liability of the (by then deceased) mortgagor. A key issue was the question of legal advice. Clearly the presence of absence of legal

advice, which is relevant under s 9 of the CRA, is an important factor, at least where there is something improvident about the loan or the surrounding circumstances. In this case it was decided that it was just not sufficient for the holder of a power of attorney to receive legal advice. The donor of the power of attorney should also be advised, at least where that person has mental capacity.

97. That is not to say that there must always be legal advice in order for a transaction to stand. Young J (with whom Tobias and Campbell JJA agreed) said:

> "63 In my view in the present set of circumstances, if a lender is to rely on independent legal advice being given to the borrower, the latter herself must receive the independent legal advice.
>
> 64 Of course, the position would be different if the borrower were clearly incapable, or if the transaction were clearly for her benefit, or if the transaction was a purely commercial one with no flavour of possible influence from or benefit to some relative or friend."

REFINANCING

***Bank of Western Australia Ltd v Tannous* [2010] NSWSC 1319**

98. This was an application to strike out a cross-claim. The principal claim was brought by Bankwest to recover monies advanced by it under a mortgage. The bulk of the loan monies had been used to pay out an existing financier (which I shall refer to as "FMA").

99. The borrowers alleged that the FMA loan was obtained by fraud, and it was on this basis that they cross claimed against FMA. Davies J noted that this approach seemed to be a pre-emptive strike by the borrowers, anticipating that the lender would rely on the proposition that generally, a borrower seeking relief under the CRA needs to give credit for any sums paid to discharge an existing obligation. His Honour referred to the decision in *Collier v Morlend Finance Corporation (Victoria) Pty Ltd* (1989) 6 BPR 13,337; (1989) NSW ConvR 55-473.

100. As his Honour explained, this general requirement arises at the second stage of determination of a CRA claim. As I have said earlier, the first stage is determination of unjustness under s 9, and the second stage is the exercise of the discretion. One of the considerations relevant to the exercise of the discretion is the benefits that the borrower has obtained - which includes the discharge of existing liabilities.

101. However, his Honour said that the new lender will not always succeed in obtaining repayment of monies to the extent that they were for a refinance. His Honour said:

> "If it can be shown that the pre-existing liability was itself unenforceable or unjust in whole or in part, the discretionary order made in respect of the unjust contract sued upon would take account of that unenforceability or that unjustness. To do so, there would be no necessity to join the prior mortgagee because no order or relief would be sought, nor would need to be sought, against that mortgagee. Because that loan agreement has been fully performed and discharged, and because any pre-existing mortgage has itself been discharged, there is no longer a justiciable issue between the borrower and the prior mortgagee/lender."

102. His Honour then referred to the NSW Court of Appeal's decision in *St George Bank Ltd v Trimarchi & Anor* [2004] NSWCA 120.

103. In that decision the NSW Court of Appeal upheld a decision of Dunford J to set aside a mortgage which was used almost entirely in support of the refinancing of a pre-existing liability, which liability had been guaranteed by the mortgagors. Some key points of this decision were:

a. the mortgagors under the original loan were guarantors, and the monies were borrowed for their son who had incurred debts in his property speculation business;

b. The mortgagors were migrants with limited ability in written and spoken English;

c. More generally the circumstances of the original loan were unjust and it would have been liable to be set aside under the CRA;

d. The son arranged the refinance with the new lender, St George;

e. St George did not contact the mortgagors about the loan, and whilst the loan was approved on the basis of a requirement that the mortgagors get independent legal advice, this did not in fact occur;

f. St George knew of the son's financial position;

g. The mortgagors, had they been properly advised at this stage, would not have proceeded with the new transaction with St George.

104. The circumstances of both the St George transaction and the earlier transaction (with National Mutual) were unjust. Essentially, the answer to the argument that the mortgagors obtained a benefit from the St George transaction to the extent that it discharged an earlier loan, was that the earlier loan was itself liable to be set aside.

105. So, it is possible in appropriate circumstances that a loan will be set aside without the need for a borrower to repay it to the extent that it represented a refinance of existing borrowings, provided it can be shown that the earlier transaction would also have been set aside. In principle, it should be necessary to establish that the mortgagor would not merely have succeeded against the earlier borrower, but would have succeeded in avoiding part or all of his or her liabilty to that lender.

106. *Tannous* breaks no new ground here, but what is important about this decision is what his Honour said about the Cross Claim. His Honour said that in a case of this type, the fact that issues will be raised about the earlier transaction does not justify the joining of the earlier mortgagee/lender. His Honour said (at [43]):

> "Where there is an issue about the unjustness of a contract or mortgage paid out by an incoming mortgagee who is the Plaintiff in proceedings, the issue is not determined by joining that prior mortgagee as a party to the proceedings. Rather, the issue is determined in the context of the discretionary order at the second stage of the Contracts Review Act proceedings. That is so, because the issue forms part of the controversy between the Plaintiff and the Defendants. The justiciable issue is what order should be made in circumstances where the contract made between the Plaintiff and the Defendants is held to be unjust. There is no justiciable issue between

the Defendants and the mortgagee/lender whose contract has been completed and whose mortgage has been discharged."