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Guarantees and "instalment warrant" arrangements

This article considers the Commissioner's comments relating to the right of a member or related party of a superannuation fund who provides a guarantee for the purposes of enabling the trustee of the fund to enter into an "instalment warrant" arrangement complying with subsection 67(4A) of the Superannuation Industry (Supervision) Act 1993.

On 4 April 2008, the Commissioner of Taxation (the **Commissioner**) issued Taxpayer Alert 2008/5 entitled Certain borrowings by self-managed superannuation funds (the **Alert**). The Commissioner observes that the "… Alert is concerned with arrangements under which the trustee of a self-managed superannuation fund (**SMSF**) enters into certain limited-recourse borrowings, which may not meet the conditions in subs 67(4A) and/or breach other provisions of the Superannuation Industry (Supervision) Act 1993 (**SIS Act**), as well as related superannuation rules."

Notwithstanding the Commissioner's comments in the Alert, a guarantor's rights against the borrower are limited to the rights of the creditor as against the borrower. As a result, if the creditor's rights as against the trustee of a fund which enters a subs 67(4A) of the SIS Act arrangement are limited in recourse, as the subsection requires, then so too will the guarantor's rights of subrogation as against the trustee in the event that the guarantor seeks redress when the trustee defaults and the guarantee is exercised by the lender.

OVERVIEW OF THE REGULATORY REGIME

The Alert is concerned with the application of subs 67(4A) of the SIS Act, which provides an exemption from the general prohibition imposed on trustees of superannuation funds with respect to borrowing. The borrowings prohibition is contained in subs 67(1) of the SIS Act, which provides that "Subject to this section, a trustee of a regulated superannuation fund must not … borrow money; or … maintain an existing borrowing of money". Subsection 67(4A) of the SIS Act provides that:

> Subsection (1) does not prohibit a trustee (the RSF trustee) of a regulated superannuation fund from borrowing money, or maintaining a borrowing of money, under an arrangement under which
>
> (a) the money is or has been applied for the acquisition of an asset (the original asset) other than one the RSF trustee is prohibited by this Act or any other law from acquiring; and
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> (b) the original asset, or another asset (the replacement) that
>
> (i) is an asset replacing the original asset or any other asset that met the conditions in this subparagraph and subparagraph (ii); and
>
> (ii) is not an asset the RSF trustee is prohibited by this Act or any other law from acquiring;
>
> is held on trust so that the RSF trustee acquires a beneficial interest in the original asset or the replacement; and
>
> (c) the RSF trustee has a right to acquire legal ownership of the original asset or the replacement by making one or more payments after acquiring the beneficial interest; and
>
> (d) the rights of the lender against the RSF trustee for default on the borrowing, or on the sum of the borrowing and charges related to the borrowing, are limited to rights relating to the original asset or the replacement; and
>
> (e) if, under the arrangement, the RSF trustee has a right relating to the original asset or the replacement (other than a right described in paragraph (c)) – the rights of the lender against the RSF trustee for the RSF trustee's exercise of the RSF trustee's right are limited to rights relating to the original asset or replacement.

Paragraph 67(4A)(d) provides that under the arrangement "… the rights of the lender against … [the trustee of the superannuation fund] … for default on the borrowing, or on the sum of the borrowing and charges related to the borrowing, are limited …" to the asset held subject to the "instalment warrant" arrangement. That is, although subs 67(4A) requires a lender's rights as against a trustee of a superannuation fund to be limited in recourse, there is no limitation prohibiting the provision of additional security, outside of the superannuation fund structure, as security for the loan. Indeed, there is no limitation on (for example) a member of the superannuation fund providing a guarantee in favor of the lender with respect to the borrowings by a trustee of a superannuation fund under a subs 67(4A) arrangement.

At para 6 of the "Description" section of the Alert, the Commissioner outlines a number of "concerns" under subs 67(4A)of the SIS Act arrangements, including that

- the interest rate for the borrowing is zero or less than a commercial rate, particularly where the lender is a related party;
- the interest rate for the borrowing exceeds a commercial rate, particularly where the lender is a related party
- interest on the borrowing is able to be capitalised;
- a personal guarantee for the borrowing is given by a third party, particularly where the guarantee is given by a member or a related party of the SMSF; and
- the asset acquired (or any replacement) is one that a trustee is prohibited from acquiring under the SIS Act or any other law, or under the SMSF's governing rules (for example, acquiring residential

property, which is not business real property, from a related party).

This article concentrates on the Commissioner's views regarding personal guarantees given in order to secure subs 67(4A) arrangements. Specifically, the Commissioner's concern, which is outlined at para 4 under the "Features which concern us" section of the Alert, is that:

> … a personal guarantee of the type outlined in para 6 (d) above may result in recourse being made to the assets of the SMSF other than the asset acquired (or any replacement) in the event that the guarantee is enforced against the trustee as the principal debtor, contrary to the intent that the exception in subs 67(4A) of the SIS Act only applies to limited recourse borrowings…

Although the Commissioner does consider that a personal guarantee "may" result in recourse being made to the assets held within the superannuation fund, it is argued here that the law of surety only allows a guarantor to stand in the shoes of a lender by way of the doctrine of subrogation. That is, to the extent that a lender's rights are limited in recourse as against the trustee of a superannuation fund with respect to specific property, so too will a guarantor's right to indemnification if the guarantor discharges the trustee's obligation under the subs 67(4A) arrangement.

In "Instalment warrants and super funds – questions and answers", the Commissioner states that whilst it may have concerns "… the Tax Office does not yet have a formal view …" in relation to (amongst other things) arrangements "… where a borrowing is guaranteed by a third party … particularly where the personal guarantee is provided by a member or a related party …".

A GUARANTOR'S RIGHT OF SUBROGATION

A guarantor is a surety, being a party that answers for the default of another. In the current context, the potential defaulting party is a trustee of a superannuation fund that enters into a subs 67(4A) arrangement (being a debtor/borrower relationship). As mentioned above, subs 67(4A) provides that recourse with respect to borrowings by a trustee of a superannuation fund must be limited to the asset purchased subject to the subs 67(4A) arrangement. The subsection does not limit liability with respect to security given to effect the arrangement, nor does it limit a third party's right to give a guarantee. All that is required is that the liability of the trustee of the superannuation fund be limited.

The relevant surety for current purposes includes an entity that guarantees the superannuation fund trustee's borrowings. A characteristic of a guarantee arrangement is that the guarantee has a right of subrogation. Prima facie, a guarantor under a subs 67(4A) of the SIS Act arrangement who discharges a superannuation fund trustee's borrowings (ie pays a liability of the trustee which is owed to its creditor) has the right to be subrogated to the right of the creditor, including any securities held by the creditor. Subrogation has been explained as follows:

> "Subrogation" literally means "substitution"; the word derives from the same Latin root as the more familiar word "surrogate". In English law the term "subrogation" denotes a process by which one party is deemed to have been substituted for another, so that he can acquire and enforce the other's rights against a third party for his own benefit. It is often said that a subrogation claimant "stands in the shoes" of the party whose rights he is deemed to have acquired.[1]

Further:

> The doctrine of subrogation derives from the English equity of putting one person in the place of another in cases where there are three or more persons involved where A discharges B's liability in circumstances where B has a right of reimbursement or recoupment in respect of the liability as against C, equity regards A as succeeding to B's right.[2]

That is, a surety, such as a guarantor, has a right to indemnify itself, via its right of subrogation, in the event that the guarantee is called upon by a creditor and met by the guarantor. Aickin J in *Israel v Foreshore Properties Pty Ltd* (in liq) (1980) 30 ALR 631at 636 observed that:

> A person who acts on such a request to pay, or who accepts the role of a surety in that manner and who pays the debt, is entitled to an indemnity from those who made the request to pay or to act as surety. … Lord Kenyon CJ in *Exall v Partridge* … [observed that] … "I admit that where one person is surety for another, and compellable to pay the whole debt, and he is called upon to pay, it is money paid to the use of the principal debtor, and may be recovered in an action against him for money paid, even though the surety did not pay the debt by the desire of the principal …"…

Gibbs ACJ in *Australasian Conference Association Ltd v Mainline Constructions Pty Ltd (in liq)* (1978) 141 CLR 335 made the following observations:

> … a right of subrogation arises by force of "that equity, upon which it is considered against conscience, that the holder of the securities should use them to the prejudice of the surety; and therefore there is nothing hard in the act of the Court, placing the surety exactly in the situation of the creditor" … The principal underlying the doctrine is that it would be inevitable for a creditor, by choosing not to resort to remedies in his power, to cast the whole of the obligation on the surety … and it is well settled, a surety who has paid the debt due to the creditor is entitled to stand in the creditor's shoes; he has the creditor's rights, but only those rights.

Cole AJA in *Austin v Royal* [1999] NSWCA 222 observed that:

> The theory underlying the equitable concept of subrogation is that a creditor, having no use for a security over his debtor's assets because the creditor's debts have been paid and obligations discharged by the guarantor, is obliged to transfer the security to the guarantor who may then enforce it to recover the moneys from the debtor which he, the guarantor, has paid to the creditor.

A "guarantee" is different to an "indemnity". Whilst a guarantee is a secondary liability, and is dependent on the primary liability of a debtor, an indemnity is a primary liability, as it is a "… promise by the promisor that he will keep the promisee harmless against loss as a result of entering into a transaction with a third party…" (*Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245).

RIGHT OF SUBROGATION IS AN EQUITABLE BASED RIGHT

A guarantor's right of subrogation does not depend on contract, but is a right recognised at equity. Campbell J in *Brueckner v The Satellite Group (Ultimo) Pty Ltd* [2002] NSWSC 378 at para 130 observed that "While a creditor who has the benefit of a guarantee is free, if he chooses, to sue the guarantor rather than to sue the principal debtor, if the creditor takes that choice the guarantor will be given a remedy by equity, of subrogation to the rights which the creditor had against the principal debtor." Campbell J went on

to explain the rationale "What is driving equity here is that, while the creditor is free to choose which of the means of recovering his debt he will adopt, his choice ought not determine where the loss ultimately lies, as between the guarantor and the principal debtor. It is for this reason that the surety is entitled, upon payment of the guaranteed debt, to be subrogated to any securities which the creditor had for that payment".

Further, Meares J in *Commissioner of State Savings Bank of Victoria v Patrick Intermarine Acceptances Ltd (in liq)* (1977) ACLR 546 at 550 observed that "Subrogation is an equitable principle; it does not depend upon principles of contract. Its modern attributes derive from English equity of putting one person in the place of another in cases where there are three or more persons involved …".

A SURETY'S RIGHTS ARE NEW RIGHTS

There are a number of UK authorities which stand for the proposition that a surety such as a guarantor does not acquire a creditor's right as against the debtor. This is because after a guarantee has been called upon, and the debtor's obligations with respect to a creditor has been discharged, then the creditor's rights are extinguished, and therefore can no longer be enforced against the debtor (see *Banque Financiere de la Cite v Parc (Battersea) Ltd* [1999] 1 AC 221).[3] Rather, to the extent that the creditor's right has been extinguished, then the surety acquires new rights as against the debtor. (*Halifax Mortgage Services Ltd v Muirhead* (1998) 76 P & CR 418).[4]

THE SCOPE OF THE SURETY'S "NEW" RIGHTS – REPLICATION OF CREDITOR'S RIGHTS

Generally, a surety's new right replicates, and does not extend past the rights of the debtor. Evans LJ in *Halifax Mortgage Services Ltd v Muirhead* (1998) 76 P & CR 418 observes that "… the rights which are transferred … [to the claimaint] … must be those which existed immediately before the discharge took place …", and that "… emphasis … [should be] … placed on the existing equitable rights of the … [surety] … rather than regarding them simply as rights which he has inherited from the … [creditor] …". Further, May LJ in *Filby v Mortgage Express (No 2) Ltd* [2004] EWCA Civ 759 held that the "… essence of the remedy is that the court declares the claimant to have a right having characteristics and content identical to that enjoyed … [by the creditor] …".

The following propositions have been made with respect to a surety's right of subrogation (see Table 1):[5]

Importantly for current purposes, the cases demonstrate that a guarantor inherits the same rights to a security interest that a creditor has. As a result, to the extent that a creditor's rights to security is limited in recourse, then so too will be the guarantor's rights. An example of a similar proposition is explained by Campbell J in *Brueckner v The Satellite Group (Ultimo) Pty Ltd* [2002] NSWSC 378:

> If the creditor has … [for example] … , through neglect, caused a security to be lost or impaired, the value of the guarantor's right of subrogation is correspondingly diminished. In other words, equity's capacity to ensure that the arbitrary choice of the creditor about from whom he seeks recovery, does not decide where the loss ultimately falls, is diminished.

As a result, Campbell J observed that:

> There then arises an equity between the creditor and the guarantor – because, as a result of the creditor's neglect, in losing or impairing a security, equity's ability to ensure that the arbitrary choice of the creditor about whom to sue does not decide where the loss ultimately falls has been diminished, equity decides that the ability of the creditor to enforce the guarantee must be correspondingly diminished. When all that is driving equity in this area is ensuring that a guarantor does not suffer in consequence of the arbitrary decision of a creditor about who to sue first, the area of equity's concern, the scope of the purpose which the equitable obligation is aiming to achieve is fully satisfied if a remedy is provided which reduces the guarantor's liability by the value of the security which has been lost.

That is, if a creditor is limited in recourse, then a guarantor's right of subrogation will similarly be limited.

RIGHTS OF A SURETY DIFFER FROM CREDITOR'S RIGHTS

There are also authorities which illustrate when the rights of a surety may differ from the rights of a creditor (see Table 2):[11]

Table 1

Number	Proposition
One	The surety's new rights inherit any defects of the creditor's original security interest.[6]
Two	The surety cannot exercise its subrogation rights such that it recovers a larger amount than the creditor could have recovered.[7]
Three	Any security interest that a surety acquires inherits the same priority as the creditor's security interest.[8]
Four	The debtor's liability to the surety may share the same qualities as the discharged liability to the creditor (eg a secondary rather than a primary liability, or a deferred rather than immediate liability).[9]
Five	The surety cannot take action to enforce a right which could not have been enforced by the creditor.[10]

Table 2

Number	Proposition
One	The Court may modify a surety's rights where the debtor (or another party) has successfully invoked a defence.[12]
Two	The surety's right to subrogation may differ as compared to the creditor's entitlement due to a third party priority to (for example) the security interest.[13]
Three	A surety that has a right of subrogation may not inherit a right of a creditor to "tack" further advances as against the security interest.
Four	The limitation period for both the surety and the creditor may not be the same.
Five	The interest charged by a surety may not be limited to the interest which a creditor could charge.

LEGISLATION AND SURETY

The equitable right of a surety is also found in legislation.[14] As an example, subs 3(1) of the Law Reform (Miscellaneous Provisions) Act 1965 (NSW):[15]

(1) A person who, being surety for the debt or duty of another, or being liable with another for a debt or duty, pays that debt, or performs that duty, is entitled

(a) to have assigned to that person, or to a trustee for that person, every judgment, specialty or other security held by the creditor in respect of that debt or duty, whether or not that judgment, specialty or other security is taken at law to have been satisfied by the payment of the debt or the performance of the duty, and

(b) to stand in the place of the creditor and to use all the remedies, and, if necessary, and on a proper indemnity, to use the name of the creditor in any proceedings to obtain from the principal debtor or any co-surety, co-contractor or co-debtor (as the case requires) indemnity for the advances made and loss sustained by the person who paid the debt or performed the duty.

Olsson J in *Johnson v Australian Guarantee Corporation Ltd* (1992) 59 SASR 382 at 389 observed that such provisions are "… a general remedial provision designed to codify and provide a broad legal framework for the law related to trade and commercial transactions; and to clarify rights of, and relationships between, parties in the absence of an expressed contrary intention". Zeeman J in *Bayley v Gibson Ltd* (1993) 1 Tas R 385 at 397 observed that the legislation "… does not derogate from the equitable right of a surety …". Further, it was observed in *Austin v Royal* [1999] NSWSC 222 that the "… statutory provisions "artificially keeps alive the security" for the benefit of the guarantor…".

WAIVING A SURETY'S RIGHTS

For completeness, it should be noted that a surety's right as against a debtor may be waived in the following circumstances,[16] including:

> "Although seemingly formulaic, the Alert provides some examples of complex legal issues that need to be considered … to both comply with the borrowings carve out … and also engineer enforceable legal arrangements."

- If, without request or obligation, a person assumes an obligation or makes a payment for another – as an example, if a person pays off a mortgage without an arrangement as between a mortgagor and mortgagee, then that person will have no right of subrogation with respect to the mortgagor (see for example *State Bank of South Australia v Rothschild Australia Ltd* (1990) 8 ACLC 925 at 940). Fox LJ in *Electricity Supply Nominees Ltd v Thorn EMI Retail Ltd* (1991) 63 P & CR 143 observed that:

  > If a person makes a voluntary payment intending to discharge another's debt, he will only discharge the debt if he acts with that person's authority or the latter subsequently ratifies the payment. Consequently if the payor makes the payment without authority and does not obtain subsequent ratification he normally has no redress against the debtor.

- If a right of subrogation is inconsistent with a statute – see for example s 65 and 66 of the Insurance Contracts Act 1984 (Cth), which respectively deal with subrogation to rights against family, and subrogation to rights against employees. See also *Re Sara Properties Pty Ltd (in liq)* [1982] 2 NSWLR 277 at 279-281.

- If the right of subrogation is excluded or limited by agreement as between the parties – see *State Bank of South Australia v Rothschild Australia Ltd* (1990) 8 ACLC 925 at 941.

- If the right of subrogation is waived, either in whole or in part – see for example *New Zealand Society of Accountants v ANZ Banking Group (New Zealand) Ltd* [1996] 1 NZLR 283 at 286.

As a result, notwithstanding the limitation of a guarantor's right of subrogation to the rights which a creditor has, in the event that a member or a related party of a superannuation fund gives a guarantee for the purposes of the trustee of the fund to enter a subs 67(4A) of the SIS Act arrangement, then the guarantor may undertake to waive its rights (if any) to subrogation as against the trustee of the fund.

CONCLUSION

Although seemingly formulaic, the Alert provides some examples of complex legal issues that need to be considered in order to both comply with the borrowings carve-out contained in subs 67(4A) of the SIS Act, and also engineer enforceable legal arrangements.

As with most arrangements which give rise to a borrowing, creditors typically seek to secure amounts lent to the maximum extent possible. In "instalment warrant" arrangements, security required by creditors will often require members or related parties of the superannuation fund trustees to provide personal guarantees.

As discussed above, as a guarantor is a surety, a guarantor will have a right of subrogation as against a trustee of a superannuation fund who has defaulted with respect to an "instalment warrant" arrangement. The effect of the right is that once an amount has been paid by the guarantor in satisfaction of the creditor's demands on the trustee as principal debtor, but discharged by the guarantor, then the guarantor may stand in the place of the creditor with respect to recovering amounts as against the trustee. However, given that a complying subs 67(4A) of the SIS Act arrangement requires a creditor to have its rights limited in recourse to the asset held subject to the instalment warrant arrangement, so will the guarantor's rights be limited in the same way.

In order to ensure beyond doubt that the exposure of trustees is limited in recourse as required by subs 67(4A) of the SIS Act, the parties to an instalment warrant arrangement (and in particular the guarantor) may waive any rights that the guarantor may have as against a defaulting trustee of a superannuation fund.

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Reference notes:

1 *Mitchell, C and Watterson, S. Subrogation – Law and Practice. Oxford University Press, Oxford, 2007, p 3.*

2 *Dal Pont, G E and Chalmers, DRC. Equity and Trusts in Australia. Lawbook Co, Sydney (4th ed), p 381.*

3 *It is noted that Halsbury, 4th ed vol 20, p 126, para 234 was cited in Commissioner of State Savings Bank of Victoria v Patrick Intermarine Acceptances Ltd (in liq) (1977 7 ACLR 546 at 551, where it is observed that "A surety who has made payment of more than his due portion of the common liability is entitled to have assigned to him all the creditor's rights and securities, whether satisfied or not, for the purpose of obtaining contribution …". However, those comments were in the context of co-contributions by sureties.*

4 *It should be noted that the doctrine of subrogation in the UK authorities seems to be based on the equitable principle of unjust enrichment, as provided for in Banque Financiere de la Cite v Parc (Battersea) Ltd [1999] 1 AC 221. However, it seems that the Australian courts have not accepted such as basis. For example, Bryson J in Challenger Managed Investment Ltd v Direct Money Corporation Pty Ltd (2003) 59 NSWLR 452 observed that the court "… would respectfully say that Lord Hoffman's relation … of subrogation to unjust enrichment … [in Banque Financiere de la Cite v Parc (Battersea) Ltd] … is not established in Australian case law."*

5 *See Mitchell, C and Watterson, S. Subrogation – Law and Practice. Oxford University Press, Oxford, para 8.20 ff.*

6 *Castle Phillips Finance Co Ltd v Piddington (1995) 70 P & CR 592.*

7 *Cheltenham & Glouster plc v Appleyard [2004] EWCA Civ 291.*

8 *Drew v Lockett (1863) 55 ER 196.*

9 *Halifax Mortgage Services Ltd v Muirhead (1998) 76 P & CR 418.*

10 *Thurstan v Nottingham Permanent Benefit Building Society [1902] 1 Ch 1.*

11 *See Mitchell, C and Watterson, S. Subrogation – Law and Practice. Oxford University Press, Oxford, para 8.26 ff.*

12 *Gertsch v Atsas [1999] NSWSC 898.*

13 *Cheltenham & Glouster plc v Appleyard [2004] EWCA Civ 291*

14 *Section 13 of the Mercantile Law Act 1962 (ACT); for the Northern Territory, s 3 of the Mercantile Law Amendment Act 1861 (SA), and see s 17 of that Act for application in South Australia; s 4 of the Mercantile Law Act 1867 (Qld); s 13 of the Mercantile Law Act 1935 (Tas); s 52 of the Supreme Court Act 1986 (Vic); and for Western Australia, s 5 of the Mercantile Law Amendment Act 1856 (Imp) (19 & 20 Vict c 97).*

15 *Inserted into the Law Reform (Miscellaneous Provisions) Act 1965 (NSW) by s 5 of the Usury, Bills of Lading and Written Memoranda (Repeal) Act 1990 No. 7 (NSW)*

16 *See Dal Pont, G E and Chalmers, DRC. Equity and Trusts in Australia. Lawbook Co, Sydney (4th ed), para 14.15.*