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# Unconscionable or unfair dealing in asset-based lending in Australia

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*This article examines the extent to which the doctrine of unconscionable conduct protects the interests of victims of exploitative asset-based lending. It considers the possibility of a loan made to a borrower unable to conserve his or her own interests and secured on the family home being set aside through general principles of unconscionable dealing in equity, including the current requirement to show a 'situational special disadvantage', under the Australian Securities and Investments Commission Act 2001 (Cth) (ASIC Act), and the Competition and Consumer Act 2010 (Cth). Moreover, this study investigates the courts' jurisdiction to reopen an unjust housing loan contract under the National Consumer Credit Protection 2009 (Cth) (Consumer Credit Code) and the Contracts Review Act 1980 (NSW). First, the article examines whether the lender knew of the vulnerability of the borrower. This article argues that the information given in a loan application may in some cases provide a basis for finding that a lender had knowledge of the inability of a borrower to look after his or her own interests for the purposes of establishing unconscionable dealing and unfair conduct.*

*The case analysis revealed that asset-based lending may constitute unconscionable conduct in certain circumstances; however asset-based lending itself is not unconscionable. Second, a lender may have a duty to make further enquiries regarding a borrower's circumstances in cases where the loan documentation is incomplete or irregular. Third, the courts are willing to consider the information contained in the loan documentation when determining whether a lender had knowledge of a borrower's personal and financial circumstances. Lastly, the requirement that a borrower should 'do equity' and account for any benefit they have received has a significant impact on the utility of the relief granted by the courts.*

## Introduction

Asset-based lending encompasses a variety of credit products that include 'subprime' or 'non-conforming' loans, that are made available to borrowers who cannot obtain loans from traditional lenders, and 'low-documentation' or 'no-documentation' loans that 'do not require as rigorous proof of creditworthiness'. In Australia, the subprime mortgage lending industry is a major contributor to lending provision, yet there were 14.6% of subprime mortgages in arrears in 2011.<sup>1</sup>

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<sup>1</sup> Mortgage Business, 'Take the Strain: Australian borrowers' (2012) August *Mortgage*

Asset-based lending arises in circumstances where a lender provides a loan on the basis of security over an asset, rather than relying on the borrower's capacity to repay the loan from their income.<sup>2</sup> The more aggressive forms of asset-based lending will usually involve a lender taking security over the borrower's only substantial asset — in most cases this is the borrower's primary residence. This will occur in circumstances where it is clear to the lender that the borrower has no capacity to repay the loan from their income. In such cases, there is a substantial risk that the borrower will default on the loan and lose their only significant asset. These inappropriate practices have the potential to lead to unconscionable dealing, and they have opened the door for unscrupulous lenders to engage in 'morally repugnant' lending practices: see *Butler v Vavladelis*.<sup>3</sup>

Arguably, what makes the more aggressive forms of asset-based lending particularly objectionable is the disparity in risk faced by the lender and the borrower. There is a substantial risk that the borrower will default on the loan and lose their only substantial asset; whereas the lender bears little<sup>4</sup> or no risk of loss.<sup>5</sup> This is because the lender is able to recover the money owed from the sale of the property. Attempts to redress inappropriate lending practices using unconscionability laws are rarely successful.

As noted in *Butler v Vavladelis*, asset-based lending itself is not unacceptable in practice.<sup>6</sup> First, lenders do not have a legal duty to lend reasonably,<sup>7</sup> nor are they required to forfeit any advantage they may have over a borrower.<sup>8</sup> Second and perhaps most importantly, asset-based lending provides the community with wider access to credit.<sup>9</sup> For example, pensioners who are 'cash-poor' but have significant assets may find that asset-based lending is the only viable source of credit. Accordingly, a blanket objection to asset-based lending would arguably disregard the segments of the population for whom it is the only viable option.

However, the more aggressive forms of asset-based lending are often perceived as problematic. '[A]ny security should be regarded as a last line of

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*Business*, p 28. See also, ABC 7.30 Report 'Australia Faces its Subprime Mortgage Scandal' 13 August 2012, at <<http://www.abc.net.au/7.30/content/2012/s3566922.htm>> (accessed 2 October 2013).

2 L Aitken, 'Asset lending' and the improvident borrower (2012) 86 *ALJ* 134 at 134.

3 [2012] VSC 186; BC201202881 at [21].

4 This is based on the presumption that the security adequately covers the loan amount and assumes that the value of the asset does not fall below the value of the loan.

5 Aitken, above n 2, at 134.

6 *Ibid*, at 137.

7 J Wadsley, 'Bank Lending and the Family Home: Prudence and Protection' (2003) 3 *Lloyds Maritime and Commercial Law Quarterly* 341 at 343, quoted in L Aitken, 'A "duty to lend reasonably" — new terror for lenders in a consumer's world?' (2007) 18 *Journal of Banking and Finance Law and Practice* 18 at 18.

8 *ACCC v CG Berbatis Holdings Pty Ltd* (2003) 214 CLR 51; 197 ALR 153; 77 ALJR 926; BC200301513; W Young, C Croft and W Smith, *On Equity*, Lawbook Co, Sydney, 2009, p 304.

9 J M Paterson, 'Knowledge and neglect in asset-based lending: When is it unconscionable or unjust to lend to a borrower who cannot repay?' (2009) *Journal of Banking and Finance Law and Practice* 18 at 36.

defence to fall back upon in exceptional circumstances only'.<sup>10</sup> The more aggressive forms of asset-based lending are contrary to this approach and view the security as the first and only defence. Furthermore, the more aggressive forms of asset-based lending can be exploitative, unfair and have devastating consequences for borrowers, such as losing the family home.<sup>11</sup>

This article examines the extent to which the doctrines of unconscionable conduct and unjust conduct protect victims of exploitative asset-based lending. Both personal, domestic and business or investment loans made to borrowers based solely on the value of the borrower's residential property, without regard to his or her income or ability to make repayments are examined. An appraisal is conducted of those judicial decisions in which loans made to borrowers unable to conserve their own interests and secured on the family home have been challenged as unconscionable or unjust. Fundamentally, the complaint in many of the asset-based lending cases is that the lender neglected to take steps to protect the interests of a vulnerable borrower when information in the loan application should reasonably have alerted the lender to that vulnerability.

This article is significant in light of the recent judicial decisions that exemplify the tough stance that courts are taking against lenders operating in the business of providing non-conventional or asset-based loans with higher risk factors.<sup>12</sup> It focuses on the more aggressive forms of asset-based lending and analyses a topical issue that prevails in the current consumer credit market.

In the first part of this article some judicial decisions are explored where loans secured over the family home were made to borrowers with little capacity to repay and who were arguably limited in their ability to protect their own interests. Similarly, the circumstances leading to the creation of unconscionable conduct as consumer redress against asset-based lending, and the recent development of the doctrine, including the current requirement to show a 'situational special disadvantage': *Perpetual Trustee Australia Ltd v Schmidt*<sup>13</sup> are discussed.

The second part of the article examines the concept of whether the lender knew of the vulnerability of the borrower and considers the knowledge being attributed to a lender on the ground that a broker was its agent. This article argues that the information given in a loan application may, in some cases, provide a basis for finding that a lender had knowledge of the borrower's inability to look after his or her own interests for the purposes of establishing

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10 J M Holden, *The law and Practice of Banking*, 8th ed, FT Prentice Hall, 1993, vol 2, p 12, quoted in Wadsley, above n 7, at 342.

11 Paterson, above n 9, at 18.

12 See, eg, *Elkofairi v Permanent Trustee Co Ltd* (2002) 11 BPR 20,841; (2003) Aust Contract R 90-157; [2002] NSWCA 413; BC200207766; *Perpetual Trustee Co Ltd v Khoshaba* (2005) 14 BPR 26,639; [2006] NSWCA 41; BC200602108; *Kowalczyk v Accom Finance Pty Ltd* (2008) 77 NSWLR 205; 252 ALR 55; 14 BPR 26,565; BC200810918; *Perpetual Trustee Australia Ltd v Schmidt* [2010] VSC 67; BC201002712; *Tonto Home Loans Australia Pty Ltd v Tavares* (2011) 15 BPR 29,699; [2011] NSWCA 389; BC201110342; *Michalopoulos v Perpetual Trustees Victoria Ltd* [2010] NSWSC 1450; BC201009718; *Valcorp Pty Ltd v Angas Securities Ltd* [2012] FCAFC 22; BC201201088; and *Butler v Vavladelis* [2012] VSC 186; BC201202881.

13 [2010] VSC 67; BC201002712 at [6].

unconscionable dealing and unfair conduct.

## Part I: Relief against asset-based lending

This section will outline the different causes of action available to a borrower seeking relief against asset-based lending. This will involve a brief overview of unconscionable conduct in equity, unconscionable conduct under the Australian Securities and Investments Commission Act 2001 (Cth) (ASIC Act), unconscionable conduct under the Competition and Consumer Act 2010 (Cth) (Competition and Consumer Act), unjust contracts under the Contracts Review Act 1980 (NSW) (Contracts Review Act) and Sch 1 of the National Consumer Credit Protection 2009 (Cth) (Consumer Credit Code).

### Unconscionable conduct in equity

The courts have discretion to grant relief and set aside a mortgage or loan agreement obtained as a result of the unconscionable conduct of a lender. Unconscionable conduct occurs where a borrower is at a special disadvantage and the lender knowingly takes unconscientious advantage of it. To establish unconscionable conduct there must be some fault element on the part of the lender, ie, their conduct must have been '*morally repugnant*' in some way.<sup>14</sup>

In order to establish unconscionable conduct in equity, three elements must be satisfied. First, the borrower must have been at a special disadvantage or disability with respect to the lender. Second, the lender must have known or ought to have known of this special disadvantage. Third, the lender took unconscientious advantage of the borrower's special disadvantage or disability. Each of these requirements will be briefly considered below.

### Special disadvantage

The borrower must have been at a special disadvantage and not merely a disadvantage.<sup>15</sup> In *Commercial Bank of Australia Ltd v Amadio* the High Court explained that a special disadvantage is one that 'seriously affects the ability of the innocent party to make a judgment as to his or her own best interests'.<sup>16</sup> There are a number of factors that may indicate that the borrower is at a special disadvantage, however there is no conclusive list.<sup>17</sup> The personal circumstances that will usually indicate that the borrower is at a special disadvantage include: poverty, sickness, age, sex, illiteracy or lack of education.<sup>18</sup> The circumstances of a particular transaction may also help to establish a special disadvantage. This is particularly relevant in the context of asset-based lending, where the court will take into account the fact that the

14 *Butler v Vavladelis* [2012] VSC 186; BC201202881, citing *Kowalczyk v Accom Finance Pty Ltd* (2008) 77 NSWLR 205; 252 ALR 55; [2008] NSWCA 343; BC200810918.

15 *ACCC v CG Berbatis Holdings Pty Ltd* (2003) 214 CLR 51; 197 ALR 153; 77 ALJR 926; BC200301513 at [64]; *ACCC v Samton Holdings* (2002) 117 FCR 301; 189 ALR 76; [2002] FCAFC 4; BC200200178 at [65].

16 (1983) 151 CLR 447 at 462; 46 ALR 402; 57 ALJR 358; BC8300072. See also Young, Croft and Smith, above n 8, p 301.

17 *Blomley v Ryan* (1956) 99 CLR 362 at 392; BC5600790.

18 *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; 46 ALR 402; 57 ALJR 358; BC8300072; *Blomley v Ryan* (1956) 99 CLR 362; BC5600790.

borrower had no income and the loan was secured against the person's only substantial asset.<sup>19</sup> The unconscientious nature of the transaction in such circumstances arises from the fact that the borrower is at a substantial risk of losing their only significant asset.<sup>20</sup>

### **Knowledge**

The lender must have known or ought to have known of this special disadvantage. In the context of asset-based lending, this requirement is usually the most challenging to establish. The commercial reality is that, lenders will often not have direct contact with the borrowers. There could be a number of intermediaries involved in any one transaction, such as, finance brokers, loan originators, loan processors and loan managers. In such circumstances, the lender is unlikely to have actual knowledge. However, the courts will refer to the information contained in the loan documentation to support a finding of constructive knowledge. Where a lender has had no involvement in the loan process, the knowledge of the intermediaries can be attributed to the lender if there is an agency relationship. This knowledge requirement will be discussed in more depth in Part II of the article.

### **Taking unconscientious advantage**

The lender must have taken unconscientious advantage of the borrower's special disadvantage or disability. This will occur if the lender actively exploits the borrower or by virtue of the lender proceeding with the transaction regardless of the borrower's special disadvantage.<sup>21</sup> Young et al explain that, once a borrower establishes that they were at a special disadvantage and the lender had knowledge of this, the onus shifts to the lender to show that they did not take unconscientious advantage.<sup>22</sup>

### **Requirement to 'do equity'**

In granting relief against unconscionable conduct, the courts are constrained by the requirement that the borrower 'do equity'. This requires the borrower to account for any benefit it has received as a result of the transaction. The High Court in *Vadasz v Pioneer Concrete (SA) Pty Ltd* explained this requirement as follows:

[t]hus unconscionability works in two ways. In its strict sense, *it provides the justification for setting aside a transaction. More loosely, it provides the justification for not setting aside the transaction in its entirety or in doing so subject to conditions, so as to prevent one party obtaining an unwarranted benefit at the expense of the other.*<sup>23</sup>

In the context of asset-based lending, the courts will grant relief on the condition that the borrower repays the loan (where the court finds that the

19 For example, *Elkofairi v Permanent Trustee Co Ltd* (2002) 11 BPR 20,841; (2003) Aust Contract R 90-157; [2002] NSWCA 413; BC200207766.

20 *Ibid*, at [57]–[59].

21 Young et al, above n 8, p 78.

22 *Ibid*, p 305, citing *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; 46 ALR 402; 57 ALJR 358; BC8300072.

23 (1995) 184 CLR 102 at 114; 130 ALR 570; 69 ALJR 678; BC9506450 (emphasis added), cited in R Barrett, 'Some themes in Australian banking and finance law — 1984 to 2003 and beyond' (2003) 31 *Aust Bus L Rev* 391 at 395.

borrower has received a benefit).<sup>24</sup> This is understandable, as it prevents the borrower from effectively retaining an unearned windfall at the expense of the lender. However, the requirement to 'do equity' may have an unsatisfactory result for a borrower when applied in practice. This will be explored in more detail below.

### Unconscionable conduct under the ASIC Act

The courts have discretion to grant relief against asset-based lending under the ASIC Act. Section 12CB of the ASIC Act prohibits a person engaging in unconscionable conduct in connection with the supply or acquisition of financial services, in trade or commerce. Section 12CB applies to the supply and possible supply of financial services.

Section 12CC of the ASIC Act provides a list of factors that the courts may take into account when determining whether there has been unconscionable conduct. These factors include the relative strengths of borrower and lender's bargaining positions, whether the borrower was able to understand the documents and the lender's failure to disclose certain risks to the borrower. There is some overlap between the factors that would be considered in establishing unconscionable conduct in equity and under the ASIC Act. However, the ASIC Act specifically states that, s 12CB is not limited by unconscionable conduct under the general law.<sup>25</sup> Accordingly, unconscionable conduct under this provision arguably has wider application than unconscionable conduct in equity.

### Unconscionable conduct under the Competition and Consumer Act

Section 20 of the Competition and Consumer Act prohibits unconscionable conduct within the meaning of the unwritten law. Section 21 of the Competition and Consumer Act prohibits unconscionable conduct in connection with the supply or possible supply of goods or services in trade or commerce.<sup>26</sup> However, these provisions do not apply to the supply or possible supply of financial services or financial products.<sup>27</sup> As a result, the unconscionable conduct provisions under the Competition and Consumer Act would not apply in cases where a borrower is seeking relief against asset-based lending.

### Contracts Review Act

The Contracts Review Act is often pleaded in the alternative to unconscionable conduct.<sup>28</sup> Section 7(1) of the Contracts Review Act enables the courts to set aside an unjust contract if it considers it just to do so.

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<sup>24</sup> Young et al, above n 8, p 178.

<sup>25</sup> Section 12CC(4)(a) of the ASIC Act.

<sup>26</sup> *ACCC v Lux Distributors Pty Ltd* [2013] FCAFC 90; BC201311903.

<sup>27</sup> Section 131A of the Competition and Consumer Act.

<sup>28</sup> See *Elkofairi v Permanent Trustee Co Ltd* (2002) 11 BPR 20,841; (2003) Aust Contract R 90-157; [2002] NSWCA 413; BC200207766; *Small v Gray* [2004] NSWSC 97; BC200400764 and *Perpetual Trustee Co Ltd v Koshaba* (2005) 14 BPR 26,639; [2006] NSWCA 41; BC200602108.



Accordingly, the courts are required to consider two points: whether the contract or a provision of the contract was unjust in the circumstances and whether it would be just to grant the relief sought.

### **Unjust contract**

Section 9 of the Contracts Review Act identifies the matters that the courts may take into account when making a determination. These include: inequality in the bargaining power of the borrower and lender, whether the borrower was unable to protect his or her interests and the borrower's relevant economic circumstances, educational background and literacy. These factors can be broadly categorised as being either substantive or procedural and the distinction has been usefully described as follows:

a contract may be unjust under the Act because its terms, consequences or effects are unjust. This is substantive injustice. Or a contract may be unjust because of the unfairness of the methods used to make it. This is procedural injustice. Most unjust contracts will be the product of both procedural and substantive injustice.<sup>29</sup>

It is clear that there is an overlap between unconscionable conduct and an unjust contract under the Contracts Review Act. In spite of the overlap, it has been argued that the threshold for relief under the Contracts Review Act is lower than that for unconscionable conduct.<sup>30</sup>

### **Relief is just in the circumstances**

The courts power to grant relief under s 7 of the Contracts Review Act is qualified. That is, the courts must be satisfied that granting relief is just in the circumstances and would avoid an unjust consequence. This will involve a consideration of the role that the lender played in the transaction. Was the lender an innocent third party without knowledge of the circumstances that made the contract unjust or was the lender in some way culpable?<sup>31</sup> Justice McDougall explained the courts approach as thus:

where a contract has been found to be unjust, it would in general be unsound to grant relief under s 7 where the party against whom relief is claimed is both innocent and ignorant of the circumstances giving rise to that injustice.<sup>32</sup>

In cases where the lender was an innocent third party, the courts may refuse to grant relief altogether. In order for a lender to be considered 'innocent', the courts will consider 'whether a failure by a lender to engage in good commercial practice was "a material factor in bringing about the problem"'.<sup>33</sup> In determining whether the lender was 'ignorant', the courts will consider whether the lender had actual or constructive knowledge of the circumstances (this is considered in more detail in Part II of the article).

<sup>29</sup> *West v AGC Advances* (1986) 5 NSWLR 610 at 620; (1986) ASC 55-500; (1986) NSW ConvR 55-306 (McHugh JA).

<sup>30</sup> See Paterson, above n 9, at 32.

<sup>31</sup> See *Tonto Home Loans Australia Pty Ltd v Tavares*; *Firstmac Ltd v Di Benedetto*; *FirstMac Ltd v O'Donnell* (2011) 15 BPR 29,699; [2011] NSWCA 389; BC201110342 at [276].

<sup>32</sup> *Small v Gray* [2004] NSWSC 97; BC200400764 at [85]; *Collier v Moreland Finance Corporation* (1989) 6 BPR 13,337; [1989] ANZ ConvR 515; (1989) NSW ConvR 55-473; BC8902259.

<sup>33</sup> *Spina v Permanent Custodians Ltd* (2009) 14 BPR 26,923; [2009] NSWCA 206; BC200906292 at [119], quoted in Aitken, above n 2, at 136.



Alternatively, the courts may grant conditional relief to a borrower in order to ensure a just outcome. For example, in cases where a lender has advanced money to the borrower, the courts may require the borrower to account for any benefits before it will set aside the loan agreement.<sup>34</sup> This is similar to the requirement to 'do equity' discussed above and also has the same practical limitations for a borrower seeking relief from an unjust contract. This will be discussed in more detail below.

### Consumer Credit Code

The Consumer Credit Code imposes responsible lending obligations on lenders (known as credit licensees) and intermediaries (known as credit assistance providers). The primary obligation of lenders and intermediaries under the responsible lending obligations is to assess the suitability of a credit contract for the borrower.<sup>35</sup> This requires an intermediary and lender to undertake enquiries regarding the borrower's financial circumstances and verify the information provided.<sup>36</sup> The Australian Securities and Investments Commission has indicated that intermediaries and lenders will be required to consider a number of factors when determining whether a loan is suitable, including: the borrower's income, expenses, assets and personal circumstances (age and number of dependants).<sup>37</sup>

In cases where the credit contract is unsuitable, an intermediary is prevented from recommending, and a lender is prevented from entering into, the credit contract.<sup>38</sup> Relevant for our purposes, a credit contract will be unsuitable in circumstances where the borrower would be unable to meet the payment obligations without substantial hardship.<sup>39</sup> If the borrower would be required to sell their primary residence, it is presumed that the borrower cannot comply with the loan agreement without suffering substantial hardship.<sup>40</sup> Interestingly, the responsible lending requirements arguably make it more difficult for lenders to engage in asset-based lending. This is because, the presumption of substantial hardship prevents an intermediary from recommending, and a lender from entering into, an asset-based loan contract, unless the intermediary or lender can prove that the borrower would not suffer substantial hardship. The lender and intermediary therefore bear the burden of satisfying themselves that the borrower will not suffer a substantial hardship.

The Consumer Credit Code applies to credit contracts provided for personal, domestic or household purpose. This has been expanded to include credit contracts for the purpose of purchasing, renovating or improving

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34 For example, *Elkofairi v Permanent Trustee Co Ltd* (2002) 11 BPR 20,841; (2003) Aust Contract R 90-157; [2002] NSWCA 413; BC200207766.

35 Sections 115, 116, 117, 118, 128, 129, 130 and 131 of the Consumer Credit Code; see also D McGill, S Corones and N Howell, 'Regulating the cost of small loans: Overdue or overkill?' (2012) 30 *C&SLJ* 149 at 155.

36 Sections 117(1) and 130(1) of the Consumer Credit Code; Australian Securities and Investments Commission, *Regulatory Guide 209: Credit Licensing: Responsible lending conduct*, September 2013, para 209.32.

37 *Ibid.*, para 209.

38 Sections 115 and 128 of the Consumer Credit Code.

39 Sections 118(2)(a) and 131(2)(a) of the Consumer Credit Code.

40 Sections 118(3) and 131(3) of the Consumer Credit Code.

residential property for investment purposes.<sup>41</sup> If a borrower signs a business purpose declaration, there is a presumption that the Consumer Credit Code will not apply.<sup>42</sup> This presumption can be rebutted, however the onus would be on the borrower to prove that the loan was provided for a Consumer Credit Code purpose.

It is important to note that lenders have a legitimate interest in encouraging borrowers to sign a business purpose declaration, thereby forfeiting their rights under the Consumer Credit Code. The Consumer Credit Code attempts to address this incentive by providing that, the presumption does not apply in cases where the lender knew or would have known (if it had made reasonable enquiries) that the loan was provided for a Consumer Credit Code purpose.<sup>43</sup> Furthermore, s 13(6) of the Consumer Credit Code prohibits a person from inducing a borrower to make a false or misleading business declaration.<sup>44</sup> It is yet to be seen whether these disincentives are effective or not.

### Case analysis

This section will consider the approach taken by the courts when granting relief against asset-based lending on the grounds of unconscionability and an unjust contract. This will involve an examination of the decisions in *Elkofairi v Permanent Trustee Co Ltd*,<sup>45</sup> *Small v Gray*<sup>46</sup> and *Butler v Vavladelis*.<sup>47</sup> These cases reveal a number of important points that should be noted by borrowers seeking relief against exploitative asset-based lending.

First, asset-based lending may constitute unconscionable conduct in certain circumstances; however asset-based lending itself is not unconscionable.<sup>48</sup> Second, in cases where a lender receives a regular and satisfactory loan application there is no duty to make further enquiries. For example, one would expect the loan application to contain information regarding the income, assets and employment circumstances of the borrower, as these are material considerations. Where the loan application is irregular or incomplete (ie, it does not contain such information), the courts will expect a lender to make further enquiries.<sup>49</sup> This was explained in *Micarone v Perpetual Trustees Australia Ltd* as follows:

on receipt of an apparently regular and satisfactory loan application, there is no obligation on the lender to pursue further detailed enquiries as to the circumstances of the applicant for the loan, the proposed business transaction to which it relates, or the commercial viability of the loan.<sup>50</sup>

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41 Section 5 of the Consumer Credit Code.

42 Section 13(2) of the Consumer Credit Code.

43 Section 13(3) of the Consumer Credit Code.

44 See also McGill, Corones and Howell, above n 35, at 153.

45 (2002) 11 BPR 20,841; (2003) Aust Contract R 90-157; [2002] NSWCA 413; BC200207766.

46 [2004] NSWSC 97; BC200400764.

47 [2012] VSC 186; BC201202881.

48 *Elkofairi v Permanent Trustee Co Ltd* (2002) 11 BPR 20,841; (2003) Aust Contract R 90-157; [2002] NSWCA 413; BC200207766.

49 *Ibid*, at [30].

50 (1999) 75 SASR 1; [2000] ANZ ConvR 597; [1999] SASC 265; BC9903786 at [625].

Third, establishing that the lender had knowledge of the circumstances is a significant hurdle for borrowers due to the widespread use of intermediaries. These cases show that the information given in a loan application may provide a basis for establishing a lender's knowledge of the borrower's financial circumstances. The role of knowledge in establishing these causes of action will be considered in more depth in Part II of this article.

Fourth, the requirement that a borrower 'do equity' has a significant impact on the usefulness of relief granted by the courts. The courts may make an order for relief against asset-based lending conditional on the borrower accounting for any benefit that has been obtained. For example, where a borrower has received and benefited from the loan proceeds, the borrower will be required to repay this money to the lender before relief will be granted.<sup>51</sup> This is despite the fact that a borrower who has defaulted on a loan is unlikely to be in a financial position to meet the condition imposed by the courts.

### *Elkofairi v Permanent Trustee Co Ltd*

In *Elkofairi v Permanent Trustee Co Ltd*, Mr and Mrs Elkofairi (the borrowers) gave the lender a mortgage over their property as security for a \$750,000 loan. The loan fell into default and the lender successfully sought possession of the property. Mrs Elkofairi appealed the decision and sought relief on the basis of unconscionable conduct and s 7(1) of the Contracts Review Act.<sup>52</sup> The court found that the lender had acted unconscionably and the loan agreement was an unjust contract under the Contracts Review Act. The court therefore ordered that the mortgage be set aside, on the condition that Mrs Elkofairi account for any benefit she received under the loan.

#### **Unconscionable conduct**

The court found that Mrs Elkofairi had the classic hallmarks of a special disadvantage: she was completely uneducated, could not read or write in English, had difficulty understanding English, suffered poor health and had difficult domestic circumstances. However, the lender had no knowledge of these personal circumstances. The court was therefore required to consider whether there were any other features of the transaction that the lender knew or ought to have known.<sup>53</sup>

The factual circumstances provided a classic example of the more aggressive form of asset-based lending. Mrs Elkofairi was unemployed and had no income other than her disability pension. She was described as 'an invalid pensioner' throughout the period in question. Furthermore, Mrs Elkofairi's interest in the property was her only major asset. In the event of default, she would be unable to repay the loan and was therefore at significant risk of losing her property.

A loan application and three letters from Mr Elkofairi's accountant were submitted to the loan originator, Aussie Home Loans. The loan application and

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<sup>51</sup> Young et al, above n 8, p 178.

<sup>52</sup> Relief was also sought on the basis of the principle stated in *Yerkey v Jones* (1939) 63 CLR 649; [1939] ALR 62; (1939) 13 ALJR 84; BC3900003, however this is not relevant for the purposes of this article.

<sup>53</sup> *Elkofairi* (2002) 11 BPR 20,841; (2003) Aust Contract R 90-157; [2002] NSWCA 413; BC200207766 at [53].

accountant's letters only contained financial information regarding Mr Elkofairi and did not refer to the financial circumstances of Mrs Elkofairi at all. The lender therefore had no information regarding Mrs Elkofairi's income and capacity to service the loan. The loan application and supporting documentation were thereafter provided to Queensland State Home Loans, who was responsible for processing the loans. Importantly, the lender had no contact with Mrs Elkofairi throughout this whole process.

The court found that the lender had acted unconscionably in the circumstances. The court took into account the 'total absence' of financial information regarding Mrs Elkofairi, the large loan amount and the fact that this loan was secured against her only substantial asset. In these circumstances, the lender should have been put on notice and made further enquiries regarding Mrs Elkofairi's capacity to repay the loan. Interestingly, the court also took into account the fact that the lender knew that Mrs Elkofairi had not received legal advice. This knowledge supported a finding of unconscionability on the part of the lender.<sup>54</sup>

This case was one of the first cases to clearly establish that asset-based lending may be unconscionable in certain circumstances. The court explained that:

[t]he unconscientious nature of the transaction was that she was thereby at risk of losing her only asset. *That risk was both immediate and real* . . . It is no answer that the respondent was content with the transaction because the loan was well secured. . . . *In my opinion, therefore, it was unconscientious for the respondent to lend a large sum of money to a person with no income with full knowledge that if the repayments under the loan were not met, it could that person's only asset.*<sup>55</sup>

Importantly, the lender argued that it did not need to be concerned with the fact that Mrs Elkofairi had no capacity to repay the loan and it was entitled to rely on the fact that the loan was adequately secured by the property. This argument was informed by notions of freedom of contract and the responsibility of each party to look after their own interests. The court categorically rejected this argument and considered that the lender was not entitled to adopt this approach in cases where a borrower is at a substantial risk of losing their only asset. Admittedly, there is a risk in every loan agreement that the borrower may default. However, the risk in this case was 'both immediate and real' as Mrs Elkofairi would almost certainly have been unable to make the repayments; resulting in the loss of her home.<sup>56</sup>

### Unjust contract

The court also considered whether the loan agreement was an unjust contract for the purposes of s 7(1) of the Contracts Review Act. The court considered the terms of the contract and the circumstances in which the contract was made.<sup>57</sup> In reaching its decision, the court took into account Mrs Elkofairi's lack of education, poor health and difficult domestic situation, even though the lender had no knowledge of these circumstances. The court also considered

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<sup>54</sup> Ibid, at [55].

<sup>55</sup> Ibid, at [57]–[59] (emphasis added).

<sup>56</sup> Ibid.

<sup>57</sup> Ibid, at [78].

the circumstances that were known to the lender: the size of the loan amount; the high debt to equity ratio of 75% and significantly, the lack of any information regarding Mrs Elkofairi's assets and income.<sup>58</sup> There was therefore a clear overlap between the factors considered when determining whether the lender's conduct was unconscionable and those relevant for the purposes of an unjust contract under the Contracts Review Act.

### Remedy

The court found that the lender had acted unconscionably and the loan agreement was an unjust contract under the Contracts Review Act. The court therefore ordered that the mortgage be set aside on the condition that Mrs Elkofairi account for any benefit she received under the loan. The proceeds of the loan were used for a mixed purpose, \$470,000 was used to discharge an existing mortgage over the property and Mr Elkofairi used the remainder for business purposes. The court found that Mrs Elkofairi had received a benefit of \$234,500, which represented her interest in the discharged mortgages. Mrs Elkofairi was therefore required to pay the lender \$234,500 in order to have the benefit of the relief granted.

Although Mrs Elkofairi was successful in her claims, this was something of a hollow victory. If Mrs Elkofairi had no capacity to repay the loan, it is likely that she would at the very least, have difficulty raising \$234,500. It is likely that a person in such a position may be required to sell the very property they are trying to save, in order to raise the required funds. Alternatively, they could fail to meet the conditions of relief and the lender would be able to proceed with the sale of the property. Regardless of the way the matter proceeds, the end result may be the same — sale of the primary residence.

It must be admitted that there are sound policy grounds for making a borrower account for any benefit he or she has received. The requirement that '[t]hey who seek equity do equity' is a maxim of fundamental importance in the courts of equity.<sup>59</sup> A borrower should be required to account for any unearned benefit they have received at the expense of the lender. Further, in granting conditional relief, the courts are essentially undertaking a risk allocation exercise; which involves consideration of whether the lender or the borrower should bear the loss, and to what extent each should bear the loss. However, the borrower is often not in a position to bear this loss and may be unable to account for the benefit it has received under the loan. As a result, in the context of asset-based lending, the practical impact of the requirement to 'do equity' may lead to an unsatisfactory result for a borrower.

### *Small v Gray*

In *Small v Gray*, Mr and Mrs Gray provided a mortgage over their primary residence as security for a loan of \$270,000. The loan was for the benefit Mrs Gray's son and daughter-in-law who intended to use the loan to purchase a property. Mr and Mrs Gray were therefore effectively acting as guarantors for the loan. Mrs Gray's son and daughter-in-law defaulted on the loan repayments almost immediately. The lenders therefore commenced

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<sup>58</sup> Ibid.

<sup>59</sup> Young et al, above n 8, at 175.

proceedings seeking to enforce their rights under the mortgage. Mr and Mrs Gray sought relief against enforcement of the mortgage on the basis of unconscionable conduct and s 7(1) of the Contracts Review Act. Mr Gray's defence was ultimately abandoned, however the court considered the arguments raised by Mrs Gray. The court found that the lender had acted unconscionably and the loan agreement was an unjust contract under the Contracts Review Act. The court therefore refused to enforce the mortgage.

### **Unconscionable conduct**

The personal circumstances of special disadvantage that were present in *Elkofairi v Permanent Trustee Co Ltd* were not present in this case.<sup>60</sup> The court therefore considered the surrounding circumstances of the transaction. The factual circumstances provide a classic example of asset-based lending. Mrs Gray was not in a position to make the loan repayments in the event that her son and daughter-in-law defaulted under the loan. She was unemployed, had no income and the property was her only substantial asset.<sup>61</sup> Further compounding the risks to Mrs Gray was the fact that the value of the property (\$240,000) was less than the amount borrowed by her son and daughter-in-law (\$270,000).

Mrs Gray's son and daughter-in-law retained a finance broker, Loan Equity to assist them to secure the loan. La Trobe Capital and Mortgage Corporation Limited (La Trobe) appear to have acted as a loan processor who accepted the mortgage application on behalf of the lender. At no time did Mr and Mrs Gray have direct contact with the lender. The court considered that La Trobe, was 'in substance' the lender's agent for the purposes of providing the loan secured by a mortgage. As a result, the knowledge of La Trobe would be imputed to the lender.

The mortgage application contained Mrs Gray financial information and clearly showed that she did not have capacity to repay the loan if required. Mrs Gray also obtained an Accountant's Certificate (which was a prerequisite to settlement of the transaction) that indicated that she did have capacity to repay the loan if required. The Accountant's Certificate was false and misleading in this respect. Importantly, there was therefore a clear inconsistency between the financial information contained in the mortgage application and the information contained in the Accountant's Certificate. La Trobe did not make any enquiries regarding these inconsistencies and the loan was ultimately approved.

There were a number of other questionable circumstances affecting the mortgage obtained over the property. Mrs Gray entered into the transaction due to inaccurate representations by the finance broker, Loan Equity. Further, her son forged Mr Gray's signature on the relevant documentation in circumstances where the vigilance of the finance broker, Loan Equity could have prevented the fraud.

The court found that lender had acted unconscionably in these circumstances. McDougall J took into account the lenders failure to consider or make enquiries regarding the 'significant discrepancy' between the

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<sup>60</sup> *Small v Gray* [2004] NSWSC 97; BC200400764 at [107].

<sup>61</sup> *Ibid*, at [92].

mortgage application and the Accountant's Certificate.<sup>62</sup> An inference could therefore be drawn that the lender provided the loan on the basis of the security over the property only. Further, the court considered that the substantial risks faced by Mrs Gray, who was effectively acting as a guarantor, 'must have been apparent' to La Trobe based on the discrepancies between the two documents.<sup>63</sup> In this case, the loan documentation was clearly irregular and the lender was required to pursue further enquiries regarding this discrepancy.<sup>64</sup> If La Trobe had conducted these further enquiries, it would have revealed that the Accountant's Certificate was incorrect and that Mrs Gray did not have the capacity to repay the loan.

### Unjust contract

The court also considered whether the loan agreement was an unjust contract for the purposes of s 7(1) of the Contracts Review Act. The court found that the agreement was both procedurally unjust and substantively unjust.<sup>65</sup> The agreement was procedurally unjust on a number of grounds, including, the fact that Mrs Gray entered into the transaction due to inaccurate representations by Loan Equity, her son forged Mr Gray's signature in circumstances where the vigilance of Loan Equity would have prevented the fraud and the Accountant's Certificate, which was a prerequisite to settlement of the transaction, was false and misleading.<sup>66</sup> The agreement was substantively unjust as Mrs Gray received no benefit from the transaction, the transaction put her only asset of significance at 'substantial risk' and there was a real likelihood that she would be called upon to perform her obligations, resulting in the loss of her property.<sup>67</sup>

The court went on to consider whether it should exercise its discretion to grant relief. The court found that La Trobe had acted as an agent of the lender. The knowledge of La Trobe was therefore imputed to the lender. On this basis, the lender was not an innocent third party without knowledge. The role of knowledge under the Contracts Review Act is considered in more detail in Part II.

The requirement that the court consider whether granting relief would be unjust is an important qualification. In the same vein, the courts have developed a number of principles which attempt to strike a balance between protecting consumers from unjust contract on the one hand, and ensuring that people are encouraged to honour their contracts on the other.<sup>68</sup> Justice McDougall referred to some of these principles in reaching his decision.<sup>69</sup> First, a contract is not unjust merely because it was not in the borrowers interests to enter into the contract or because enforcement would

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62 Ibid, at [107].

63 Ibid, at [108].

64 See also, *Micarone v Perpetual Trustees Australia Ltd* (1999) 75 SASR 1; [2000] ANZ ConvR 597; [1999] SASC 265; BC9903786.

65 Pursuant to the characterisations expounded by McHugh JA in *West v AGC Advances* (1986) 5 NSWLR 610; (1986) ASC 55-500; (1986) NSW ConvR 55-306.

66 *Small v Gray* [2004] NSWSC 97; BC200400764 at [89].

67 Ibid, at [92].

68 *West v AGC (Advances) Ltd* (1986) 5 NSWLR 610 at 622; (1986) ASC 55-500; (1986) NSW ConvR 55-306.

69 *Small v Gray* [2004] NSWSC 97; BC200400764 at [85].



cause the borrower to lose their home.<sup>70</sup> Second, there is a distinction between the contract and the underlying transaction.<sup>71</sup> Accordingly, a party seeking relief cannot simply rely on the fact that a transaction or investment has proved to be unwise.<sup>72</sup>

### **National Consumer Credit Code**

This case demonstrates the incentive that lenders and intermediaries may have to encourage a borrower to sign a business purpose declaration. Because Mrs Gray signed a business purpose declaration, there was a presumption that the Consumer Credit Code did not apply. Mrs Gray was encouraged to sign the business purposes declaration by the finance broker, who advised her that the loan application was more likely to be successful if she did. At no time did anyone explain the significance of the business purpose declaration to Mrs Gray. As a result, she was completely unaware that by signing the business purpose declaration she was losing significant rights. Interestingly, Mrs Gray received legal advice, however the court considered that the legal advice did not adequately convey the importance of signing the business purpose declaration.<sup>73</sup>

In this case, the loan was clearly not used for a business purpose. There was therefore a strong argument that the finance broker had breached s 13(6) of the Consumer Credit Code, which prohibits a person from inducing a borrower to make a false or misleading business purpose declaration. However, this issue was not raised in the proceedings.

### **Accountant's certificate**

This case also highlights the potential issues arising from the inter-relationships between the various parties involved. The accountant was presented as an 'independent expert' who would provide the Accountant's Certificate. As already noted the Accountant's Certificate was a prerequisite to settlement of the transaction and contained statements regarding Mrs Gray's ability to repay the loan. However, in reality the accountant was not 'independent' as he had been commissioned by the finance broker. In turn, the finance broker was acting in the interests of (and was remunerated by) Mrs Gray's son and daughter-in-law. It was therefore in the interests of Mrs Gray's son and daughter-in-law (and by extension the finance broker) that an Accountant's Certificate be issued. On the other hand, this was clearly not in the best interests of Mrs Gray, who was effectively acting as a guarantor. In such circumstances, Mrs Gray was clearly vulnerable.

### **Remedy**

The court found that the lender had acted unconscionably and the loan agreement was an unjust contract under the Contracts Review Act. The court

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70 Ibid, citing *Esanda Finance Corp Ltd v Tong* (1997) 41 NSWLR 482 at 491; [1998] ANZ ConvR 70; (1997) NSW ConvR 55-819; BC9701658.

71 *Elders Rural Finance Ltd v Smith* (1996) 41 NSWLR 296 at 309 per Handley JA; (1997) ASC 56-366; (1997) NSW ConvR 55-806; BC9605711.

72 *Elkofairi v Permanent Trustee Co Ltd* (2002) 11 BPR 20,841; (2003) Aust Contract R 90-157; [2002] NSWCA 413; BC200207766 at [78].

73 *Small v Gray* [2004] NSWSC 97; BC200400764 at [34].

therefore refused to enforce the mortgage. Since, Mrs Gray had received no benefit from the transaction there was no requirement for her to 'do equity'. This result can clearly be contrasted with *Elkofairi v Permanent Trustee Co Ltd*. It is therefore arguable that relief against unconscionability and an unjust contract will be more useful to a borrower who has obtained no benefit from the loan. In cases where a borrower has obtained a benefit, the requirement that the borrower 'do equity' and repay the loan to the lender means that a borrower may be unable to satisfy the conditions for relief imposed by the courts.

The court found that the lender had acted unconscionably and the loan agreement was an unjust contract under the Contracts Review Act. The court therefore refused to enforce the mortgage. Since, Mrs Gray had received no benefit from the transaction there was no requirement for her to 'do equity'. This result can clearly be contrasted with *Elkofairi v Permanent Trustee Co Ltd*. It is therefore arguable that relief against unconscionability and an unjust contract will be more useful to a borrower who has obtained no benefit from the loan. In cases where a borrower has obtained a benefit, the requirement that the borrower 'do equity' and repay the loan to the lender means that a borrower may be unable to satisfy the conditions for relief imposed by the courts.

### *Butler v Vavladelis*

In *Butler v Vavladelis*, Mr and Mrs Vavladelis were the victims of a fraud perpetrated by their daughter. The daughter borrowed \$400,000 from the lender in her parents name and their property was used as security for the loan. The loan fell into default and the lender commenced proceedings for possession of the property. Mr and Mrs Vavladelis claimed relief on the basis of unconscionable conduct. The court found that unconscionable conduct was arguable and ordered that the judgment for possession be set aside and the lender be restrained from selling the property pending further proceedings.

#### **Unconscionable conduct**

Mr and Mrs Vavladelis displayed the classic hallmarks of a special disadvantage: they were elderly, had limited education and difficulty reading, writing and speaking English. Accordingly, the court found that they were at a special disadvantage with respect to the lender and unconscionable conduct was arguable in the circumstances. However, the court did not consider the knowledge of the lender as it was primarily concerned with establishing whether unconscionable conduct was arguable. The court thereafter considered the surrounding circumstances of the transaction. The factual circumstances provide a classic example of the more aggressive asset-based lending. Mr and Mrs Vavladelis had no income and received a pension. Apart from savings of \$10,000, the property was their only substantial asset. In such circumstances, it was clear that they did not have capacity to repay the loan.

The daughter appeared to have engaged the services of a finance broker to obtain financing. The finance broker contacted the lender's solicitor and indicated their interest in obtaining a loan for \$400,000 secured by a first mortgage over a property. Mr and Mrs Vavladelis had no knowledge of these events and only became aware of these facts once the loan went into default

and they were evicted from the property. A valuation was undertaken by the lender's solicitor, which valued the property at \$615,000. Once the valuation had been obtained the solicitor arranged for the lender to advance the loan. The lender's solicitor failed to make any enquiries regarding the personal circumstances of the borrower. The court considered that the solicitor had acted as an agent of the lender. As a result, the solicitor's constructive knowledge was attributed to the lender itself.<sup>74</sup>

Not only did the lender's solicitor fail to make any enquiries of its own regarding the borrower's circumstances, it did not bother to consider whether the finance broker had made such enquiries. The court found that:

[t]here was no evidence of the solicitors [and lender] making any enquiries as to the circumstances of Mr and Mrs Vavladelis; in particular as to their age, ability to understand the English language, health, *the purpose of the mortgage loan, their income or their ability to repay the amounts due . . .* under the proposed mortgage. There is no evidence that the solicitors asked the finance broker as to whether the broker had made enquiries as to these relevant circumstances.<sup>75</sup>

The failure to enquire supported an inference that the loan had been provided on the basis of the security only. The court referred to the reasoning in *Elkofairi v Permanent Trustee Co Ltd* in reaching this conclusion. Importantly, the court clarified the position that asset-based lending is not itself unconscionable, however the surrounding circumstances may make it unconscionable.<sup>76</sup> In this case the asset-based lending was compounded by the failure to make any enquiries regarding the personal circumstances of Mr and Mrs Vavladelis.

### Remedy

The court found that unconscionable conduct was arguable in the circumstances.

The court therefore ordered that the judgment for possession be set aside and the lenders restrained from selling the property. This relief was subject to the condition that Mr and Mrs Vavladelis provide the lender with further security pending resolution of the matters in further proceedings. In this case, Mr and Mrs Elkofairi did not receive a benefit under the loan. However if the court granted unconditional relief, the lender's interests would be prejudiced.<sup>77</sup> As a result the court considered that conditional relief was appropriate and the provision of further security by Mrs Elkofairi was sufficient to protect the interests of the lender.

The court characterised its approach as minimising prejudice to the lender. At first glance, this appears to be a different consideration to that adopted in *Elkofairi v Permanent Trustee Co Ltd*. However, it is argued that whether characterised as minimising prejudice to the lender or requiring the borrower to account for a benefit, these two considerations are different sides of the same coin. Mr and Mrs Elkofairi were required to provide further security even though the property the subject of the proceedings was their only

<sup>74</sup> *Butler v Vavladelis* [2012] VSC 186; BC201202881 at [22].

<sup>75</sup> *Ibid*, at [22] (emphasis added).

<sup>76</sup> *Ibid*, at [17].

<sup>77</sup> *Ibid*, at [30].

substantial asset. It is therefore likely that they would have had great difficulty in satisfying this condition. Importantly, similar to *Elkofairi v Permanent Trustee Co Ltd* the practical result of the relief was unsatisfactory, in light of the financial circumstances of the borrower.

## Part II: Knowledge and unconscionable conduct

### Knowledge of the lender

A lender's knowledge regarding the personal and financial circumstances of the borrower is central to establishing unconscionable conduct. In order to establish unconscionable conduct, the lender must have known or ought to have known of the borrower's special disadvantage.<sup>78</sup>

The knowledge required is either 'actual' knowledge or 'constructive' knowledge.<sup>79</sup> A lender will have actual knowledge where it knows the circumstances of the transaction. In cases where there are a number of intermediaries and the lender has no direct contact with the borrower, they are unlikely to have actual knowledge.<sup>80</sup> Alternatively, a lender will have constructive knowledge, which flows from the circumstances of the transaction.<sup>81</sup> Put another way, the lender has sufficient awareness of the circumstances so that it 'ought' to have known.<sup>82</sup> Young et al explain that:

[t]he 'ought to know' component has also been described as knowledge of facts, which would raise the possibility of special disadvantage or disability in the mind of any reasonable person.<sup>83</sup>

It is easy to see why knowledge forms the basis of unconscionable conduct. Without actual or constructive knowledge it could hardly be argued that a lender has behaved in a 'morally repugnant' manner.<sup>84</sup> The lender's fault arises from the fact that it knew or ought to have known of the borrower's special disadvantage and yet it proceeded to take advantage of the borrower's position regardless. This requirement is one that causes borrowers seeking relief against asset-based lending significant issues, particularly in cases involving intermediaries.<sup>85</sup>

### Use of intermediaries

#### Reasons for the use of intermediaries

The use of intermediaries in a loan transaction has significant implications for a borrower attempting to establish that a lender had knowledge of the

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78 *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 462; 46 ALR 402; 57 ALJR 358; BC8300072.

79 *Ibid*, at CLR 463.

80 Paterson, above n 9, at 27.

81 L Aitken, 'Battling Big Banks' (December 1996) 7 *Journal of Banking and Finance Law and Practice* 295 at 304; Paterson, above n 9, at 27.

82 *Amadio* (1983) 151 CLR 447 at 463; 46 ALR 402; 57 ALJR 358; BC8300072. The degree of knowledge that is required for this requirement to be satisfied is unclear, see Young et al, above n 8, p 305.

83 Young et al, above n 8, p 304.

84 *Ibid*.

85 Paterson, above n 9, at 25.

circumstances. As the cases discussed in Part I show, there could be a number of intermediaries involved in any one transaction. These intermediaries will usually have a specific role to play in the loan process. Gray and Maclean suggest that the increasing prevalence of intermediaries in loan transactions has occurred for two reasons. First, the use of securitisation as a financing tool has resulted in large institutional lenders reducing their exposure to retail lending.<sup>86</sup> Second, the tendency for large institutional lenders to reduce their distribution networks by closing down bank branches.<sup>87</sup>

There is clear commercial incentive for lenders to use intermediaries:

a lender [is] able to reach a significant number of potential borrowers without the need to employ staff directly, or to build or maintain physical infrastructure. By this means, a lender [is] able to build a substantial book quickly, using intermediaries (mortgage managers and introducers) to bring forward, approve and manage loan applications and loans.<sup>88</sup>

There is also a legal incentive for lenders to use intermediaries. The use of intermediaries enables a lender to outsource its legal risks by ‘avoid[ing] the legal consequences of facts that [it] might prefer not to know’.<sup>89</sup>

Further, borrowers also arguably benefit from the use of intermediaries. Such benefits arise to the extent that the use of intermediaries results in the streamlining and simplification of the loan process. This potential benefit was recognised by the court in *Violet Home Loans Pty Ltd v Schmidt*,<sup>90</sup> where it was noted that, ‘[t]here may also be benefits for borrowers because the simplified processes and outsourcing likely lead to lower costs’.<sup>91</sup> Regardless of the reasons for the increasing prevalence of intermediaries in loan transactions, the impact on borrowers seeking relief against unconscionable conduct is significant.

### Impact on establishing knowledge

Where a lender outsources the loan process to intermediaries, it is less likely to have direct knowledge of the circumstances surrounding the transaction. It will therefore be more difficult for a borrower to establish that the lender had actual knowledge.<sup>92</sup>

The loan documentation (for example the loan application, income declaration statement or accountant’s certificate) will usually contain the borrower’s financial information. This may be the only source of information regarding the transaction for a lender in such circumstances. The courts have shown a willingness to consider the loan documentation when determining

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86 R Gray and A Maclean, ‘Finance Brokers — a regulatory anomaly’ (2003) 14 *Journal of Banking and Finance Law and Practice* 200 at 200.

87 *Ibid.*

88 *Tonto Home Loans Australia Pty Ltd v Tavares; Firstmac Ltd v Di Benedetto; FirstMac Ltd v O’Donnell* (2011) 15 BPR 29,699; [2011] NSWCA 389 at 10; BC2011103422.

89 G E Dal Pont, *Law of Agency*, 2nd ed, LexisNexis, Sydney, 2008, at [22.49].

90 (2013) 300 ALR 770; 93 ACSR 205; [2013] VSCA 56; BC201301401.

91 Dal Pont, above n 89, at [67].

92 Paterson, above n 9, at 27.

whether a lender had knowledge of the borrower's special disadvantage.<sup>93</sup> This approach is encouraging as it takes into account the commercial realities of loan transactions.

### Case analysis

In *Elkofairi v Permanent Trustee Co Ltd* the lender had no direct contact with Mrs Elkofairi and the only information (or lack thereof) regarding her financial circumstances was contained in the loan application and accountant's letters. The lender's failure to make further enquiries regarding Mrs Elkofairi's financial circumstances supported an inference of asset-based lending. Although the lender did not have actual knowledge, the court considered that it had constructive knowledge of Mrs Elkofairi's financial circumstances based on the loan documentation.

In *Small v Gray*, the information contained in the loan application and Accountant's Certificate formed the basis of the lender's knowledge. The lender's failure to make enquiries regarding the discrepancy between information contained in the loan application and the Accountant's Certificate supported an inference of asset-based lending. Similar to the finding in *Elkofairi v Permanent Trustee Co Ltd*, although the lender did not have actual knowledge of the borrower's circumstances or capacity to repay the loan, the court considered that the lender ought to have known.

These two cases demonstrate the courts' willingness to recognise the commercial reality of a loan transaction. In some cases where intermediaries are used, a lender may not have direct contact with a borrower and the lender's only source of information will be the loan documentation. However, what happens in cases where a lender is completely removed from the loan process and the lender does not review the loan documentation? This occurred in *Perpetual Trustees Australia Pty Ltd v Schmidt*, where the lender 'had nothing to do with the loan other than providing the funds'.<sup>94</sup> In such cases, establishing that an intermediary acted as an agent of the lender may be the only way to attribute the knowledge of the intermediary directly to the lender.

### Attributed knowledge and unconscionable conduct

#### Agency

Agency is a legal concept that 'connote[s] an authority or capacity in one person to create legal relations between a person occupying the position of principal and third parties'.<sup>95</sup> A principal will be liable for the acts of an agent acting within their scope of authority. Furthermore, there is a presumption at law<sup>96</sup> that the knowledge of the agent is imputed to the principal.<sup>97</sup>

Accordingly:

<sup>93</sup> See cases of *Small v Gray* [2004] NSWSC 97; BC200400764; *Elkofairi v Permanent Trustee Co Ltd* (2002) 11 BPR 20,841; (2003) Aust Contract R 90-157; [2002] NSWCA 413; BC200207766.

<sup>94</sup> [2010] VSC 67; BC201002712 at [73].

<sup>95</sup> *International Harvester Co of Australia Pty Ltd v Carrigan's Hazeldene Pastoral Co* (1958) 100 CLR 644 at 652; (1958) 32 ALJR 160; BC5800260.

<sup>96</sup> There are limitations to the presumption, for example where a third party knows that the agent will not disclose the information to the principal.

[w]here the presumption operates a principal cannot deny liability to a third party on the basis that the agent had not disclosed relevant and material information . . . and that had the information been made the principal would not have affected the dealing.<sup>98</sup>

It is in a lender's best interests to characterise the relationship with an intermediary as being something other than agency. On the other hand, it is in the borrower's best interests for this relationship to be characterised as one of agency. In such circumstances lenders are better placed to secure their interests. Particularly when one considers that a borrower may not be aware of the different intermediaries involved in processing the loan.

In cases where the lender has had no direct contact with the borrower and the loan documentation does not reveal the personal circumstances of the borrower, agency may be the only way to establish that the lender had knowledge of the borrower's special disadvantage. In order to make a lender liable two elements must be established: that an agency relationship exists and the intermediary acted within its scope authority. The borrower will usually bear the onus of proving agency,<sup>99</sup> even though they will often have the least knowledge regarding the nature of the relationship between the lender and intermediary.

### Agency relationship

There are three main ways in which an agency relationship can be created: by express or implied agreement, by subsequent ratification of the actions of the agent or by operation of the law.<sup>100</sup> Express agency is created by express agreement between the parties (whether in writing or orally), whereas implied agency arises from the conduct of the parties and the nature of their relationship.<sup>101</sup> Implied agency is particularly relevant for our purposes.<sup>102</sup>

In determining whether an implied agency exists, the courts will consider the nature of the dealings and the conduct of the parties. Importantly, the courts may find an implied agency even where there is a written agreement that attempts to disclaim that such a relationship exists. Factors that may indicate that an implied agency exists include: whether the intermediary is acting for the benefit of the lender, the level of control that the lender has over the actions of the intermediary and whether the intermediary is required to comply with the lender's instructions.<sup>103</sup> It is worthwhile noting that, there is a presumption that a finance broker acts as an agent of the borrower.<sup>104</sup> This

97 *Vane v Vane* (1873) 8 Ch App 383 at 399; *Ford Excavations Pty Ltd v Do Carmo* [1981] 2 NSWLR 253; F M B Reynolds, *Bowstead and Reynolds on Agency*, 18th ed, Sweet & Maxwell, Art 95, p 514.

98 Dal Pont, above n 89, p 627.

99 *Perpetual Trustees Aust Ltd v Schmidt* [2010] VSC 67; BC201002712 at [80].

100 Dal Pont, above n 89, p 87.

101 *Ibid*, p 90.

102 This is because it is not in the lenders best interests to characterise the relationship between itself and an intermediary as being one of agency.

103 *Perpetual Trustees Aust Ltd v Schmidt* [2010] VSC 67; BC201002712 at [152]–[154].

104 Dal Pont, above n 89, p 26.



presumption can be rebutted by facts indicating that the broker was in fact an agent of the lender.<sup>105</sup>

### Scope of authority

In order to create an agency relationship the principal must confer authority on the agent.<sup>106</sup> Importantly, the principal is not liable for the acts of an agent that are performed outside the agent's scope of authority.<sup>107</sup> Accordingly, if an agency relationship is established, it is in the lender's best interest to ensure that the scope of authority is limited.<sup>108</sup>

Authority can be 'actual' or 'ostensible'. Actual authority is found where the principal grants and the agent accepts authority to perform specific tasks on the principal's behalf.<sup>109</sup> Whereas ostensible authority is that which the principal represents to a third party that the agent holds. The principal is therefore estopped from denying that the agent acted without its authority. Actual authority can be further divided into 'express' or 'implied' actual authority. Express actual authority arises by specific written or oral authorisations; whereas implied actual authority is inferred from both the conduct of the parties and the circumstances of the case.<sup>110</sup> This article is concerned with implied actual authority.

### Case analysis

In *Perpetual Trustees Australia Pty Ltd v Schmidt*, the borrower was induced to invest in property developments by a conman, Mr Maddocks. In order to fund these investments, the borrower obtained a \$190,000 loan secured by a mortgage over his home. The borrower was ultimately defrauded by the conman and the loan fell into default. The lender commenced proceedings seeking possession of the property. The borrower claimed that the finance broker and/or loan originator and processor (Violet Home Loans) acted unconscionably in breach of the general law, the Trade Practices Act 1974 (Cth)<sup>111</sup> (now the Competition and Consumer Act) and the ASIC Act. The trial judge found that Violet was the lender's agent and had acted unconscionably in breach of the general law, the Trade Practices Act 1974 (Cth) and the ASIC Act. Violet appealed this decision on a number of grounds in *Violet Home Loans Pty Ltd v Schmidt* and the appeal was dismissed.

Mr Maddocks retained the services of a finance broker, *Medallion Finance Concepts Pty Ltd* (Medallion) to source the funding. Mr Maddocks completed the application form and income declaration for Mr Schmidt to sign. These

105 For example, *Conlan v Register of Titles* (2001) 24 WAR 299; [2001] WASC 201; BC200104400 at [230].

106 Dal Pont, above n 89, p 95, citing *NMFM Property Pty Ltd v Citibank Ltd (No 10)* (2000) 107 FCR 270; (2000) 186 ALR 442; [2000] FCA 1558; BC200006827 at [522] per Lindgren J.

107 *Phoenix Assurance Co Ltd v Berechree* (1906) 3 CLR 946; 12 ALR 559; BC0600038.

108 J O'Sullivan, 'The Roles of Managers and Agents in Syndicated Loans' (September 1992) *Journal of Banking and Finance Law and Practice* 183.

109 *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50; 11 ACSR 642; 11 ACLC 952.

110 Dal Pont, above n 89, p 183.

111 For offences committed before January 2011 the Trade Practices Act 1974 (Cth) applies. For offences committed after January 2011 the Competition and Consumer Act applies.

documents contained false information and described Mr Schmidt as a self-employed painter who had been in full-time employment for 25 years. The loan application stated that Mr Schmidt's annual income was \$75,000, while the income declaration stated that it was \$65,000. The finance broker then passed the loan documentation onto Violet. Violet, the loan processor, was responsible for processing all of the supporting documentation. Violet noted the discrepancy in Mr Schmidt's income and asked the finance broker to amend the documentation so that the income was the same on both documents. Violet also requested that the finance broker provide an Australian Business Number (ABN). The finance broker changed the income to \$45,000 in both documents so as to avoid the requirement to provide an ABN. The completed loan documentation was thereafter sent to the loan manager, Macquarie Securitisation Ltd (MSL). At no time did Medallion, Violet, MSL or the lender have direct contact with Mr Schmidt. All dealings were conducted through Mr Maddocks and the lender 'had nothing to do with the loan other than providing the funds'.<sup>112</sup>

Mr Schmidt did not have much of a formal education, however he could read and write in English. At the relevant time, he was a retired pensioner. The property used as security for the loan was his only substantial asset. Accordingly, he did not have the capacity to repay the loan and if he defaulted on the loan he was likely to lose his only substantial asset. The trial judge, with whom the court agreed, found that Violet had turned a blind eye to the irregularities and participated in 'massaging' the figures regarding Mr Schmidt's income so that they were not entitled to rely on the information.<sup>113</sup> The trial judge therefore treated the loan as asset-based lending and considered that in the circumstances, Violet had acted unconscionably.<sup>114</sup>

Relevant for the purposes of this section of the article, the lender, Violet and the loan manager entered into a Mortgage Origination Agreement (MOA) that stipulated the role and responsibilities of each party. The MOA clearly described Violet as being an independent contractor and specifically prohibited Violet from holding itself out as an agent of the lender or the loan manager.<sup>115</sup> Despite this, the trial judge considered that the surrounding circumstances and nature of their dealings indicated that an implied agency existed. First, Violet was acting for the lenders benefit in securing the loan application and processing the loan. Second, the loan contract indicated that the true nature of the relationship was one of implied agency. The loan application stated that, Violet was authorised 'to exercise all the powers, rights and functions of Perpetual under [the] loan contract and the securities on its behalf'. The trial judge considered that Violet was 'to all intents and purposes, [the lender's] right hand in procuring the loan and managing it after the funds were released'. Third, their dealings indicated a real level of control over Violet's activities which pointed to an agency relationship. The MOA dictated in precise terms the manner in which Violet would deal with borrowers and Violet was required to permit the lender to inspect its documents.

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112 *Schmidt* [2010] VSC 67; BC201002712 at [123].

113 *Ibid.*

114 *Ibid.*, at [198].

115 *Ibid.*, at [152]–[154].

The court was thereafter required to consider whether Violet had acted within its scope of authority in processing the loan. The MOA between the lender, Violet and the loan manager required personal interviews of the borrowers to be undertaken. Violet delegated this task to the finance brokers, however the finance brokers failed to personally interview Mr Schmidt. It was argued that, Violet did not have authority to delegate this task and had acted outside its authority. The court considered that the requirement to interview borrowers was not a limitation of the scope of authority, rather it was a promise as to the manner it would exercise its authority.<sup>116</sup> Accordingly, Violet had acted within its scope of authority.

This case highlights the difficulty that borrowers face when trying to attribute the knowledge of an intermediary to the lender.<sup>117</sup> Not only must the borrower establish that an agency relationship exists but they will also be expected to establish that the intermediary acted within its scope of authority. As evident in this case, lenders will go to great lengths to try and preclude an agency relationship from existing in the first place. Even where this hurdle is overcome, the lender can attempt to limit liability by ensuring that any alleged scope of authority is as limited as possible.

In this case, the intermediary was required to follow certain guidelines. It was alleged that departure from the guidelines was outside Violet's scope of authority. Although this argument was unsuccessful, it is clear that any departure by an intermediary from the required procedures may support a finding that the intermediary acted outside its scope of authority. This raises an important issue of risk allocation. In such circumstances, the borrower arguably should not have to bear the risk of misconduct by an intermediary as the lender is better placed to bear this risk.

## Knowledge and unjust contracts

### Knowledge of the lender

Knowledge is not a requirement of establishing an unjust contract under the Contracts Review Act. However, it will be a factor taken into account when determining whether the relief sought is just in the circumstances. Accordingly, the courts may find that the loan agreement is an unjust contract and yet refuse to grant relief under the Contracts Review Act. In *Perpetual Trustee Co Ltd v Koshaba*, Basten JA explained as follows:

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 such ignorance may be relevant in determining whether to grant relief.<sup>118</sup>

In the context of asset-based lending, the courts will consider the role that the lender played. Was the lender an innocent third party without knowledge of

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<sup>116</sup> Ibid, at [167]–[168].

<sup>117</sup> See also *Tonto Home Loans Australia Pty Ltd v Tavares*; *Firstmac Ltd v Di Benedetto*; *FirstMac Ltd v O'Donnell* (2011) 15 BPR 29,699; [2011] NSWCA 389; BC201110342.

<sup>118</sup> (2005) 14 BPR 26,639; [2006] NSWCA 41; BC200602108 at [119]; Paterson, above n 9, at 32.

the circumstances that made the contract unjust or was the lender in some way culpable?<sup>119</sup> Justice McDougall explained the courts approach as thus:

where a contract has been found to be unjust, it would in general be unsound to grant relief under s 7 where the party against whom relief is claimed is both innocent and ignorant of the circumstances giving rise to that injustice.<sup>120</sup>

Accordingly, in cases where the lender had no actual or constructive knowledge of the circumstances, the courts may refuse to grant relief altogether.

As already noted, the use of intermediaries by a lender makes it more difficult for a borrower to establish that the lender had knowledge of the circumstances.<sup>121</sup> The courts have shown a willingness to rely on the information provided in the loan documentation when making a determination regarding the lender's knowledge. However, in cases where the lender was not involved in the loan process at all, agency will be the only way to attribute the knowledge of the intermediary to the lender. It is therefore clear that a borrower seeking to establish a lender's knowledge for the purposes of the Contracts Review Act face the same issues as those seeking to establish unconscionable conduct.

### Case analysis

In *Small v Gray*, the court found that La Trobe accepted the mortgage application on behalf of the lender and was, in substance, the agent of the lender.<sup>122</sup> In determining whether the relief would be just in the circumstances the court took into account the lender's knowledge. The information contained in the loan application and Accountant's Certificate formed the basis of the lender's knowledge. Justice McDougall considered that there was no basis for finding that the lender knew or ought to have known of the procedural injustice. However, he considered that the substantive injustice should have been apparent to the lender based on the discrepancy between the mortgage application and Accountant's Certificate.

As already noted, the lender did not have any direct contact with Mrs Gray, and as a consequence did not have direct knowledge of the circumstances. However, as the knowledge of La Trobe was attributed to the lender, it was not unjust to grant relief in the circumstances. This case shows the role that knowledge plays in seeking relief against an unjust contract. Further, it highlights the importance of agency as way to attribute the knowledge of an intermediary to a lender.

### Conclusion

With 14.6% of Australian subprime loans in default, inappropriate and irresponsible subprime lending is a major concern. It is therefore important

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119 See *Tonto Home Loans Australia Pty Ltd v Tavares*; *Firstmac Ltd v Di Benedetto*; *FirstMac Ltd v O'Donnell* (2011) 15 BPR 29,699; [2011] NSWCA 389 at 276; BC201110342.

120 *Small v Gray* [2004] NSWSC 97; BC200400764 at [85]; *Collier v Moreland Finance Corporation* (1989) 6 BPR 13,337; [1989] ANZ ConvR 515; (1989) NSW ConvR 55-473; BC8902259.

121 Paterson, above n 9, at 27.

122 *Small v Gray* [2004] NSWSC 97; BC200400764 at [96].

that victims of these loans have access to redress against exploitative lenders and brokers. The doctrine of unconscionable conduct should be the most suitable remedy for subprime borrowers, as it focuses on the unconscientious use of power by stronger parties.

Part I of this article provided an overview of asset-based lending and the objections to the more aggressive forms of asset-based lending. It is argued that the more aggressive forms of asset-based lending can be exploitative and have devastating consequences for borrowers. There are a number of causes of action available to a borrower seeking relief against asset-based lending. This section undertook an examination of these causes of action, with particular focus on unconscionable conduct in equity and unjust contracts under the Contracts Review Act 1980 (NSW). This involved a critical analysis of the courts approach to borrowers seeking relief against asset-based lending in *Elkofairi v Permanent Trustee Co Ltd*,<sup>123</sup> *Small v Gray*<sup>124</sup> and *Butler v Vavladelis*.<sup>125</sup> These cases revealed a number of important principals and issues that should be noted. First, asset-based lending may constitute unconscionable conduct in certain circumstances; however asset-based lending itself is not unconscionable. Second, a lender may have a duty to make further enquiries regarding a borrower's circumstances in cases where the loan documentation is incomplete or irregular. Third, the courts are willing to consider the information contained in the loan documentation when determining whether a lender had knowledge of a borrower's personal and financial circumstances. Lastly, the requirement that a borrower should 'do equity' and account for any benefit they have received has a significant impact on the utility of the relief granted by the courts.

Part II of this article examined the role of a lender's knowledge regarding the borrower's personal and financial circumstances when establishing unconscionable conduct or an unjust contract. Knowledge is a central component of unconscionable conduct. Where a lender does not have actual or constructive knowledge of a borrower's circumstances, unconscionable conduct cannot be established. On the other hand, knowledge is not a requirement for establishing an unjust contract. However the lender's knowledge will be taken into account when the courts determine whether relief should be granted to the borrower. This section argued that lenders are less likely to have actual knowledge of a borrower's circumstances due to the increasing use of intermediaries in the loan process. The courts have therefore shown a willingness to take into account the loan documentation when considering the level of a lender's knowledge. However, in cases where a lender has had no involvement in the loan process, the lender is unlikely to have actual or constructive knowledge. In such circumstances, agency is the only way for an intermediary's knowledge to be attributed to the lender. The onus therefore falls on the borrower to establish that an intermediary acted as an agent of the lender, even though the borrower will usually have little knowledge regarding the nature of the relationship.

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123 (2002) 11 BPR 20,841; (2003) Aust Contract R 90-157; [2002] NSWCA 413; BC200207766.

124 [2004] NSWSC 97; BC200400764.

125 [2012] VSC 186; BC201202881.

This article considered whether the doctrine of unconscionable conduct protects the exploitative actions of asset-based lenders and brokers in providing desperate individuals with inappropriate credit. Overall, the courts were open and flexible in determining what constituted a special disadvantage in asset lending cases.