No guarantee in guarantees

Lenders need to go beyond independent advice

By RICHARD MITRY

Richard Mitry is a solicitor at Mitry Lawyers. The author acted for the respondents referred to in this article.

The NSW Appeal Court decision in *Fast Fix Loans v Samardzic & Anor*[1] is likely to have significant implications for the practices of 'low-doc' lenders and warrants consideration by solicitors providing independent legal advice to prospective borrowers and guarantors. The Appeal Court affirmed the decision of the Supreme Court to set aside a guarantee and mortgage that an elderly Serbian couple entered into at the behest of their property developer son, in circumstances where they had independent legal advice in a language they understood.

The court's decision may require lenders in future to give more careful consideration to the financial and other circumstances of guarantors, instead of borrowers alone.

Lenders may be required to look beyond a certificate of independent legal advice to determine the content of the advice and ensure a guarantor is aware of the significance of the risk they are exposing themselves to, particularly where the risk is high.

The decision highlights that these considerations, and all the surrounding circumstances, should be borne in mind by solicitors when providing independent advice to both borrowers and guarantors.

Facts

The lender, Fast Fix Loans, had appealed from the decision of Hoeben J, who ordered that a deed of loan which contained the guarantee, a deed of variation of loan and a mortgage over the respondents' home at Bowral be set aside under the *Contracts Review Act 1980* (NSW). In its place, the lender sought an order for possession over the mortgaged property.

The Appeal Court, constituted by Bathurst CJ, Allsop P, and Campbell JA, in applying the principles of the *Contracts Review Act*, considered the notion of "asset lending" insofar as it applied to guarantors, the significance of the likelihood of default by the borrower and whether the risk had been overstated by the trial judge, and the jurisdiction of the courts to grant relief against an innocent party who is unaware of the special disability of the party seeking the relief.

In doing so, the court reinforced the notion that to find that a contract is unjust for the purposes of the *Contracts Review Act* will depend on "all the circumstances and not on labels".[2]

Personal characteristics

The guarantors were born in the former Yugoslavia, educated in the Serbian language and both left school at the age of 12. At the time of entering into the guarantee, in early 2008, they were both retired and received the government pension as their sole source of income, having spent their working life performing manual labour or in factory jobs.

Both respondents spoke broken English, and the trial judge found that their capacity to understand English was insufficient to enable them to understand the deed of loan and mortgage which the appellant sought to enforce.

Entry into the guarantee and mortgage

In November 2006, a company controlled by the respondents' son entered into a call option to purchase a property in Forster NSW for $1.33 million plus GST, to be exercised nine months from that date (August 2007). In March 2007, the company submitted a development application to develop 22 apartments on the Forster property. In July 2007, the

company applied to borrow $1.1 million and the respondents' son was, at that time, advised by a finance broker that the Forster property alone would be sufficient security for that borrowing.

In October 2007, the son was advised that the option period had been extended to 16 November 2007. If the option was not exercised by that time, he was advised that the $22,000 option fee would be forfeited. In December 2007, council adjourned the decision to grant the development application until late February 2008.

The finance broker advised in December 2007 that another unencumbered property was needed to borrow more than $640,000. He further advised that the appellant, Fast Fix Loans, would only provide finance (in excess of $640,000 already borrowed from another institution) if a first mortgage on the unencumbered property along with a second mortgage on the Forster property could be provided as security.

The son expected to settle on the purchase of the property in February 2008, following which time he would obtain the development approval and refinance the Forster property to pay off the loan to the appellant.

In December 2007, the respondents' son met with the appellant's representatives and informed them that the only unencumbered property that could be offered as security was one owned by his parents in Bowral.

The Bowral property was purchased by the respondents in 2007 as vacant land, and the house was built and completed in 2009. As neither respondent worked at the time, the construction was funded from the proceeds of the sale of their former home.

After inspecting the Bowral property, the appellant advised the respondents' son that they would lend $450,000 repayable in three months at 2 per cent interest per month (with 4 per cent per month default interest), on the condition that a first mortgage on the Bowral property and a second mortgage over the Forster property could be provided as security. The respondents would be required to guarantee the loan, and provide a first mortgage over their property at Bowral as security.

In February 2008, the respondents were contacted by their son who requested that they sign bank documents to help him get out of a "big problem". The respondents agreed to help on the basis that their obligation ended in three months. They trusted their son, and had guaranteed a loan for him on one previous occasion.

The respondents were advised by a Serbian-speaking solicitor who, in the presence of their son, summarised the documents, identified the parties, the amount being borrowed, interest rate and securities being provided. They understood the risk to their home if their son did not repay the loan but thought that their liability would end in three months.

However, it was found that the respondents did not understand the significance of how high the interest rate was, and the part played by the property at Forster, nor did they understand the financial position of their son or his company. The transaction was an "improvident" one, where the respondents obtained no benefit but assumed a substantial risk which they did not fully understand.

Asset lending

The lender made no enquiries as to the capacity of the respondents to meet the obligations contained in the deed of loan. The court found that the appellant was aware there would be only two possible sources of repayment - a successful refinancing of the Forster property or enforcement of the security over the Bowral property. Neither required the lender to consider the financial circumstances of the respondents.

The guarantee in question made the obligations of the respondents the same as those of the primary borrower, being principal and not collateral in nature.

The trial judge characterised the arrangement between the appellant and the respondents as asset lending, where the

lender had no regard for the guarantors' ability to repay the primary loan. The appellant had argued that this concept was erroneously extended to guarantors, as opposed to primary borrowers.

However, the court held that such a debate was "over semantics", and that asset lending, a term used in cases such as *Perpetual Trustee v Khoshaba*,[3] is a "convenient expression", not a legal frame of reference. Asset lending would be a consideration, among others, in examining all the circumstances of the case.

The circumstances in the present case, which were considered in detail by the primary judge, included the real and significant risk of default by the borrower who was in a "precarious position", where the respondents gained no benefit and where there was no basis for the lender to believe that the respondents fully appreciated the risk they were exposing themselves to.

Innocence of the lender

The appellant had also argued that the primary judge erred in finding that the appellant was not an innocent party, unaware of the special disadvantage of the respondents. In *Beneficial Finance Corporation Ltd v Karavas*,[4] Meagher JA referred to the injustice of depriving an innocent person of valuable property by granting relief under the *Contracts Review Act* where the person is unaware of the special disability of the party seeking the relief.

However, the court held that such an argument was again over semantics, and it would be required to consider all the circumstances of the case. The court would not be required to import mala fides into the lender's act.

In any event, the court found that the lender's lack of knowledge of the financial circumstances of the respondents was a product of its own failure to enquire about those circumstances.

ENDNOTES

1. [2011] NSWCA 260.
2. Ibid at [43].
3. [2006] NSWCA 41.
4. (1991) 23 NSWLR 256.