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BANKING AND FINANCIAL SERVICES LAW ASSOCIATION ANNUAL CONFERENCE

"UPDATE ON CASE LAW DEVELOPMENTS"

Thursday 7 June 2002, 11.50am

Sheraton Mirage Hotel – Gold Coast

The Hon P de Jersey AC
Chief Justice

Justice O'Regan and I will provide a synopsis of some of the more interesting recent cases, and do so from a Trans-Tasman perspective. We will, I suppose, adopt a "nation of origin" approach – but we do not depend on numbers, and there is of course no "contest"!

Since the Australian High Court's fairly recent decisions in *Commercial Bank of Australia v Amadio*[1] and *Garcia v National Australia Bank*[2] and somewhat longer ago in *Blomley v Ryan*[3], lenders have been on notice as to potential liability in circumstances of undue influence and unconscionability. What have the last six months thrown up in those areas?

Unconscionability

1. The Full Court of the Federal Court confronted unconscionability in the setting of s 51AA of the *Trade Practices Act* 1974 (Cth)[4] in *ACCC v Samton Holdings Pty Ltd*.[5] Prior to that decision, the greater weight of judicial opinion had favoured a narrow approach to unconscionability under that section.[6] That was the approach established by *Amadio*, where the court formulated these pre-requisites:

> "(i) a party to a transaction was under a special disability in dealing with the other party with the consequence that there was an absence of any reasonable degree of equality between them and (ii) that disability was sufficiently evident to the stronger party to make it *prima facie* unfair or 'unconscientious' that he procure, or accept, the

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[1] (1983) 151 CLR 447.
[2] [1998] HCA 48.
[3] (1956) 99 CLR 362.
[4] Which proscribes "conduct that is unconscionable within the meaning of the unwritten law, from time to time".
[5] [2002] FCA 62.
[6] See P Tucker "Unconscionability: The Hegemony of the Narrow Doctrine under the *Trade Practices Act*", pre-proof edition of paper accepted for publication (TPLJ) p. 2.

> weaker party's assent to the impugned transaction in the circumstances in which he procured or accepted it".[7]

An issue in *Samton* was whether the s 51AA statutory "unconscionability" should be confined to *Amadio* "special disability" cases, or extended more broadly.

The facts? A husband and wife purchased a "lunch bar" run on leased premises. The lease was due to expire. It contained an option to renew for 7 years. The purchasers purported to exercise the option, 16 days late. The landlords wished to resume possession, but agreed to renew the lease in return for payment of an additional $70,000. The ACCC brought action under s 51AA alleging that, given the purchasers' situation, the lessor's offer to renew for $70,000 was unconscionable "within the meaning of the unwritten law from time to time".[8]

At first instance, Carr J held this conduct fell short, though not far short, of the sort of conduct equity would regard as unconscionable, while observing that the landlord had "adopted an avaricious, opportunistic approach and struck a very hard bargain".[9] The ACCC appealed. The Full Court dismissed the appeal.

Was the section intended to embrace only the narrow "special disability" field of unconscionability covered in *Blomley*[10] and *Amadio*[11]? The Explanatory Memorandum said it was.[12] But then the section speaks of the "unwritten law" applicable "from time to time": not frozen as at the moment of enactment. That "unwritten law" is, of course, what some now call "the common law of

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[7] *Amadio* (1983) 151 CLR 447 at [462] per Mason J. For further commentary see M Lees, "Contract, Conscience, Communitarian Conspiracies and Confucius: Normativism Through the Looking Glass of Relational Contract Theory", [2001] *MULR* 4.
[8] As per the wording of s 51AA(1) *Trade Practices Act* 1974 (Cth).
[9] [2001] FCA 1725 at [99].
[10] (1956) 99 CLR 362.
[11] (1983) 151 CLR 447.
[12] See also M Lees, "Contract, Conscience, Communitarian Conspiracies and Confucius: Normativism Through the Looking Glass of Relational Contract Theory", [2001] *MULR* 4 www.austlii.edu.au/au/journals/MULR/2001/4.html (accessed 16 May 2002) p.14.

Australia”. The Full Court considered the statutory doctrine to be broader, rather than narrower, while noting that the scope of unconscionable conduct should not be left so widely as to include conduct no more than simply “unfair” in the eye of the judge.[13]

The Court listed five categories of cases of unconscionable conduct for which equity has been prepared to grant relief[14], and which may be regarded as potentially falling within the section: first, exploitation of special disadvantage - being “constitutional” as per *Amadio*, or what is termed “situational” – that is, deriving from particular features of the parties’ relationship[15]; second, transactions tainted by the defective comprehension of a party, the influence of another party and an absence of independent advice to the aggrieved party[16]; third, equitable estoppel as described by *Walton Stores v Maher*[17]*;* fourth, relief against forfeiture and penalty in accordance with *Legione v Hately*[18]; and fifth, cases of unilateral mistake as in *Taylor v Johnson*[19].

According to this judgment, the words “conduct that is unconscionable”:

1. are capable of variable meaning, dependent on the circumstances;
2. are not limited to the prescriptive, so-called “narrow” doctrine of unconscionability; but
3. are not so wide as to extend to every instance of unfair conduct: they contemplate conduct which may be brought within an established equitable category.[20]

Notwithstanding the Explanatory Memorandum or Second Reading Speech, the Court has taken a broader approach, with statutory “unconscionability” extending to the broad range of conduct in respect of which equity has traditionally intervened.

[13] [2002] FCA 62 at [50].
[14] See [2002] FCA 62 at [48]-[50].
[15] As per *Louth v Diprose* (1992) 175 CLR 621; *Bridgewater v Leahy* (1998) 194 CLR 457.
[16] As per *Garcia* [1998] HCA 48.
[17] (1988) 164 CLR 387.
[18] (1983) 152 CLR 406.
[19] (1983) 151 CLR 422. However, note the criticism of the inclusion of unilateral mistake in *op. cit* n.6 at p.10.

But that did not avail the appellant on the facts. While recognising that the purchasers were at what could be termed a "serious disadvantage", due to their exposed position and limited bargaining power, that disadvantage fell short of the special disadvantage required under the Act, the category of "special disability" being the only category arguably available. More than just commercial vulnerability, however extreme, was necessary, especially where the party suffering the disadvantage was an experienced businessperson. It could not be the case that "any tenant whose careless failure to exercise an option to renew a lease results in economic disadvantage (should) be entitled to a renewal of that term".[21]

What is the ultimate position emerging from this case? It is, I suggest, that the commercial vulnerability of otherwise experienced business people cannot of itself amount to a special disadvantage for the purposes of that relevant category of "unconscionability" under s 51AA.

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2. Staying with unconscionability, the Queensland Court of Appeal in *National Australia Bank v Freeman*[22] found against a farmer alleging a mediation agreement with a bank was induced by economic duress, and in a situation – from his aspect – of "special disadvantage". He alleged the bank took unconscionable advantage of that. He relied on overt indications of his disability: speaking disjointedly, shaking, attacking people at the mediation and foaming at the mouth.[23] On those matters, he was not believed.[24]

He, also in more orthodox defence terms, contended the bank could not enforce its rights because it had represented it would not do so until the drought ended and his business interests either achieved a particular gross annual income or his rural property achieved its maximum stock carrying capacity (neither of which had occurred).[25] He also alleged negligence by the

[20] *Op cit*. n.6 at p.10.
[21] [2002] FCA 62 at [66]. See also *CG Berbatis Holdings v ACCC* [2001] FCA 757 at [82].
[22] [2001] QCA 473.
[23] [2001] QCA 473 at [31].
[24] See also L. Boulle "The Dog that did Not Bark: Mediation Style" (2001) 4(2) *ADR Bulletin* 22.
[25] [2001] QCA 473 at [4]-[6].

bank because it refused to support his interest subsidy application, leading to his having to sell breeding stock to meet the bank's demand to reduce one of the facilities instead of using the interest subsidy. These contentions, by nature unpromising, failed, as did all.

When will "economic duress" warrant setting aside an agreement? One asks, first, whether any applied pressure induced the victim to enter into the contract; and second, whether the pressure went beyond what the law is prepared to countenance as legitimate.[26] Relief will not be granted <u>only</u> on the basis of mere, even great, inequality.[27]

For all its stigma, "black letter law" still operates here with a degree of prescription. In *Crescendo Management Pty Limited v Westpac Banking Corporation*[28], McHugh J adopted something said (in dissent) in *Barton v Armstrong*:[29]

> "…in life, including the life of commerce and finance, many acts are done under pressure, sometimes overwhelming pressuring, so that one can say that the actor had no choice but to act. Absence of choice in this sense does not negate consent in law: for this the pressure must be one of a kind which the law does not regard as illegitimate. Thus, out of the various means by which consent may be obtained, advice, persuasion, influence, inducement, representation, commercial pressure – the law has come to select some which it will not accept as a reason for voluntary action: fraud, abuse of relation of confidence, undue influence, duress or coercion."

There is real danger with concepts by nature diffuse – as with unconscionability, that they also become unpredictable; a degree of uncertainty may render commercial life exciting: too much, leave it intolerable. The law should be sufficiently predictable to allow the confident resolution of problems, if not in the client's rooms, then at least in the solicitor's office. It should ideally not be necessary to resort to the court. The challenge for the courts is to avoid plunging these sorts of concepts into an abyss of subjective fairness where nothing is predictable.

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[26] *Crescendo Management v Westpac* (1988) 19 NSWLR 40 at 46.
[27] *Westpac v Cockerill* (1998) 152 ALR 267 at 290.
[28] (1988) 19 NSWLR 40 at 45.

In *Freeman*, the inequality in bargaining positions did not flow from disparity substantially brought about by the bank's antecedent conduct.[30] There was no undue pressure brought to bear by the bank in any unconscionable way. It was held, as a matter of fact, that the customer was functioning satisfactorily at the time the negotiations were being conducted, and that no representations or agreement about deferred repayment were made - nor was there a promise to support the subsidy application.

The case is interesting, in terms of principle, for its retreat from "fuzzy edges".

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3. The vulnerability of lenders to suit in an area not susceptible of precise definition is well illustrated by *Westpac Banking Corporation v Paterson.*[31] Husband and wife grant a mortgage. They divorce.[32] The mortgage is re-financed by another lender. The ex-wife understood the first mortgage transaction. When the refinancing was contemplated, the new lender suggested she seek independent legal advice. She declined. Come enforcement of the subsequent mortgage, she and – some may feel extraordinarily – her ex-husband, seek its avoidance as unconscionable.[33] Their essential ground seems to have been that their being divorced put the new proposed mortgagee on enquiry, which it failed to follow through.

At first instance, the Judge found the bank knew of what he called the "ambiguous" relationship between ex-wife and ex-husband, that the ex-wife was not independent and that she had misunderstood the nature of the transaction and the risks involved.[34] It was thus held to be unconscionable for the bank to enforce the mortgage against the ex-wife. The Bank appealed, seeking the enforcement of the mortgage.[35]

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[29] (1976) AC 104 at 121.
[30] [2001] QCA 473 at [44].
[31] [2001] FCA 1630.
[32] [2001] FCA 1630 at [11].
[33] [2001] FCA 1630 at [14].
[34] Outlined in [2001] FCA 1630 at [20].
[35] Grounds of appeal outlined in [2001] FCA 1630 at [21].

The Full Court upheld the appeal. The ex-wife was not under a special disability requiring special assistance or explanation, nor was she in a position of serious disadvantage in relation to her dealings with the bank or her husband, merely because she was an ex-wife. She was offered independent legal advice before she signed the new mortgage, but declined on the basis she already had obtained similar advice before the original mortgage. The liability of the ex-wife under the new mortgage was similar to her liability under the original mortgage, and it paid out the existing mortgage. Even were it unfair for the lender to accept the ex-wife's agreement to the new mortgage, the transaction should not be avoided, but rather the parties should be placed back into their original position.[36]

This lender was subjected to a trial, and appeal, because of a plainly untenable, adventurous contention, which came perilously close to suggesting former spouses could not effectively contract jointly.

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4. It is important to the maintenance of a sound economy that lenders not be daunted or frustrated by courts which are overly protective of borrowers. The generally free circulation of capital is critical to economic vibrancy. Policy considerations strongly contribute to where the courts draw the line for intervention in these cases: protect the vulnerable, certainly, but be careful in the definition of vulnerability.

In *Siglin v Choules & Ors*[37], the West Australian Full Court, by majority, overturned a Master's summary entry of judgment for possession in favour of a mortgagor. Interestingly, the majority facilitated a trial notwithstanding its expressed conclusion that "inevitably…the appellant may have considerable difficulty in establishing her defence at trial".

The use of the word "inevitably" suggests a different result may have ensued under the *Uniform Civil Procedures Rules* in Queensland, which allow applications by plaintiff or defendant, and encourage a somewhat more robust

[36] [2001] FCA 1630 at [27] – [36].

approach. The issue under the *UCPR* (r 292) is whether the party has “no real prospect” of success and there is no need for a trial.

In *Siglin,* a 75-year-old woman signed a mortgage over her unit for the benefit of her son who signed as guarantor. The sum borrowed was $400,000, and the mortgage included a guarantee.[38] The borrower defaulted and a notice of demand was served. The lenders were a group of investors who contributed various sums to make up the loan. The borrower relied on unconscionable conduct as enunciated in *Amadio*. She argued that if she had obtained independent legal advice before the execution of the mortgage, she would have sought information about the project and would not have signed the mortgage. She did not read the mortgage and had no understanding of it. She was not told that some of the funds would be used for the prepayment of interest and for mortgage fees. She was not shown any valuation of the property and had not made any enquiries as to its value.[39]

Now the *Garcia* principles[40], evident from the overhead, would, to warrant unenforceability, require these conditions be satisfied:

(1) in fact, the surety did not understand the purpose and effect of the transaction;

(2) the transaction was voluntary (in the sense that the surety obtained no gain from the contract the performance of which was guaranteed);

(3) the lender is to be taken to have understood that, as a wife, the surety may repose trust and confidence in her husband in matters of business and therefore to have understood that the husband may not fully and accurately explain the purport and effect of the transaction to his wife; and that

(4) the lender did not itself take steps to explain the transaction to the wife, or find out that a stranger had explained it to her: *Garcia v NAB* (1998) 194 CLR 295 at 408.

[37] [2002] WASCA 9.
[38] [[2002] WASCA 9 at [19].
[39] [2002] WASCA 9 at [28] – [32].

While (4) was met[41], (2) was plainly not: the mother secured the payout and removal of a prior mortgage.[42] There was no evidence to satisfy (3). The Full Court majority acknowledged the Garcia principles had not yet expressly been extended beyond spouses.[43] It seems to have countenanced a trial to allow ventilation of the possibility of relief to a mother borrowing to assist a child where the mother lacked the ability to repay.[44]

One wonders how far parties should be drawn along, where the likely outcome is "inevitably" attended with "considerable difficulty", against the prospect the law may be extended in a way which will accommodate the case at hand.

Neither the instant parties, nor the system, is assisted by courts' not entering judgment, as soon as possible, in clear cases.

Interrelationship between undue influence and unconscionable dealing

5. A single judge of the New South Wales Supreme Court in *Freeman v Brown*[45] reminded us of the relationship between the concepts of undue influence and unconscionable dealing.

An alcoholic with severe brain damage sold a property. The contract and instrument of transfer were effected on the same day. A solicitor involved previously with the vendor told the purchaser's solicitors that he would not act because the vendor was brain damaged.[46] The purchaser secured a mortgage back to cover most of the cost of the property. The vendor claimed he was under a special disadvantage in dealing with the purchaser because of impaired mental faculties, illness, consumption of alcohol, inexperience in business and lack of legal assistance as to the consequences of the

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[40] As enunciated in *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395 at 408.
[41] [2002] WASCA 9 at [37].
[42] [2002] WASCA 9 at [34] – [35].
[43] Although it has been extended in England to the situation of mother and son in *Royal Bank of Scotland v Etridge* [2001] UKHL 44.
[44] [2002] WASCA 9 at [54].
[45] [2001] NSWSC 1028.
[46] [2001] NSWSC 1028 at [34].

transfer.[47] Thus, the vendor also claimed he was unable to protect his own interests and that the purchaser unconscionably took advantage of him. The vendor claimed he entered into the transactions as a result of undue influence by the purchaser: the purchaser knew or ought reasonably to have known of the purchaser's significant mental disabilities and took advantage of them.

The Court found in favour of the vendor on the claims of both undue influence and unconscionability. The Court noted that while the equitable principles relating to relief against unconscionable dealing, and the principles relating to undue influence, are closely related, they are two separate and distinct doctrines while not mutually exclusive.

Undue influence looks to the quality of the consent or assent of the weaker party whereas unconscionable dealing looks to the conduct of the stronger party in attempting to enforce, or retain the benefit, of a dealing with a person under a special disability in circumstances where it is not consistent with equity or good conscience that he or she should do so.

In this case, the purchaser

> "became party to transactions which, of their very nature, must have been recognized by him as having features of concession, risk and unorthodoxy which a counter party having the capacity to look after his or her own interests would never have dreamed of accepting.[48]

Consequently, the transaction was set aside. The judge noted that the real point was that equity

> "will neither allow advantage to be taken of a person labouring under a disability nor sanction an overbearing of the vulnerable party's judgment by a stronger party's influence. These forces may be at work even though the person affected becomes a willing participant in a transaction which on its face shows no real sign of unfairness."

Misrepresentation by a bank's officers.

6. A factually interesting case determined last year by Queensland's Central Judge illustrates the corporate risk of having undisciplined players

[47] [2001] NSWSC 1028 at [3].
[48] [2001] NSWSC 1028 at [47].

within large organizations. In this case - *Pace v Westpac Banking Corporation*[49] - the bank was held liable in damages for the negligent misrepresentation of a bank manager that money to fund a subdivision would likely be forthcoming. This manager's response to inquiries, described by the Judge as "cavalier", was the regrettable Australian vernacular: "no problems."

Two poorly educated labourer brothers of Maltese origin approached Westpac to obtain various loans for the purposes of buying and subdividing land. They always dealt with the same bank manager who approved certain loans which were eventually paid off.[50] On a number of occasions, the manager acted in apparent defiance of instructions from his superiors.[51] When the brothers signed a contract to purchase more land, they made it clear to the manager that they not only needed money to buy the property, but also required further money to develop it[52]. They claimed the manager had assured them that the second loan would be given[53]. It was not, and the brothers sued the bank for breach of contract – contending the manager's statement that the bank would finance the subdivision gave rise to an enforceable contract; and amounted to misleading and deceptive conduct contrary to s 52 *TPA*, and negligent misstatement.

The Court held the assurances of the manager did not give rise to any binding contract: many essential features of a contract were missing (eg. no amount of money, or other terms were agreed upon).[54] However, the brothers established the bank misled them. The manager knew or ought to have known that they would rely on the advice or assurance he gave as to the bank's preparedness to lend.[55] It was reasonable for the brothers to do so, they relied on the assurance, and loss was a foreseeable outcome.

[49] [2001] QSC 415.
[50] [2001] QSC 415 at [1], [3], [9].
[51] [2001] QSC415 at [13], [21] and [23].
[52] [2001] QSC 415 at [28]-[32].
[53] [2001] QSC 415 at [36].
[54] [2001] QSC 415 at [38].
[55] [2001] QSC 415 at [42] – [44].

Damages were calculated as the difference between the amount spent on the land and paid to the bank, and its residual market value.

Securities

7. The financial community has developed sophisticated financial products, some of which are not easy of comprehension, especially for those of us who only occasionally trespass into this field. One such creature is the "high yield equity note".

Under the Macquarie Bank's system[56], an investor, paid for the note 85-90% of the market value of the specified underlying shares. For the term of the note – usually three months – interest was paid. The investor authorised Macquarie to purchase the "underlying shares" on maturity of the note. If their value then exceeded the price of the note, the investor received back his price plus interest. If less, the investor received that lesser sum and interest. The issue arose whether these notes (so-called HYENAs) could be advertised save by prospectus,[57] per Chapter 6D of the *Corporations Act* 2001 (Cth). Macquarie sought an exemption under s 741, which was refused, on the basis of ASIC's view that the HYENAs were "securities" under s 92(3). Macquarie sought review by the Administrative Appeals Tribunal.[58]

The Tribunal held the notes were not securities under s 92(3), so that the prospectus requirement did not apply. The Tribunal appears to have concluded the notes were not debentures, noting they were given outside the ordinary course of banking business[59], with repayment not by reference to a fixed debt, but regulated by an external consideration, the value of the underlying shares. Neither were the notes "securities" under s 92(3)(e): they did not involve options to acquire shares. That was because any "acquisition" was not at the invitation of the investor, but unilaterally ordained by Macquarie.

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[56] [2001] AATA 868 at [24] – [27].
[57] [2001] AATA 868 at [24] – [27].
[58] *Macquarie Bank v ASIC* [2001] AATA 868.

The Tribunal did express its sympathy for ASIC's proposition that because of the complex hybrid character of HYENAs, they were the sort of security which should be regulated by prospectus to protect unsuspecting investors.[60] There is now an argument that HYENAs and the like could fall within the definition of "financial product" under s 763A of the *Financial Services Reform Act* 2001 (Cth) and, consequently, subject to financial product disclosure under Pt 7.9 of that Act.[61]

Trade Practices Act – third line forcing, exclusive dealing; Section 47 TPA – severability – illegality

8. Moving to guarantees, *SST Consulting Services Pty Limited v Riesen & anor*[62] illustrates the situation of a guarantee which truly rode out the storm – it was held to be enforceable despite containing unlawful third line forcing provisions. The issue was determined on an application to strike out parts of a defence.

A lender alleged default by guarantors of a loan. The guarantors alleged the loan agreement was an agreement to effect the unlawful purpose of exclusive dealing as defined in s 47(6) of the TPA ("third line forcing"), proscribed by s 47(1).[63] The offending clauses provided:[64]

> "Default events which render within 7 days of demand payment of principal and interest calculated to end of term in relation to the loan include:
>
> 1. The failure to direct all pack and unpack…including transport or as the lender shall advise at agreed cost in line with market conditions.
>
> 2. … will direct all work of pack and unpack…to the corporations that the lender shall direct. Such work shall include transport."

The lender sought to sever this provision and strike out the defence.

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[59] [2001] AATA 868 at [23].
[60] [2001] AATA 868 at [45].
[61] See T Glover, "Securities Industry and Managed Investments: HYENAs are not debentures, securities or options to acquire shares under the Corporations Act 2001," (2002) 20 *CSLJ* 122 at 125.
[62] [2001] NSWSC 804.
[63] [2001] NSWSC 804 at [21].

The Court (a single judge) held that the offending provisions were severable[65]: their elimination would leave a "clear, coherent and normal commercial agreement". Perhaps more interestingly, would retention of the provisions condemn the guarantee for illegality?

Referring to *Yango Pastoral Company Pty Limited & Ors v First Chicago Australia Limited & Ors,*[66] the Judge reached these conclusions:

- s 47of the TPA reveals a public policy that exclusive dealing of the kinds proscribed by s 47 ought not to be permitted because it tends to inhibit "a proper level of economic competition in the community";[67]
- public policy can be enforced by the appropriate penalty provisions of the TPA. Any breach as to exclusive dealing can attract draconian pecuniary penalties and a wide range of injunctive and other remedial measures and there is no reason to think those remedies will be inadequate to protect legitimate public interests;[68] and
- there is a difference between a lender seeking to enforce the very provision which has been outlawed by the TPA, and the case where the lender is seeking to have lawful recourse to enforce normal and lawful obligations to repay loans. To deny the lender any legal recourse at all may be unconscionable, and confer upon the guarantors an unjust enrichment. [69]

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[64] [2001] NSWSC 804 at [16].
[65] [2001] NSWSC 804 at [21].
[66] [1978] 139 CLR 410.
[67] [2001] NSWSC 804 at [23].
[68] [2001] NSWSC 804 at [23].
[69] Note: The Treasury Department has considered amendment of s47 of the TPA. The amendments include introduction of a substantial lessening of competition test for the third line forcing provisions of the TPA and a further amendment to treat third line forcing involving related companies in the same manner as third line forcing by a single corporate entity.

Liquidation – funding of litigation by creditors

9. Particularly relevant in today's economic climate are two cases concerning the rights of funding creditors in liquidation proceedings. The first is *Elfic Ltd & Ors v Macks & Ors.*[70]

The lenders were in the Elders Group (now under the control of Foster's Brewing Group Limited). Through a series of transactions, they lent substantial amounts to the Emanuel companies. Before being placed into liquidation owing $304 million, the borrowers entered into a number of transactions with the lenders. Macks, the liquidator of the borrowers alleged these transactions breached the Corporations Law. Macks sought to pursue the lenders to recover the moneys, but the borrowers lacked the means to fund the litigation.[71] Macks, with Federal Court approval, entered into an arrangement with two creditors under which the creditors funded the litigation in return for 35% of the net recoveries.[72]

Before the Queensland Court of Appeal, the lenders sought orders setting aside the funding arrangements as champertous, and the removal of Macks as liquidator for not acting in the best interests of the creditors as a whole.[73] The Court covered many issues. The lenders failed.

The Court held that the liquidator's statutory power under s 477 of the Corporations Law to dispose of the company's property entitled him to enter into funding arrangements otherwise champertous. This involved rejection of one of the major planks of the appellant's argument.[74]

Additionally, provisions in the funding arrangement which required the liquidator to consult the funding provider, were held not to have the effect of relevantly removing control of the proceedings from the liquidator. The arrangement required Macks to seek approval from the funding creditors before certain key events. The Court was prepared to accept that the loss of

[70] [2001] QCA 219. Applied in *Re Sit Simplex Stulte Pty Ltd* [2001] QSC 363.
[71] [2001] QCA 219 at [1]-[2].
[72] [2001] QCA 219 at [3].
[73] [2001] QCA 219 at [5].
[74] [2001] QCA 219 at [173] – [176]; [191] – [194]

some control did not render the funding arrangement an abuse of process.[75] Also, the power to dispose of property under s 477(2)(c) must be exercised in the interests of the creditors. Here, lenders who were potential defendants in the litigation were also the most significant creditors. The Court consequently had to resolve the question whether the funding arrangement was nevertheless in the interests of the creditors. This was obviously a problematic issue.

The Court recognised difficulties in situations where the largest creditor is also the potential defendant in the action sought to be funded. But that circumstance alone is not sufficient to limit the liquidator's power of disposition under s477(2)(c); nor does it provide a basis for concluding the funding arrangement must be an abuse of process.[76] You may be interested to note that the trial concerning the collapse of these companies is to begin in the second half of our court year, set down for 6 months.

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10. Finally, *State Bank of NSW & Anor v Brown & Ors.*[77]: is it right to give 100% priority to indemnifying creditors?

Litigation commenced by a liquidator was considered complex and time consuming with only a 60% chance of success. Initially, only one of the unsecured creditors agreed to fund the litigation. Later, another unsecured creditor joined in.

Four years later, the first creditor withdrew financial support. The other unsecured creditors were advised of the existence of the proceedings and of the funding by other creditors, but did not make enquiries with a view to deciding whether or not to offer to join in supporting them. The matter ended up being settled in favour of the liquidator, in a modest amount, and the

[75] [2001] QCA 219 at [103] – [108].
[76] [2001] QCA 219 at [123] – [129].
[77] [2001] NSWCA 223.

question for determination was whether the two funding creditors should receive 100% of the proceeds.[78]

The New South Wales Court of Appeal confirmed they should. Factors to be considered included: risk taken, sum recovered, the failure by other creditors to provide an indemnity, the proportion between the debts of indemnifiers and others and public interest in encouraging creditors to provide indemnities so as to enable assets to be recovered.[79]

With respect to the first creditor, even though it had withdrawn funding, it still fell within s 450(a) of the NSW Companies Code 1981, and its successor, s 564 of the Corporations Law, and had assumed a risk of losing the moneys it paid for the litigation. Thus, it had given consideration of the type required by s 450/s 564. The terms of s 564 are as follows (see overhead):

> **"Section 564: Power of Court to make orders in favour of certain creditors**
>
> Where in any winding up:
>
> (a) property has been recovered under an indemnity for costs of litigation given by certain creditors, or has been protected or preserved by the payment of moneys or the giving of indemnity by creditors; or
>
> (b) expenses in relation to which a creditor has indemnified a liquidator have been recovered;
>
> the Court may make such orders, as it deems just with respect to the distribution of that property and the amount of those expenses so recovered with a view to giving those creditors an advantage over others in consideration of the risk assumed by them."

As a general rule, Hodgson JA held that all significant creditors, including contingent creditors, should be given an opportunity to join in funding recovery claims.[80] Nevertheless, in circumstances where all that the creditors have established is that they were not asked, and that they would have considered a request on its merits but not necessarily gone ahead with the contribution, then the Court is entitled to exclude these creditors from the proceeds.[81]

[78] [2001] NSWCA 223 at [100].
[79] See also Young J "Recent Cases" (2001) 75 *ALJ* 544.
[80] [2001] NSWCA 223 at [106].
[81] [2001] NSWCA 223 at [102].

Accordingly, in this case, as the other creditors knew about the litigation but failed to contribute towards its funding, the benefit of the proceeds of the litigation should be directed to the creditors who did. Furthermore, given the precarious nature of the litigation and the amount spent, the creditors who contributed should be entitled to the proceeds of the litigation.[82]

Hodgson JA offered this helpful analysis of the application of s 450/s 564 in such a case:

> "I accept that it is not the object of the section to encourage litigation for the sake of litigation, or for the private benefit of creditors who provide the indemnity or the funds. In my opinion, there are two public purposes involved in the encouragement of pursuit of claims by liquidators, namely to benefit creditors and shareholders generally, and to recover property from wrong-doers and thus discourage misconduct in relation to corporations.
>
> In my opinion, both purposes may be advanced by the grant of an advantage of 100 per cent of the recovered funds to supporting creditors in appropriate cases. Plainly, such a benefit can support the objective of recovering property from wrong-doers. In my opinion also, the grant of a 100 per cent advantage in cases where recovery turns out to be relatively small can also support the objective of benefiting creditors generally, by encouraging the support of litigation in cases where there is a prospect of a large recovery which would inure for the benefit of all creditors, but which may in certain eventualities result only in a small recovery. Of course, if a 100 per cent advantage is too readily granted in such cases, this could unduly encourage the settling of claims for less than their reasonable value; but this risk can be taken into account when settlements are approved, as well as in applications by supporting creditors to be given an advantage."[83]

[82] [2001] NSWCA 223 at [110].
[83] [2001] NSWCA 223 at [91]-[92].