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Case Note: Bofinger v Kingsway Group Limited (2009) 239 CLR 269

The High Court of Australia has clarified the question of priority between a guarantor of a first mortgage and later registered mortgagees in relation to the distribution of sale proceeds in the case of *Bofinger v Kingsway Group Limited*. The case makes it clear that guarantors will rank ahead of subsequent mortgagees and may rely on their right in equity to claim compensation from the first mortgagee.

The case is particularly important for second or subsequent mortgagees, who may find themselves suddenly unsecured under these principles if specific steps to protect their interests are not taken when consenting to guarantor dealings with security properties.

Facts

The Bofingers were directors of B&B Holdings, which had borrowed money from three lenders. The loans were separate and secured by first, second and third mortgages over land owned by B&B Holdings (**B&B Holdings property**). The Bofingers were also guarantors of the loans and provided their own land (**Bofinger property**) as security to the first, second and third mortgagees for the debts of B&B Holdings.

In order to discharge their liability under the guarantees to the first mortgagee, the Bofingers sold the Bofinger property with the consent of all three mortgagees and made payment to the first mortgagee. The first mortgagee then sold the B&B Holdings property to satisfy the balance of its debt. The first mortgagee paid the surplus of the proceeds to the second mortgagee.

Question of priority

Having made payment to the first mortgagee to satisfy part of the guaranteed debt, the Bofingers contended that they were entitled to the surplus of the sale proceeds to the extent of that payment through the principle of subrogation, which allows a guarantor to stand in the shoes of a lender and have all the rights of the lender against the borrower, and imposes an obligation on the lender to account to the guarantor for any recovery in excess of the full amount of its debt.

The second mortgagee objected on various grounds, including that the guarantee given by the Bofingers to it waived the guarantor's rights 'which may be inconsistent with the provisions of this deed or in any way



restrict... the rights, remedies or recourse' of the second mortgagee.

Decision

The court found in favour of the Bofingers, deciding that the Bofingers should have received the surplus money because they were entitled to be subrogated to the rights of the first mortgagee, in priority to the second mortgagee. It was reasoned that a second mortgagee, when advancing money, knows perfectly well that there is a prior charge on the property and his security will be limited so that it is a matter of indifference whether the first mortgagee or the guarantor make a prior claim for that amount.

Of importance was the fact that the second and third mortgagees had consented to the sale of the Bofinger property without requiring that the Bofingers relinquish their right to subrogation in relation to sale of the B&B property.

Accordingly, any surplus in the hands of the first mortgagee was held by it as a constructive trustee for the Bofingers. The first mortgagee was obliged to account the surplus to the Bofingers as such and was liable to pay equitable compensation to them.

While the Bofingers were still liable to the second and third mortgagee under guarantees to the second and third mortgages, the second and third mortgagees had now become unsecured.

The court commented that the Bofingers could have excluded their right to subrogation by agreement or inequitable conduct. However, in this case, the guarantees did not provide for a waiver of this nature. In deciding on the application of the terms of the guarantee, the court noted that where there is ambiguity, terms are to be interpreted in favour of the surety. The court held that the waiver only applied to the

guarantor's rights to the second mortgagor, and not in relation to the guarantee given to the first mortgagor.

Implications

Consenting to transfers

Second and subsequent mortgagees should take care when consenting to transfers of security properties, to ensure that all parties to the transaction agree that the guarantor(s) waive their right to subrogation so that they do not take priority to the second mortgagee's interests.

Drafting guarantees

Guarantee documents should be reviewed to cover the circumstances of this case, expanding waiver provisions to any rights of subrogation in respect of prior mortgages, charges and other interests.

Surplus proceeds

In exercising a power of sale where a guarantor has made a contribution and there are subsequent registered mortgagees, first mortgagees should take care in distributing the surplus. Because surplus funds are considered by the courts as being held by the first mortgagee in trust, the first mortgagee may be called to account for the funds personally if they are distributed incorrectly.

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