ALERT

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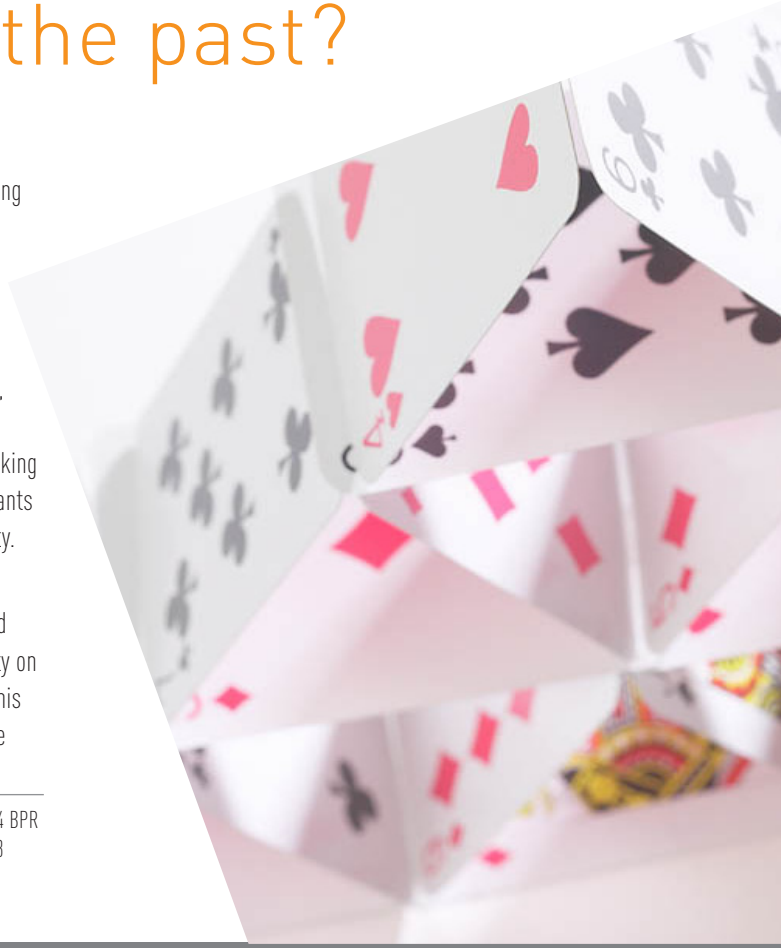
Asset based lending: a thing of the past?



Introduction

A growing judicial trend has arisen that frowns on asset based lending, tending towards a policy requirement that lenders take appropriate steps to ensure their loans will be serviceable.

Several New South Wales Court of Appeal decisions have held that asset based lending in circumstances where a borrower has no possibility of repaying the loan may be unconscionable,[1] and two recent decisions of the Victorian Supreme Court and Federal Court demonstrate that Australian courts are doing what they can to make asset based lending a thing of the past.

Lenders beware: *Butler v Vavladelis* [2012] VSC 186

The recent Victorian Supreme Court decision of *Butler v Vavladelis* [2012] VSC 186 should sound as a warning bell to all lenders in the business of 'asset based lending' in this country. It is a judgment that adds further momentum to the growing judicial trend of rejecting what has been described as a 'morally repugnant' lending practice.[2]

The plaintiffs in this case were the clients of a law firm that conducted a solicitor's mortgage practice. The solicitors arranged for the plaintiffs to lend the sum of $400,000 to the defendants on the security of their family home. The defendants, Mr and Mrs Vavladelis, were two elderly Greek migrants with no formal education in the English language and little English speaking ability. Apart from savings of approximately $10,000, the defendants had no other assets besides their interest in the security property. They had no income and lived on their pensions.

The mortgage soon fell into default and the plaintiffs sought and obtained default judgment for possession of the security property on two occasions. Neither application for judgment was opposed. This decision concerned an application by the defendants to set aside

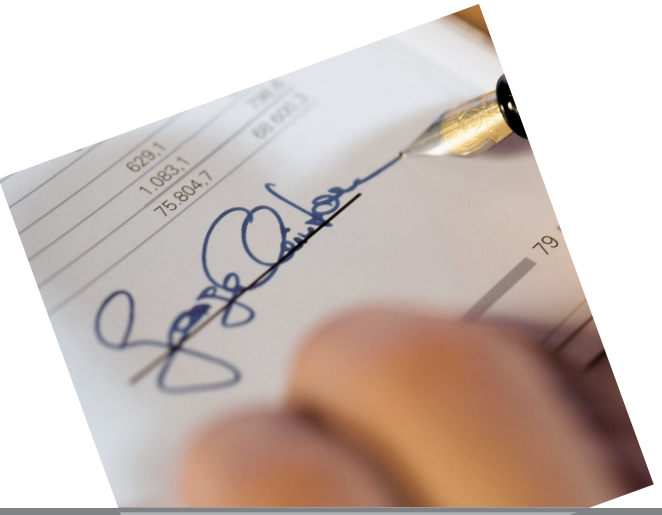
1 See eg *Elkofairi v Permanent Trustee Co Ltd* (2003) 11 BPR 20,841; (2003) Aust Contract R 90-157; [2002] NSWCA 413; *Perpetual Trustee Co Ltd v Khoshaba* (2005) 14 BPR 26,639; [2006] NSWCA 41; and *Kowalczuk v Accom Finance Pty Ltd* (2008) 77 NSWLR 205; (2008) 252 ALR 55; (2008) 229 FLR 4; (2008) 14 BPR 26,565; [2008] NSWCA 343

2 *Butler v Vavladelis* [2012] VSC 186 at para 21

the default judgment. The defendants also sought an injunction restraining the plaintiffs from proceeding with a mortgagee's sale of the property.

The defendants sought to set aside the default judgment on two grounds: first, because their signatures were forgeries; and second, because the plaintiffs, through their solicitors and agents, had engaged in unconscionable conduct by participating in 'asset based lending'.

Justice Hargraves dealt swiftly with the forgery defence, rejecting it as a ground on which the default judgment could be set aside. The defendants maintained that they were the victims of forgery perpetrated by their daughter, whom they alleged forged their signatures on the mortgage documents. However, the court held that the mortgage must be taken as indefeasible unless the mortgagees or their agents were party to or privy to that forgery. The defendants put forward no evidence to suggest that the plaintiffs or their solicitors had any knowledge of the alleged forgery.



The second defence raised by the defendants was met with greater success. During the course of his judgment, Justice Hargraves held that asset based lending by mortgagees may, depending upon the circumstances of the particular case, constitute unconscionable conduct entitling the mortgagor to set aside the mortgage instrument. However, His Honour cited the decision of *Perpetual Trustees Australia Limited v Schmidt*,[3] where it was held that the mere fact that a loan is asset based is not of itself sufficient to make it unconscionable; something more is required to make the conduct of the lender morally repugnant.

Based on the evidence before him, Justice Hargraves held that it was clearly arguable that the plaintiffs, through their solicitors as their agents, engaged in pure asset based lending. The solicitors adopted the position that all they needed to do was ensure their clients were adequately secured and obtain a certificate from an independent solicitor to the effect that the defendants had read and understood the mortgage documents. They made no enquiries as to the circumstances of the defendants, including their ability to repay the loan, and it was this failure to make *any* relevant enquiries that made the conduct arguably unconscionable. Justice Hargraves held, at paragraph 7 of his judgment, that:

> *'There is no evidence of the solicitors 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 from time to time under the proposed mortgage.'*

On this basis His Honour found that there was an arguable defence to the mortgagee's claim for possession of the property and he set aside the default judgment (on certain conditions).

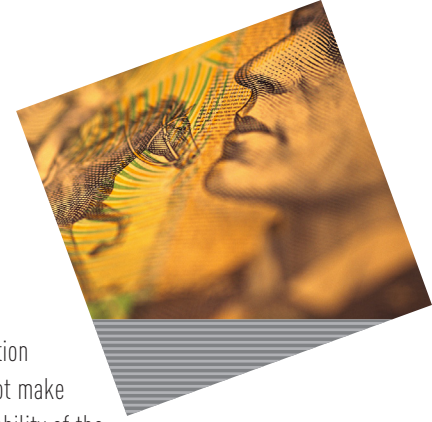
The decision in *Butler v Vavladelis* highlights the importance of implementing and adhering to prudent lending practices when it comes to asset based lending. It is not sufficient to simply ignore the particular circumstances of the borrower and rely on the fact that the loan is adequately secured. A diligent lender must make enquiries of every borrower, including their ability to repay the loan, regardless of the amount of the security. A failure to do so may be found to constitute unconscionable conduct entitling the borrower to set aside the mortgage instrument.

Valcorp Pty Ltd v Angas Securities Limited [2012] FCAFC 22

In the recent case of *Valcorp Pty Ltd v Angas Securities Limited* [2012] FCAFC 22 (8 March 2012), the Federal Court held that a lender can be found to have contributed to its loss if the lender has not made sufficient or adequate inquiries as to the borrower's ability to service the loan.

The borrowers, Mr & Mrs Opie, applied to three related non bank lenders, Angas Securities Limited (**Angas**), Barker Mortgages Pty Ltd (**Barker**) and KWS Capital Pty Ltd (**KWS**) for loans totalling $2.88 million, to pay out loans on foot with La Trobe Investment

3 *Perpetual Trustees Australia Limited v Schmidt & Anor* [2010] VSC 67 at para 200



Services Australia Pty Ltd. The lenders shared a director and thus, Barker and KWS relied on the inquiries that Angas undertook.

The loans were to be secured by first, second and third mortgages over Mrs Opie's property – a penthouse four bedroom apartment located in Glenelg North, South Australia.

Angas engaged Valcorp Australia Pty Ltd (**Valcorp**) to provide a valuation, prepared by Mr Alfonso Taormina, a director of Valcorp. The valuation expressed the opinion that the fair market value of the property was $3.6 million.

As part of the lenders' serviceability assessment requirements, the Opies provided financial information that, on its face, should have rung alarm bells – the information given was inconsistent:

- taxable income was said to be nil; however generated income was stated as $250,000; and
- assets in company shares varied from being valued at $3 million to suddenly being valued at $14 million.

Further, the letters of offer for each of Angas, Barker and KWS all contained a number of special conditions that required the Opies to prove their service capacity. The primary judge stated that this endorsed that the lenders were aware that the Opies may not be able to service the loan in any event.

Despite not being provided with conclusive documentation that fulfilled the special conditions in the letters of offer by Angas, Barker and KWS, the loans were drawn down on 28 November 2007. The Opies went into default at February's interest, the first month they were required to pay interest (the prior months were prepaid and deducted from loan funds at settlement).

After negotiations and further defaults, Angas took possession of the property on 11 December 2008 and subsequently sold it for $1.75 million, an amount substantially less than the valuation made by Valcorp.

Angas, Barker and KWS sued Valcorp for negligence in relation to its valuation of the security asset property. They argued that Valcorp was negligent and had engaged in misleading and deceptive conduct in contravention of section 52 of the *Trade Practices Act 1984* (Cth).[4] Each of the lenders claimed compensation for the loss of the principal amount advanced and consequential loss.

The primary judge found that Valcorp was negligent; however reduced the claim by 25% because it was also found that each of the lenders was negligent because they failed to carry out adequate enquires as to the Opies' financial position and ability to service the loan based on the pre-transaction evidence. Additionally, Angas had an obligation to its investors to make a proper assessment of serviceability (as in its prospectus). No reasonable prudent lender would have accepted the information provided by the Opies to Angas because it was so plainly inadequate in establishing the serviceability of the borrowers.[5]

Ultimately, Angas and each lender were negligent in their pre-transaction conditions because they also did not make adequate inquiries into the serviceability of the borrowers when it was blatantly obvious that this was required.

To add injury, on appeal the Federal Court increased the 'contributory negligence' on the part of the lenders to 50%.

It should be noted that this was not a simple case of the lenders not conducting any inquiries at all – the lenders made some inquires, however:

> *'The character of negligence reflected an indifference by the respondents [the non bank lenders] as to whether the Borrower was reliable and as to whether the Borrowers had the financial capacity to service the loans, and therefore, an indifference to the protection of its own interests and … to the integrity of the representations it had made in the prospectus.'*[6]

This case brings into sharp focus the need for lenders to bear in mind that:

1. If the lender has procedures in place to assess serviceability, they must adequately adhere to them.
2. If the information provided to the lender by the borrower flags the need for further inquires, they must inquire further.
3. A lender cannot solely rely on value of the asset for serviceability; it must form its own substantiated opinion.

4 Now the *Competition and Consumer Act 2010* (Cth)

5 *Valcorp Australia Pty Ltd v Angas Securities Limited* [2012] FCAFC 22 (8 March 2012) at [75]

6 Ibid at [124] – [125]

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Conclusion

The above decisions exemplify the tough stance that courts are taking against financiers in the current market. Interestingly, the decisions suggest that the courts will similarly take a tough stance against lenders that operate in the business of providing non-conventional loans with higher risk factors.

These cases serve as a reminder of the importance of lenders making proper inquiries as to loan serviceability, and of the consequences that lenders might face for failing to do so.

Commentators have raised the point that it seems odd that a defendant has no defence to a mortgagee's claim for possession based upon an allegation of fraud unless the fraud is committed by the mortgagee (consistent with many years of authority about indefeasibility of title), and yet can potentially defeat a mortgagee's claim for possession based on what has until recently been viewed as legitimate lending practice.

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