

**The Dangers of Low Documentation Loans**  
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**The Litigation Perspective**

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1. The aim of my presentation is to give a short overview of how Courts, at least in NSW, have approached some of the problems that arise more frequently in low documentation lending.

**The power to set aside or rewrite loans**

2. The Court's more popular jurisdictions pursuant to which they may set aside or rewrite loans are as follows:
  - (a) if the Court determines the loan is "unjust" within the meaning of section 70 of the *Consumer Credit Code* (the "Code"). This jurisdiction is only available if the loan is found to be regulated by the Code and can be avoided if the borrower has signed (even a false) business purpose declaration (see section 11);
  - (b) if the Court holds the loan was "unconscionable" within the meaning of section 12CB of the *Australian Securities and Investments Commission Act, 2001*. This jurisdiction is perhaps similar to the Code (although that is yet to be tested) and is available if the loan was in truth for a personal, domestic or household purpose (ie a business purpose declaration has no effect);
  - (c) if the Court considers the loan was "unconscionable" in accordance with general equitable principles. This is a much more limited

jurisdiction and the borrower has a more onerous task in demonstrating they had a “special disability”<sup>1</sup>; or

- (d) in NSW, if the Court determines the loan was “unjust” within the meaning of section 9 of the *Contracts Review Act*, 1980. This jurisdiction is not available if the loan was entered into for purpose of a trade, business or profession carried on by the borrower (again a business purpose declaration has no effect).

### **The risks for low doc loans**

- 3. The relaxation of debt serviceability and income verification criteria combined with a greater reliance on intermediaries (such as brokers and mortgage originators) has increased risks for borrowers , for example:

- (a) being successfully taken advantage of by fraudsters: eg *Permanent Trustee Australia Ltd v Gusevski* [2005] NSWSC 1281; *Perpetual Trustee Co Ltd v Khoshaba* [2006] NSWCA 41; and
- (b) foolishly refinancing when in extreme financial distress: *Permanent Mortgages v Cook* (2006) ASC 155-082; [2006] NSWSC 1104 (and on appeal [2007] NSWCA 219).

- 4. The increased risk for lenders is that the Court may determine the resulting loan was “unjust” if it finds the decision to lend was based on what has been judicially termed “pure asset lending” (or in its less genteel form “equity stripping”). Basten JA in *Khoshaba* explained this as follows:<sup>2</sup>

“To engage in pure asset lending, namely to lend money without regard to the ability of the borrower to repay by instalments under the contract, in the knowledge that adequate security is available in the event of default, is to engage in a potentially fruitless enterprise, simply because there is no risk of loss. At least where the security is the sole residence of the borrower, there is a public interest in treating such contracts as unjust, at least in

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<sup>1</sup> See eg *Commercial Bank of Australia Ltd v Amadio & Anor* (1983) 46 ALR 402  
<sup>2</sup> At [128].

circumstances where the borrowers can be said to have demonstrated an inability reasonably to protect their own interests, for the purposes of, for example, s 9(2)(e) or (f). That does not mean that the Act will permit intervention merely where the borrower has been foolish, gullible or greedy. Something more is required: see *Esanda Finance Corp Ltd v Tong* (1997) 41 NSWLR 482 at 491 (Handley JA) cited with approval in *Elkofairi* (above) at [77] by Beazley JA.”

5. That “*something more*” is, from a lender’s perspective, perhaps not much. In *Khoshaba* it was that both borrowers were Iranian immigrants who spoke English as a second language, who had worked in low level jobs and were now on the age pension. They had been induced into investing in the failed schemes of Karl Suleman and a broker had, without their knowledge, falsified their income information. As Basten JA observed:<sup>3</sup>

“These disadvantages were to some extent offset by the fact that they received advice from their Australian educated daughter, but his Honour found that both the parents and the daughter were naive, apparently in relation to financial matters. These circumstances would probably not have justified a finding that the borrowers were under a special disadvantage or disability, for the purposes of equitable principles of unconscionable dealing, but in my view they are sufficient to satisfy the requirements of the particular public interest identified above, in concluding that asset lending may be unjust.”

6. The *Khoshaba*’s were essentially relieved of their obligations under the loan and the loss fell on the lender. Similarly in *Gusevski*, Mrs Gusevski was a woman who had a range of serious psychological and physical disabilities, was in part time employment and received the sole parent pension. She was taken advantage of by a putative broker who romanced her into signing loan documents which he had obtained by submitting clearly false information, without her knowledge, to the lender. Newman AJ wholly set aside the loan as the lender “*knew, or had the information in its possession to enable it to know, that this mortgage was sheer folly when looked at from the ability of the ...debtor to make the interest payments. The only part of the transaction which was not folly was the extent of the security.*”<sup>4</sup>

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<sup>3</sup> At [101].

<sup>4</sup> At [26] and [27].

7. However not all foolish borrowers will necessarily benefit from the concept of unjust asset based lending. There is, I think, some comfort in the observation of Spigelman CJ in *Khoshaba* that if a lender engages in this type of lending it is the fact the “*security is the family home of a low income earner and a pensioner*” that will be given “*significant weight*” in the determination of unjustness.<sup>5</sup>

### **Cook ats Permanent Mortgages – Anatomy of a Test Case**

8. The Legal Aid Commission of NSW represented Mr and Mrs Cook in the lenders’ repossession proceedings from about mid 2003. From relatively early in the proceedings the solicitor at Legal Aid, John Moratelli, and I identified that this case could push the boundaries of what had previously been found to be “unjust” lending. This was before *Khoshaba* was handed down by the Court of Appeal in 2006 (which then made our task a little easier).
9. Despite the fact the proceedings were commenced by Permanent Mortgages in 2003, due to various interlocutory steps taken by them and us, the case was not heard until 2006. And that’s a lesson for lenders: choose carefully which interlocutory points you take, as it will slow things down.
10. The two key issues in the case were:
  - (a) determining whether the lender could rely upon a false business purpose declaration signed by the Cooks so as to avoid the operation of the Code. While the application of the Code was not important for the determination of unjustness, regulation by the Code opened up an further action by the Cooks for the imposition of punitive civil penalties against the lender; and

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<sup>5</sup> At [85].

- (b) determining whether the loan and mortgage obtained by Cooks, who had admittedly signed false documents to get the loan, was nonetheless unjust.

*The foolishness of the Cooks: a clear example of equity stripping*

11. Michael and Karen Cook are, to put it gently, simple people: poorly educated and only just literate. Michael was the breadwinner and his income took a turn for the worse by reason of treatment for cancer, a redundancy, a work place accident and casual work.
12. As at December 2000 the Cooks position had been that they owed the Commonwealth Bank \$107,664.18. The interest rate under that loan was 6.65% pa. Their home was valued at \$175,000. Accordingly, their equity was approximately \$70,000.
13. Their financial trouble hit crisis point in 2000 and, for most us, it would have been apparent that their income was not likely to be sufficient to service their home loan. By the end of that year, their interests would clearly have been served by selling their home (and only significant asset) in order to realise their substantial equity in the property, and reorganising their affairs in a way that was sustainable.
14. Instead, with the “assistance” of a number of finance intermediaries, the Cooks entered in to series of short term loans, the effect of which was to increase the debt secured over their home by October 2006 to well over \$390,000 (which was by then far in excess of the value of their home). Thus, by the time Permanent Mortgages sought to recover their funds it was our argument that the Cooks had been effectively stripped of their only asset.
15. Their series of disastrous borrowings commenced in December 2000 when the Cooks refinanced their Commonwealth Bank home loan, which was in default, with a \$120,000 12 month interest only business loan (referred to in the judgment as the “Singleton loan”). The loan offer was made by RL Kremnizer

& Co, solicitors, and the mortgage manager was La Trobe Home Loans of Australia Pty Limited. The upfront transaction costs (solicitors, brokers and government charges) were \$5,208.50 (which if amortised across the term of the loan was the equivalent of an additional 4.3%pa interest). The interest rate was 11.75% reducing to 9.25% upon payment within 7 days.

16. The Cooks fell into default in April 2001, that is, within about four months and possession proceedings were commenced by RL Kremnizer on 18 June 2001. A writ of possession was issued at the request of RL Kremnizer on 20 August 2001.
17. In June 2001 the Cooks sought to refinance the Singleton loan. RL Kremnizer offered another 12 month interest only loan in the amount of \$138,000 with an interest rate of 11.25% reducing to 8.75% upon payment within 7 days (referred to in the judgment as the “Hipsley loan”). La Trobe Capital and Mortgage Corporation was the mortgage manager. The available evidence, being an account ledger of RL Kremnizer, suggests that transaction costs were in the order of \$6,062.30 (equivalent to an additional 4.37% pa interest across the term of the loan).
18. The Hipsley loan was advanced to the Cooks on 28 August 2001. The Cooks fell immediately into default and proceedings were commenced by RL Kremnizer in November 2001. In April 2002 Mr Cook obtained the early release of his superannuation of \$12,000 to meet the arrears and legal fees. The Cooks were in default again the next month. They arranged a further refinance in July 2002 from Liberty Financial. It appears that loan funds of \$175,676 were advanced by Liberty on 1 August 2002.
19. The Cooks fell into arrears on the Liberty Loan in October 2002 and borrowed \$22,000 from “Cash King”. The amount required to repay Cash King 7 months later in May 2000 was \$38,778.
20. The Cooks were soon in default in relation to the Cash King and Liberty Financial loans.

21. In February 2003 the Cooks again sought refinancing which ultimately led them to enter the loan and mortgage the subject of the judgment. In March 2003 RL Kremnizer made two 12 month, interest only, business loan offers of \$45,000 and \$200,000 respectively. La Trobe Home Loans of Australia was the mortgage manager. The lender on the \$200,000 loan was Permanent Mortgages. The transaction costs on the loans were \$14,451.35 (equivalent to an additional 5.89% pa interest across the term of the loans).

*The issues*

22. The documentation submitted by the Cooks included a patently false business purpose declaration and accountant's certificate, as well as inflated income figures. However their loan "application" document clearly demonstrated that they had no business or investments and that the whole of the monies were being used to discharge an earlier mortgage. The bottom line from all the documents provided in support of the loan was the lender could not rely upon the dishonest documents submitted by the Cooks in their foolish desperation, because any cursory analysis revealed the falsity.
23. As Patten AJ concluded what the documents and correspondence indicated was that the lender had "*intended no more than that the transaction be documented in a way which would take it outside the Code*".<sup>6</sup> This then led to his Honour's important conclusion with respect to the application of the Code that, when the false business purpose declaration had been received, the lender "*knew or had abundant reason to believe that the credit was to be applied wholly or predominantly for personal domestic or household purposes*"<sup>7</sup> because at that time it knew:<sup>8</sup>

"... the Defendants were refinancing a mortgage in default over their home; that they had furnished no statement of assets and liabilities; that they had provided no evidence of any business or investment; that they had failed to

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<sup>6</sup> At [51].

<sup>7</sup> At [65].

<sup>8</sup> At [64]

complete the questions in the mortgage application form as to the purpose of the loan and that, in a number of significant respect, the Lending Procedure Manual of La Trobe had not been complied with.”

24. His Honour then summarised the issues with respect to whether the loan was unjust as follows:<sup>9</sup>

“Whether I should hold the mortgage unjust in this case involves a balancing exercise. On the one hand are the circumstances that the Defendants speak English as their first language; were experienced borrowers; had the services of a solicitor; were extremely anxious to obtain the loan; and were prepared to sign false statements and procure false certificates. On the other hand, the beneficial nature of the Code indicates that it was intended to protect the unsophisticated and meagrely educated, such as the Defendants, from their own foolishness. Given the means of the Defendants and their credit history, the Plaintiff, in my view, was aware, or would have been aware, had it made the most perfunctory of enquiries, that the Defendants were not capable of servicing the loan even at the lower rate of interest and could only satisfy their obligations by selling the mortgaged property for a sum sufficient to cover the principal and interest. It was likely that they would thus become obligated to pay interest on the amount of the credit, not at 8.8% p.a., but at the much higher rate of 13.8%.”

25. Patten AJ then referred to the concept of pure asset lending and *Khoshaba* and held that:<sup>10</sup>

“Undoubtedly, the Defendants were foolish but, in my opinion, the circumstances of this case constitute the “something more” contemplated by Basten JA, in that the Plaintiff or its agents who were, or should have been, aware of the foolishness had, in effect, encouraged it.”

26. The remedy fashioned by his Honour was to relieve the Cooks of the transaction costs, enforcement expenses and the higher rate of interest but to permit the lender to recover the lower rate on interest.<sup>11</sup> Notably, his Honour did not award the Cooks costs, despite their substantial success in the proceedings.

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<sup>9</sup> At [88].

<sup>10</sup> At [92].

<sup>11</sup> At [95].

## Court of Appeal

27. We challenged the adequacy of this remedy in the Court of Appeal. We argued that Patten AJ, in having found the lender engaged in unjust equity stripping, had erred in failing to provide relief which would substantially restore the loss of the Cooks equity in their home consequent upon the respondents unjust conduct, by declining to relieve them of the obligation to pay interest on the funds advanced.
28. Among other things, we invoked the mandatory considerations of “public interest” under both the Code and *Contracts Review Act*. In the proceedings before Patten AJ we had called expert evidence on the adverse consequences of lending practices such as those adopted by the respondent from Associate Professor Keen.
29. Associate Professor Keen gave evidence that this type of lending (which he termed “Ponzi loans”) had a destabilising effect upon economy. His evidence was that where there is widespread lending on the basis of asset values, unconstrained by assessment of servicing capacity, asset prices become highly inflated and debt levels rise. As a consequence, the ability of the economy to withstand “shock” declines, and the impact of any downturn becomes markedly accentuated.
30. While Associate Professor Keen’s evidence was accepted by the Patten AJ his Honour took the view that:<sup>12</sup>
- “Against any public interest in discouraging loans of the type identified by Professor Keen and Mr Carrail, there is, of course, a public interest in the enforcement of contractual obligations freely entered into. In the result, I do not regard the public interest as of much significance in resolving this case. Rather, I think the greater focus should be upon factors personal to the Defendants, or more directly concerned with the particular transaction.”
31. We argued that in the face of legislation requiring that the public interest be taken into consideration, and evidence that lending practices of the type

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<sup>12</sup> At [85].

engaged in by the lender had public interest implications, it was not open to the trial judge to dismiss those considerations in determining what relief ought to be granted. We urged that the recognition of a public interest in favour of the enforcement of agreements is not a sound basis for failing to consider public interest arguments against enforcing them, particularly where the provision which imposes the requirement that the public interest be considered specifically provides for the avoidance or modification of contractual obligations. If the existence of a public interest in the performance of contracts provides a basis for ignoring other public interest considerations, then the mandatory requirements that the public interest be considered would be of limited application.

32. The Court of Appeal was not persuaded and Giles JA (with whom Beazley and Hoeben JJA agreed) stated:<sup>13</sup>

“I have some difficulty in seeing that the health of the economy falls within the public interest to which regard may be had in determining injustice of the particular transaction. Be that as it may, the public interest in either of the respects mentioned above, if taken into account in determining injustice, has further effect only in determining the relief which should be granted in relation to the particular transaction. “Ponzi” loans no doubt have a part to play in the financial system, and whether they be desirable or undesirable has at best a tenuous connection with the relief to be granted in respect of the particular transaction. I do not think that error is shown in the judge’s preference to place the greater focus on the particular transaction.”

33. Notably, other judicial officers may not find the argument so elusive. Windeyer J in *Accom Finance Pty Ltd v Mars Pty Ltd* [2007] NSWSC 726 observed that:<sup>14</sup>

“Mr Paterson and Professor Keen gave expert evidence on the public interest issue. Neither really took the matter far. The general effect of their evidence was that if the loans were not genuine short term loans but were loans entered into by the lender with the intention that they go into default then that was contrary to the public interest. It would be difficult to argue against that, and it is supported by paras 128 and 131 in the judgment of Basten JA in *Elkofairi* (sic *Khoshaba*). In the present case the required facts were, in my

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<sup>13</sup> At [14].  
<sup>14</sup> At [67].

view, not established, although as I have said this conclusion was not reached without difficulty.”

34. Perhaps an explanation for such differing views lies in the consequences of any finding as perceived by the relevant judicial officer. During the hearing before the Court of Appeal this exchange occurred between Senior Counsel for the Cooks and the Bench:

“HOEBEN J: If you look ..[at your submissions and the allegation] ... that his Honour acted on a wrong principle in not relieving them completely of the obligation to pay interest and this may be the purpose of the appeal. That would be an error which would, if we found it was an error of the *House v The King*-type which would apply to just about every mortgage of this kind and, as we know from the professor’s evidence, there are many of them. And so what this court is being invited to do is to make a finding that in cases of this kind where you have predatory lending the obligation to pay interest or a failure by a trial judge to relieve the plaintiffs of the obligation to pay interest is an error. It’s a fairly far reaching proposition.

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..., that’s why I posed the proposition to you that by raising this public interest issue you were at least implicitly inviting the court to do something which would discourage this, hence my comment about inviting us to do something punitive and of course that’s really the job for Macquarie Street and the legislature, not us.

DONALDSON: Well interestingly Macquarie Street has required of your Honours or of any judge dealing with an application under the code or under the Act to take into account public interest. His Honour, and with respect to him, understandably struggled with that a little bit in the face of submissions from the respondent that this is all about the relationship between this lender and this borrower and how do you assess injustice on the basis of public interest concerns, and that’s not an easy question to answer.

You might well say what is the role of public interest in determining whether a contract which is an arrangement between two particular individuals is unjust in the circumstances in which it was made. It might be suggested that any public interest factors that might be regarded as important or relevant in making determinations under this Act really don’t go to questions of injustice. So it’s rather odd that this requirement has been inserted in s 70 or subsection 72 rather than in the relief section for example. But it’s there and it can only mean we submit that the broader implications from a public interest point of view of the transaction that’s being reviewed need to be taken into account and we say Professor Keen’s evidence is a very direct example of how it can be important.”

35. The Court then deconstructed our argument of equity stripping on the basis that it did not take into account three matters:<sup>15</sup>
- (a) the Cooks were in default under the previous loan, and would have had to pay at least some penalty interest until the mortgaged property was sold together with the expenses of sale;
  - (b) the Cooks were able to occupy the mortgaged property for the period of the loan obtained from the respondent;
  - (c) the Cooks would obtain the benefit or detriment from any increase or decrease in the value of the mortgaged property during the term of the loan from the respondent, so that their equity at the expiration of the respondent's loan could be greater or less than any equity they might have realised in 2003. There was no valuation evidence directed to this, and so it was not possible to carry out the exercise properly required if the argument were followed through.
36. The clarification of these issues is in fact of assistance to borrowers in future cases to distinguish the relief ordered by Patten AJ.
37. However the end result of our appeal for the Cooks was, ironically, that we obtained relief in terms of overturning Patten AJ's decision not award us costs but didn't better the position of the Cooks. But there was perhaps some comfort in the fact that it did substantially worsen the position of the lender.
38. Nonetheless, the Cooks' still have another chance in the civil penalty proceedings which are yet to be heard in the Consumer Trader and Tenancy Tribunal.

### **Conclusion**

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<sup>15</sup> At [18].

39. The Courts, at least in NSW, are loath to invoke the “public interest” element in the determination of “unjustness” in any manner to generally deter the underlying element of asset lending in the low doc loan industry. Each case will thus fall to be determined very much on its own facts. However the increasing appearance of lax documentation as a consequence of low doc loans is making it easier for those representing vulnerable borrowers to escape from these contracts with the loss falling on the lender.