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Mortgagor's Power to Mortgage

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2. Indefeasibility of Mortgage Title *17 Nov 2003*
3. Mortgage Drafting in NSW *17 Mar 2004*
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14. Licensing a Responsible Entity *20 March 2008**
15. Proportionate Liability in claims against Valuers *29 Oct 2008**
16. Examinations under the Corporations Act and ASIC Act *5 March 2012*†

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A. Introduction

Many defects in mortgage title are cured by registration by virtue of the indefeasibility provisions of the Real Property Act 1900 (NSW). Nevertheless the mortgagor's capacity to mortgage the land remains of great importance for:

1. Lenders whose mortgage was blocked by a caveat[1] or internal LPI flag[2]. This is because section 41 of the RPA provides that:

   > No dealing, until registered in the manner provided by this Act, shall be effectual to … to render such land liable as security for the payment of money, but upon the registration of any dealing … the land shall become liable as security in manner and subject to the covenants… specified in such dealing...

   The effect of this section is to make mortgages in registerable form that are remain unregistered for whatever reason simply equitable mortgages and dependant upon the general law for their efficacy.

2. Lenders who intentionally lend on the security of unregistered mortgages (so called caveat lenders[3]). These mortgages are enforceable through equity only and gain nothing from the lodgment of the caveat other than putting the world on notice of the existence of the claim which *may* effect the determination of priorities between competing unregistered interests.

3. Lenders who utilise *all monies* mortgages. These are mortgages which depend on extraneous documents for their efficacy by purporting to secure all monies owing by the mortgagor to the mortgagee. They cannot when read alone be said to delimit or qualify the title. Thus although they are upheld they secure nothing:

   > That which is attained by registration is, in the words of s 42, an estate or interest in the land. Registration does not validate all the terms and conditions of the instrument which is registered. It validates those which delimit or qualify the estate or interest or are otherwise necessary to assure that estate or interest to the registered proprietor.[4]

4. Lenders who although protected by indefeasibility for part of their debt realize a shortfall upon the sale of the security and need to enforce the personal covenants to repay.
5. Company title[5] and Old System title mortgages.

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[1] This can be guarded against by settling at the Land Titles Office. Where the incoming mortgage is substantially being used to pay out an existing mortgage this precaution is not usually necessary. Where a subsequent mortgage is involved the monies should not be released until after registration of the mortgage.

[2] The LPI has a system of internal flags which prevent automatic registration of dealings on suspect titles. These effectively operate the same way as caveats do but the world is not on notice of them. Mortgages will appear on a title search as an unregistered dealing but not be processed. The power to refrain from registering the mortgage comes from s36(1E) of the RPA.

[3] Known as such because they protect the priority of their unregistered mortgage by lodging a caveat on title.

[4] PT Limited v Maradona (1992) 25 NSWLR 643 at 679 per Giles J.

[5] A precursor to strata title company title involves the freehold being vested in a company with the owners of specific bundles of shares in the company having exclusive rights of occupation to specific parts of the building.

B. Minors

1. Unregistered mortgages

The common law rule (which applies to unregistered mortgages) is that a contract with a minor cannot be enforced during the minority but if, upon reaching majority, the minor ratifies the contract it can then be enforced[6] but not if it is repudiated[7] within a reasonable time. *The Minors (Property and Contracts) Act* 1970 (NSW) nominates eighteen years onwards as being *sui juris* (fully legally competent). Section 26 of the Act allows the Court to grant a minor capacity for specific transactions but it does no more than make any such contract *presumptively binding*. Section 47 provides that a guarantor of a minor's debts is bound as though the minor were not a guarantor.

2. Subrogation to unpaid vendors lien

An unpaid vendor's lien rests upon the equitable principle that a party which has obtained possession of property pursuant to a contract shall not keep it without payment; Fisher and Lightwood's Law of Mortgage, 2nd Australian ed. (2005), para. 2.23.

In *Nottingham Permanent Benefit Building Society v. Thurstan* [1903] A.C. 6 the House of Lords held that a mortgage given by an infant to purchase real property was void by reason of s. 1 of the Infants Relief Act 1874; but that as the loan was applied to pay the purchase price owed by the infant purchaser to the vendor, the lender was entitled by subrogation to such a lien as the vendor would have had as against the purchaser (had the infant purchaser not paid).

Whether it applies to a unregistered mortgage with a minor in NSW uncertain. Thurston was decided upon the basis of a loan made void by statute. In NSW the *The Minors (Property and Contracts) Act* 1970 applies which makes such a contract voidable only. The distinction is relevant because in *Orakpo v. Manson Investments Ltd.* [1978] AC. 95 at 114 it was held that a mortgagee who obtained a valid security has abandoned the lien because he had got what he bargained for even if it was unenforceable. Tadgell JA in the Victorian Court of Appeal decision of *Commonwealth Bank of Australia v Horvath* [1996] ANZ ConvR 501 at 652 wrote:

> If the mortgage had not derived validity from its registration there would in my opinion be no reason not to apply here the principle that the House of Lords in approved in Thurston[8].

However this case is of no assistance because s49(a) of the Supreme Court Act of Victoria was based on the English legislation and made the mortgage void and so not inconsistent with *Orakpo*. It is submitted that the rule in *Orakpo* should not be followed in NSW in this respect because it is inconsistent with the equity between the parties that an infant purchaser be able to derive the benefit of the land it contracted to buy without paying for it.

The vendor's lien extends not only to the unpaid purchase price but also to interest on it: *Williams v Contovasilis* [2007] NSWSC 646 per Young CJ in Equity. Once the lien has

[6] Codified in Minors (Property And Contracts) Act 1970 - Sect 30
[7] Codified in Minors (Property And Contracts) Act 1970 - Sect 31, reasonable time is substituted for before obtaining nineteen years.
[8] See also Ormiston JA at 654 and Phillips JA at 680 who both agreed.

been established, it is enforceable by judicial sale: *Commonwealth Bank of Australia v Horvath* [1996] ANZ ConvR 501 and *Contovasilis.*

3. Registered mortgages

In the Victorian Court of Appeal decision of *Commonwealth Bank of Australia v Horvath* [1996] ANZ ConvR 501 Tadgell JA wrote:

> A contract to sell an estate or interest in Torrens title land, made by the registered proprietor who is a minor, will have immediate effect: and, fraud aside, registration of a transfer of the estate or interest sold will confer on the transferee, as against the minor, an indefeasible title unless the minor can resist the effect of registration by reference to some claim at law or in equity which binds the transferee. To say, merely, that the contract which justifies the transferee's registration, or on which the registration depends, has been avoided after the registration, or is voidable at common law, will not achieve a defeasance of the title which registration confers. So much is made clear by the decisions of Street J. in *Mayer v Coe* [1968] 2 N.S.W.R. 747 at 754 and *Ratcliffe v Watters* [1969] 2 N.S.W.R. 146 at 151-3, which were approved by Barwick C.J. in *Breskvar v. Wall* at 387, with whom Windeyer J. at 399 and Owen J. at 400 specifically agreed. Defeasance can only be justified (again leaving fraud aside) if the minor can point to a right in personam …

In considering what might amount to a right in personam Tadgell JA rejected the notion the minority alone (even with notice) could qualify as a *in personam* right citing with approval Professor D. J. Harland, in *The Law of Minors in Relation to Contracts and Property*, (1974), at p. 114, wrote that:

> … it is difficult to characterise as a "right in personam" the right of a minor to avoid, on the ground of lack of capacity, a disposition made by him. Such a right does not arise out of some aspect of the specific dealings between the parties giving rise to such rights as a right to attack the transaction on the ground of fraud or undue influence or to maintain that the transferee holds the properly subject to some equitable right of the transferor. The right asserted by the minor arises quite independently of the particular dealings between the parties and is based on his general lack of capacity arising from his age.

Phillips JA in the same case agreed (at 678) noting:

> At trial the existence of any unconscionable conduct of the part of the bank was expressly negatived by the judge and that finding, though attacked on this appeal, cannot properly be disturbed. The claim to a right in personam therefore depends wholly upon s. 49 of the Supreme Court Act [which renders contracts with minors void] and on balance I do not think that that section establishes in the appellant a right in personam which is sufficient to disturb the bank's title by registration. Deriving from s. 49 his "right" is neither more nor less than a claim to title which is adverse to that now asserted by the bank as registered mortgagee and as such it is pre-eminently a claim which is extinguished by the paramountcy accorded to the register. It is no more than a right to have the instrument set aside and as such it is not enough in itself.

This seems to leave open the possibility that a mortgagee exercising undue influence over a minor could be said to give rise to an *in personam* right.

In New South Wales a practical question of great importance arises. For many years it was thought that the case of *P T Ltd v Maradona Pty Ltd* (1992) 25 NSWLR 643 applied only to guarantors but a series of cases commencing with *Perpetual Trustees Victoria Limited & Anor v Tsai* [2004] NSWSC 745, including *Printy v Provident Capital Limited & Anor [2007] NSWSC 287, Chandra & Anor v Perpetual Trustees Victoria Ltd & Ors [2007] NSWSC 694* and *Sabah Yazgi v Permanent Custodians Limited* [2007] NSWCA 240 have drawn clear attention to the vulnerability of *all monies* mortgages generally which rely for their efficacy on the integrity of extraneous documents (usually a deed of loan). Lenders have been slow to update their documents and the majority of mortgages used in NSW are still all monies mortgages. It therefore raises the specter of a minor avoiding the extraneous document (the deed of loan) pursuant to s31 of *The Minors (Property and Contracts) Act* 1970. In such a scenario the lead case of *Horvath* will be of limited assistance because although Tadgell JA at 652 and Ormiston JA at 654 and Phillips JA at 680 were all at pains to state that if they were wrong on the issue of indefeasibility then an unpaid vendor's lien based on *Thurstan* would apply - that case involved a jurisdiction where a contract with a minor was void. In NSW under *The Minors (Property and Contracts) Act* 1970 contracts with a minor are only voidable. Thus the same uncertainty raised by *Orakpro* would apply and lenders might not be able to claim a vendors unpaid lien. This interpretation is given weight because in such a circumstance the mortgage would still be held indefeasible – it would simply secure no debt and thereby be doubly distinguishable from the obiter of the learned judges in Horvath.

C. Persons of unsound mind

1. The insanity defence

The position in Australia found in the unanimous decision of the Privy Council[9] in *Hart v O'Conner* [1985] AC 1000 and confirms the position in *McLaughlin's case* (1904) 1 CLR 243 and *Tremills'* case, 18 V.L.R. 607. Their Lordships noted that in *Imperial Loan Co. Ltd v Stone* [1892] 1 Q.B. 599 Lord Esher MR said:

> When a person enters into a contract, and afterwards alleges that he was so insane at the time that he did not know what he was doing, and proves the allegation, the contract is as binding on him in every respect … as if he had been sane when he made it, unless he can prove further that the person with whom he contracted knew him to be so insane as not to be capable of understanding what he was about.

and Lopes LJ in the same case:

> A defendant who seeks to avoid a contract on the ground of his insanity, must plead and prove, not merely his incapacity, but also the plaintiff's knowledge of that fact, and unless he proves these two things he cannot succeed.

[9] Lord Scarman, Lord Bridge of Harwich, Lord Brightman and Sir Denys Buckley

After reviewing other authorities including *Tremills'* case, their Lordships concluded:

> To sum the matter up, in the opinion of their Lordships, the validity of a contract entered into by a lunatic who is ostensibly sane is to be judged by the same standards as a contract by a person of sound mind, and is not voidable by the lunatic or his representatives by reason of "unfairness" unless such unfairness amounts to equitable fraud which would have enabled the complaining party to avoid the contract even if he had been sane.

Their Lordships expressly rejected the argument that an insane person had special contractual status regardless of the knowledge of the lender (which made the contract vulnerable if it was *unfair*). Where the lender is ignorant of the mortgagor's condition the only escape is in accordance with general principles of equitable fraud.

In determining the standard of impairment which triggers a successful defence based on insanity the High Court in *Gibbons v Wright* (1954) 91 CLR 423 at 428 unanimously held:

> The mental capacity required by the law in respect of any instrument is relative to the particular transaction which is being effected by means of the instrument, and may be described as the capacity to understand the nature of that transaction when it is explained… Ordinarily ..[this] means… the "general purport" of the instrument; but in some cases it may mean the effect of a wider transaction which the instrument is a means of carrying out.

2. Foundation of the insanity defence

By denying relief to the insane but ostensible sane mortgagor the rule seems to contradict basic principles of contract law which require mutual assent. The explanation for this apparent anomaly lies in the lineage of the rule which was explained by their Lordships in *Hart v O'Conner* [1985] AC 1000 at 1018 as follows:

> The original rule at law, and still the rule in Scotland, was that a contract with a person of unsound mind was void, because there could by no consensus ad idem. This was later qualified by a rule that a person could not plead his own unsoundness of mind in order to avoid a contract he had made. This in turn gave way to a further rule that such a plea was permissible if it could be shown that the other contracting party knew of the insanity.

From this it is apparent that the remedy is a legal one based on their being no contract *at law*. In which case the issue at stake is whether the contract is *void ab initio* (rather than voidable).

That the insanity defence is legal (rather than equitable) is further supported by noting that their Lordships in *Hart* wrote at 1024:

> It seems to their Lordships quite illogical to suppose that the courts of common law would have held that a person of unsound mind, whose affliction was not apparent, was nevertheless free of his bargain if a contractual imbalance could be demonstrated which would have been of no avail to him in equity. Nor do their Lordships see a sufficient foundation in the authorities brought to their attention to support any such proposition.

The High Court case of *Gibbons v Wright* (1954) 91 CLR 423 seems to reach a different conclusion. After reviewing copious authorities Dixon C.J., Kitto and Taylor JJ in a single judgement finally determined that:

> Upon the authorities as they now stand, it appears to us that we ought to regard it as settled law that an instrument of conveyance executed by a person incapable of understanding its effect, in the sense of its general purport, is not on that account void, though in the circumstances it may be voidable by the conveyor or his representatives.

However Gibbons was followed by the pre-Australia Act decision of the Privy Council in *Hart v O'Conner* [1985] AC 1000. The water is muddied further by the decision of *PT Ltd v Maradona Pty Ltd* (1992) 25 NSWLR 643 (which did not consider *Hart*) where Giles J wrote:

> Where mental infirmity is in question, the defence of *non est factum* must be distinguished from the defence that the instrument is voidable by reason of mental incapacity. In *Gibbons v Wright* (1954) 91 CLR 423 at 442-443, it was pointed out that it is erroneous to assume "that a plea that the defendant was unable to understand the nature of the document sued upon is equivalent to, or involves, an allegation that he did not intend to sign it". Such a plea does not deny the execution of the document, but assumes the execution. It concedes that the mind, such as it was, went with the act of execution, but it asserts that the state of mind was such that if the other contracting party were aware of it he ought not to be allowed to insist upon the contract. The basis of the defence of *non est factum*, however, is that in truth the document was not executed at all.

His Honour went on to find that in the case before him a mortgagor's dementia was so severe that the pleas of *non est factum* was made out.

3. The insanity defence and registered mortgages

Whether a successful insanity defence results in a void or voidable contract is of no importance to the registered mortgagee. Provided that there are no personal equities, provided there are no equitable defences (such as Amadio or Garcia type defences), provided the mortgage is not an *all monies* mortgage, the registered mortgagee will be protected by indefeasibility.

4. The insanity defence and unregistered mortgages

The unregistered mortgagee is dependant upon its rights in personam and therefore on the enforceability of the contract. If the contract is void or voidable the unregistered mortgagee will not be able to proceed against either the mortgagee or the security.

5. Subrogation to unpaid vendors lien

If the mortgage is void then the unregistered mortgagee will nevertheless be entitled to the unpaid vendor's lien. If a mortgage was registered but unenforceable (for example because of an all monies clause) or found to be voidable it is possible a NSW Court would apply *Orakpo v. Manson Investments Ltd* [1978] AC. 95 at 114 and hold the lien had been abandoned.

6. Protected Estates Act 1973 (NSW)

The Protected Estates Act 1973 makes provision for the affairs of persons incapable of managing their affairs to be vested in the Protective Commissioner. The status of such persons is to be found in the unanimous High Court decision of *Gibbons v Wright* (1954) 91 CLR 423:

> The law relating to persons who are lunatics so found must be put on one side at the outset. Such a person is held incompetent to dispose of his property, not because of any lack of understanding (indeed he remains incompetent even in a lucid interval), but because the control, custody and power of disposition of his property has passed to the Crown to the exclusion of himself. Accordingly his disposition is completely void: Re Walker (1905) 1 Ch 160 . For a similar reason, the conveyance of a person in respect of whom, though he is not a lunatic so found, a receiver has been appointed under s. 116(1) (d) of the Lunacy Act 1890 (Imp.) (53 and 54 Vict. c. 5), has been held to be void: Re Marshall (1920) 1 Ch 284 . (at p440).

Section 24(2)(f) of the Act gives the Protective Commissioner the power to mortgage land owned by the protected person.

Normally the Protective Commissioner will place a caveat on the title of land owned by a protected person. If this was not done or fraudulently removed and a lender took a registered mortgage it would (subject to personal equities) be indefeasible.

D. Corporations

1. Capacity of the company & its officers to enter into mortgages

Lenders previously had to concern themselves with whether a corporation had the power to enter into a mortgage. The answer was to be found in the company's articles of association and the lender was taken to be on constructive notice of the contents of these articles.

> The Legislature then devised the plan of incorporating these companies in a manner unknown to the common law…providing at the same time that all the world should have notice who were the persons authorised to bind all the shareholders, by requiring the copartnership deed to be registered…and made accessible to all; … All persons, therefore, must take notice of the deed …If they do not choose to acquaint themselves with the powers of the directors, it is their own fault, and if they give credit to any unauthorised persons they must be contented to look to them only, and not to the company at large. The stipulations of the deed, which restrict, and regulate their authority, are obligatory on those who deal with the company; and the directors can make no contract so as to bind the whole body of shareholders, for whose protection the rules are made, unless they are strictly complied with[10].

The danger of dealing with a company which did not have the power to mortgage its land or not in the manner and form that it did has effectively been abolished by the following provisions of the Corporations Act 2001 (Cth):

[10] Ernest v Nicholls (1857) 6 H. L. Cas. 401 at 418 per Lord Wensleydale.

Section 124(1)	Gives a company the power to anything a natural person can do.
Section 125	Provides that while a company's constitution may limit its powers and objectives actions outside of those limitations are not invalid.
Section 128	A person is entitled to make the assumptions in section 129 in relation to dealings with another person who has, or purports to have, directly or indirectly acquired title to property from a company. The company and the other person are not entitled to assert in proceedings in relation to the dealings that any of the assumptions are incorrect. The assumptions may be made even if an officer or agent of the company acts fraudulently, or forges a document, in connection with the dealings.
Section 129(1)	A person may assume that the company's constitution (if any), and any provisions of this Act that apply to the company as replaceable rules, have been complied with.
Section 129(2)	A person dealing with a company can assume the directors and secretaries on ASIC's register were properly appointed and have the normal authority of a director or secretary of a similar company.
Section 129(3)	A person dealing with a company can assume persons held out to be officers or agents of the company were properly appointed and have the normal authority of that kind of officer or agent of a similar company.
Section 129(4)	A person dealing with a company can assume the officers or agents of the company properly perform their duties.
Section 129(5)	A person dealing with a company can assume the a document has been duly executed if it has been signed in accordance with s127(1). If someone signs the document and states next to their signature that they are the sole director and sole company secretary it can be assumed to be correct.
Section 129(6)	Similar assumption in relation to documents executed under seal.
Section 130(1)	Abolished constructive notice of the details of the company's affairs held with ASIC.[11]

[11] Note that this does not apply to charges – under s130(2) this assumption does not apply to charges.

2. Indoor management rule

According to Fisher and Lightwood's Law of Mortgage (2nd Australian ed. (2005), para. 11.33) the reforms contained in s124 & 125 of the Corporations Act do not operate to validate a mortgage made in breach of a company's constitution.[12] If this is the case then the indoor management rule still has application. Laid down in *The Royal British Bank v. Turquand* 119 ER 886 the "indoor management" rule, was said by Lord Simonds in *Morris v. Kanssen* (1946) AC 459, at p 474, to be correctly stated in Halsbury's Laws of England as follows:

> But persons contracting with a company and dealing in good faith may assume that acts within its constitution and powers have been properly and duly performed and are not bound to inquire whether acts of internal management have been regular.

Lord Simonds qualified the rule by noting:

> It is a rule designed for the protection of those who are entitled to assume, just because they cannot know, that the person with whom they deal has the authority which he claims. This is clearly shown by the fact that the rule cannot be invoked if the condition is no longer satisfied, that is, if he who would invoke it is put upon his inquiry. He cannot presume in his own favour that things are rightly done if inquiry that he ought to make would tell him that they were wrongly done.

Mason CJ in *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146 reinstating a decision of Young CJ in Eq emphasised this point noting:

> However, there is no reason why a third party should be entitled to rely on the formal validity of the instrument and to assume that the seal has been regularly affixed if the very nature of the transaction is such as to put him upon inquiry. If the nature of the transaction is such as to excite a reasonable apprehension that the transaction is entered into for purposes apparently unrelated to the company's business, it will put the person dealing with the company upon inquiry. It is one thing to assume that the common seal has been regularly affixed to an instrument apparently executed for the purposes of the company's business; it is quite another thing to assume that the seal has been regularly affixed when the transaction is apparently entered into otherwise than for those purposes.

This is in line with s128(4) of the Corporations Act which holds:

> A person is not entitled to make an assumption in section 129 if at the time of the dealings they knew or suspected that the assumption was incorrect.

In considering what amounts to suspicion the definition of Kito J in *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266 at 303:

> A suspicion that something exists is more than a mere idle wondering whether it exists or not; it is a positive feeling of actual apprehension or mistrust, amounting to

[12] However note paragraph 11 of the judgement of Mason CJ in *Northside Development Pty Ltd v Registrar General* (1990) 170 CLR 146

"a slight opinion, but without sufficient evidence", as Chambers's Dictionary expresses it.

Mason CJ in *Northside* (after noting the changes introduced by s68A of the Companies Codee in 1984 – the current equivalent being ss 124 and 125) grandly laid down the doctrine that:

> …to hold that a person dealing with a company is put upon inquiry when that company enters into a transaction which appears to be unrelated to the purposes of its business and from which it appears to gain no benefit is, in my opinion, to strike a fair balance between the competing interests. Indeed, there is much to be said for the view that the adoption of such a principle will compel lending institutions to act prudently and by so doing enhance the integrity of commercial transactions and commercial morality.

It is therefore conceivable that this rule was intended to continue in parallel what is now ss 124 and 125. To a large extent s129(1) is a codification of the rule.

3. Execution by a company

Section 127 of the Corporation Act reads:

> (1) A company may execute a document without using a common seal if the document is signed by:
>
> (a) 2 directors of the company; or
>
> (b) a director and a company secretary of the company; or
>
> (c) for a proprietary company that has a sole director who is also the sole company secretary--that director.
>
> Note: If a company executes a document in this way, people will be able to rely on the assumptions in subsection 129(5) for dealings in relation to the company.
>
> (2) A company with a common seal may execute a document if the seal is fixed to the document and the fixing of the seal is witnessed by:
>
> (a) 2 directors of the company; or
>
> (b) a director and a company secretary of the company; or
>
> (c) for a proprietary company that has a sole director who is also the sole company secretary--that
>
> Note: If a company executes a document in this way, people will be able to rely on the assumptions in subsection 129(6) for dealings in relation to the company.

Section 127(4) makes clear these are not the only methods by which a company can execute a contract while s126 reads:

(1) A company's power to make, vary, ratify or discharge a contract may be exercised by an individual acting with the company's express or implied authority and on behalf of the company. The power may be exercised without using a common seal.

The New South Wales LPI (Land & Property Information) forms provide for a mortgage to be executed with or without a seal or by "an authorized officer" of the corporation.

4. Indefeasibility

The indoor management rule is of no avail to the lender put on enquiry, while the statutory assumptions cannot be relied upon where the lender has "knowledge or suspicion" that something was amiss. However if the mortgage is registered the lender will at least be able to enforce its rights *in rem* (against the land) provided that it did not participate in a fraud[13]. Section 42 of the Real Property Act (NSW) reads:

> Notwithstanding the existence in any other person of any estate or interest which but for this Act might be held to be paramount or to have priority, the registered proprietor for the time being of any estate or interest in land recorded in a folio of the Register shall, except in case of fraud, hold the same, subject to such other estates and interests and such entries, if any, as are recorded in that folio, but absolutely free from all other estates and interests that are not so recorded…

In order to defeat the title of a registered proprietor, the fraud must be actual (and not mere equitable) fraud on the part of - or to the knowledge of - the holder of the registered interest claiming indefeasibility or his agents: see *Assets Co Ltd v Mere Rohini*[14]; Bahr *v Nicolay (No 2)*[15]and *Grgic v ANZ Banking Group Ltd*[16]. In *Assets Co Ltd v Mere Rohini* the Privy Council stated at 210 per Lord Lindley:

> …by fraud in these Acts is meant actual fraud, ie, dishonesty of some sort, not what is called constructive or equitable fraud- an unfortunate expression and one very apt to mislead, but often used, for want of a better term, to denote transactions having consequences in equity similar to those which flow from fraud. Further, it appears to their Lordships that the fraud which must be proved in order to invalidate the title of a registered purchaser for value, whether he buys from a prior registered owner or from a person claiming under a title certified under the Native land Acts, must be brought home to the person whose registered title is impeached or to his agents. Fraud by persons from whom he claims does not affect him unless knowledge of it is brought home to him or his agents. The mere fact that he might have found out fraud if he had been more vigilant, and had made further inquiries which he omitted to make, does not of itself prove fraud on his part. But if it be shewn that his suspicions were aroused, and that he abstained from making inquiries for fear of learning the truth, the case is very different, and fraud may be properly ascribed to him. A person who presents for registration a document which is forged or has been fraudulently or improperly obtained is not guilty of fraud if he honestly believes it to be a genuine document which can be properly acted upon.

[13] And provided there is no in personam right, no equitable defence and the mortgage was not an all monies mortgage.
[14] [1905] AC 176
[15](1988) 164 CLR 604
[16] (1994) 33 NSWLR 202

This test then arguably puts the mortgagee in no better position than the "suspicion" in s128(4) of the Corporations Act.

5. The position of the defrauded company

A company defrauded by a director or other officer can still sue the Registrar General as nominal defendant pursuant to s129 of the Real Property Act which reads:

> (1) Any person who suffers loss or damage as a result of the operation of this Act in respect of any land, where the loss or damage arises from:
>
> …..
>
> (e) the person having been deprived of the land, or of any estate or interest in the land, as a consequence of fraud, or

In *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146 the security in question was fraudulently mortgaged to secure the debts of one of the directors. On its face the documents appeared to be properly executed including the affixing of the company seal. The company sought compensation from the Torrens Assurance Fund and the Registrar General sought to avoid liability on the basis of the indoor management rule and provisions of the RPA and Conveyancing Act. Mason CJ (with whom Brennan, Dawson and Guadron JJ agreed) held:

> … by reason of the registration of the instrument of mortgage and subsequent transfer, the appellant sustained a loss within the meaning of the sub-section. The registration of the instruments conferred an indefeasible title on Barclays and the third party purchaser. In the circumstances of this case that registration deprived the appellant of its estate or interest in the land, thereby causing it to sustain loss or damages. In one sense the appellant lost its estate or interest in the land because the borrower failed to repay the loan, but in this case it is not disputed that, subject to the arguments already dealt with, the registration of the instruments was the cause of the appellant's loss for the purposes of s.12[9]

E. Trustees

1. Under the Real Property Act

The primary reason the Torrens system was created is to protect mortgagees and purchasers of real property from losing their interests due to subsisting interests in the form of express, implied and constructive trusts. The provisions which achieve this in the NSW Real Property Act are:

Section 82(1) which reads:

> …the Registrar-General shall not record in the Register any notice of trusts whether express, implied, or constructive.

Section 43(1) which reads:

> Except in the case of fraud no person contracting or dealing with … the registered proprietor of any registered estate or interest shall be required or in any manner

> concerned to inquire or ascertain the circumstances in or the consideration for which such registered owner or any previous registered owner of the estate or interest in question is or was registered, or to see to the application of the purchase money or any part thereof, or shall be affected by notice direct or constructive of any trust or unregistered interest, any rule of law or equity to the contrary notwithstanding; and the knowledge that any such trust or unregistered interest is in existence shall not of itself be imputed as fraud.

Note that "or dealing with" is defined by s74(A) of the act as meaning registered dealings, ie: registered mortgages.

Section 42(1) which reads:

> Notwithstanding the existence in any other person of any estate or interest which but for this Act might be held to be paramount or to have priority, the registered proprietor for the time being of any estate or interest in land recorded in a folio of the Register shall, except in case of fraud, hold the same, subject to such other estates and interests and such entries, if any, as are recorded in that folio, but absolutely free from all other estates and interests that are not so recorded…

Section 96 which reads:

> A fiduciary registered as proprietor pursuant to section 93[17] shall hold the estate or interest in respect of which the fiduciary is so registered in trust for the persons for whom and purposes for which that estate or interest is applicable by law, but for the purposes of any dealing therewith the fiduciary shall be deemed to be absolute proprietor thereof.

The intent and implication for land held in trust is clear – they are a matter between trustees and beneficiaries. If a trustee breaches his trust the beneficiary must carry the loss not the mortgagee. The only exception is fraud – of the kind defined by Lord Lindley, personal equities or where an all monies mortgage has been used. Mere notice of the trust is not enough. In *Commonwealth Bank of Australia v. Nick Frisina Pty. Limited* [1999] NSWSC 907 with Hodgson CJ in Eq:

> the mere notice that the Bank may be considered as having… is insufficient to defeat the Bank's legal title. There would, in my opinion, need to be positive evidence [that]… the Bank had notice; that is, evidence of an actual breach of trust in the receipt of advances and the correlative expansion of the charge, of application of the advances otherwise than in accordance with the determination of the true trustees, and of consequential loss to beneficiaries.

The notice the Bank has would have to be such that suspicions were aroused – to the level of turpitude described by Lord Lindley in *Assets Co Ltd v Mere Rohini* at 210.

[17] Section 93 concerns the registration of executors and others upon death of a registered proprietor.

2. Under the common law

The common law position is relevant because it applies where an *all monies* mortgage is used or the mortgage is unregistered or a caveat blocks registration. This was illustrated in *Frisina*[18] with Hodgson CJ in Eq holding (in relation to an *all monies mortgage*):

> In my opinion, such notice as the Bank had of any breach of trust fell well short of what would have been required to give rise to a personal equity or to amount to fraud...However, the Bank has to go outside its indefeasible title to quantify the amount in respect of which it has a charge. If the Bank's registered mortgage had itself specified the amount of the debt secured by it, then in my opinion indefeasibility would go to the extent of the Bank having security for a debt in that amount. But in fact, no amount was specified in the mortgage.

Under the common law rule a trust cannot borrow (rendering purported borrowings only a debt owing by the false trustee and unrecoverable from the trust or its assets) unless the trust instrument or statute grants that power – *Stroughill v Anstey* 12 Eng. L. & Eq. 357, 42 ER 700.

There are various provision in the Trustee Act (NSW) 1925 which imply into the trust instrument or grant outright the power to mortgage both with and without the sanction of the court.

Section 38 applies to non-charitable trusts. Section 38(1) by widening existing powers (lenders still need to read the trust deed):

> Where a trustee is authorised by the instrument… to pay or apply capital money for any purpose or in any manner, the trustee shall have … power to raise the money required by … mortgage of all or any part of the trust property for the time being in possession held upon the same trust...

and section 38(1A) by granting the power (regardless of the contents of the trust deed) to mortgage land to pay taxes and rates.

> Where a trustee holds land in respect of which moneys are due and payable for rates or taxes or in respect of which the trustee is under a statutory obligation to expend moneys and the trustee has no moneys subject to the same trusts as such land wherewith to pay such rates or taxes or discharge such statutory obligation the trustee shall have and shall be deemed always to have had power to raise the money required to make such payment or discharge such obligation by sale or mortgage of the whole or part of such land or by sale, conversion, calling in, or mortgage of all or any part of the trust property for the time being in possession held upon the same trusts as such land.

[18] [1999] NSWSC 907

Section 82 reads:

> (4) The Court may authorise the trustee, as to the Court seems fit:
>
> (a) to raise the amount by mortgage of the land, or by sale of a part thereof.
>
> (8) No purchaser or mortgagee paying or advancing money upon any sale or mortgage authorised by the Court under this section shall be required to see to the application of the purchase money or mortgage money...

The protection afforded to lenders in sub-section 8 addresses the fact that traditionally the lenders under a mortgage were been unable to recover against the trust if the monies were misappropriated by the trustee. As a consequence a great body of case law developed as to when a lender was justified in accepting the receipt of the trustee versus when the lender had a duty to see to the application of the monies. The duty has been more generally abolished by Section 39 of the Trustee Act (NSW)1925 which reads:

> No … mortgagee, paying or advancing money on a … mortgage purporting to be made under any trust … shall be concerned to see that the money is wanted, or that no more than is wanted is raised, or to see to the application thereof.

Lenders[19] who are able to satisfy themselves (by reviewing a copy of the trust instrument[20]) that a trustee is authorised the trust instrument, or by statue, to raise money by mortgage may still need to concern themselves with s66B(2) of the Conveyancing Act 1919 NSW which reads:

> Notwithstanding anything to the contrary in the instrument (if any) creating a trust for sale or power of sale of property or in the settlement of the net proceeds, the proceeds of sale or other capital money shall not be paid to or applied by the direction of fewer than two persons as trustees, except where the trustee is a trust corporation, or the trustee was appointed as a sole trustee by the instrument creating the trust or power, but this subsection does not affect the right of a sole personal representative as such to give valid receipts for, or direct the application of, the proceeds of sale or other capital money; nor, except where capital money arises on the transaction, render it necessary to have more than one trustee.

This provision cannot impinge on an otherwise indefeasible mortgage[21]. Hodgson CJ in Eq in *Commonwealth Bank of Australia v. Nick Frisina Pty. Limited* [1999] NSWSC 907 questioned whether it applied to mortgages but noted "other capital amount" might but found it unnecessary to determine the question. He did find that if it did apply to mortgages and action was brought by beneficiaries they would have to show causation. Therefore prudent lenders to non-corporate trustees should (where there is more than one trustee) obtain the direction to pay and receipt of at least two of the trustees.

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[19] Who are not otherwise protected by indefeasibility.

[20] Usually a bank will insist on receiving a copy certified as a true copy of the original deed by a registered Notary.

[21] *Commonwealth Bank of Australia v. Nick Frisina Pty. Limited* [1999] NSWSC 907 per Hodgson CJ in Eq at paragraph 26.

F. Co-owners

1. Joint tenants

In Wright v Gibbons [1949] HCA 3; (1949) 78 CLR 313 Latham CJ observed (at p323):

> The interests of each joint tenant in the land held are always the same in respect of possession, interest, title and time. No distinction can be drawn between the interest of any one tenant and that of any other tenant. If one joint tenant dies his interest is extinguished. He falls out, and the interest of the surviving joint tenant or joint tenants is correspondingly enlarged.

A mortgage by one joint tenant of his interest would sever the tenancy but under Torrens system land it has been held not to sever the tenancy[22]. A transfer from the owner of the charged portion to the owner of the uncharged portion is subject to the charge.[23] If the transfer is made pursuant to an order of the Family Court the charge is likewise preserved.[24] *Lyons v Lyons* [1967] VR 169 at 181 and *Penny Nominees Pty Ltd v Fountain* (No 3) (1990) 5 BPR 11284 have both been nominated authority for the proposition that upon the death of the owner of the charged portion the mortgagee's interest is lost (see Fisher and Lightwood's Law of Mortgage, 2nd Australian ed. (2005), para. 37.6) however in both cases the mortgage was unregistered. As unregistered mortgages they were equitable and therefore relied upon their in personam effect (which died with the indebted joint tenant).

2. Tenants in Common

Tenants in common hold their interests in divisible shares. Thus upon the death of one of the co-owners his shares pass with his estate and remain encumbered.

3. Co-owners generally

Where the co-owners are spouses there exists a unique equitable defence Yerkey v Jones (1939) 63 CLR 649.

Where one of the signatures of co-owners is forged the other is still bound *Small & Ors v Gray & Ors* [2004] NSWSC 97. Small is also authority for the proposition that if the mortgage by one of the two joint owners charges the land the other mortgagor can still escape by raising a defence under the Contracts Review Act – in which case an order under s66G will be made.

Great care should be taken in drafting mortgages to co-owners. In *Kerry Jane Fraser v Kirsty Power And Ors.* [2000] NSWSC 257 poor drafting was held to be fatal in enforcing a mortgage over a family home where the debts secured were all the husbands. Simos J reasoned as follows:

> It was submitted on behalf of the plaintiff that, having regard to the description of the "MORTGAGOR" as set out above, the relevant part of this clause *"Sixthly"* should be read as follows:-

[22] Lyons v Lyons [1967] VR 169 at 181
[23] Lord Abergavenny's case (1607) 6 Co Rep 78b; 77 ER 373 also see *Penny Nominees Pty Ltd v Fountain* (No 3) (1990) 5 BPR 11284
[24] *Penny Nominees Pty Ltd v Fountain* (No 3) (1990) 5 BPR 11284

"SEAN BARRIE FRASER and KERRIE JANE FRASER hereby covenant with the Mortgagee that SEAN BARRIE FRASER and KERRIE JANE FRASER will duly and punctually pay to the Mortgagee all the moneys which are or which may hereafter become owing or payable by SEAN BARRIE FRASER and KERRIE JANE FRASER jointly to the Mortgagee ...".

It was further submitted on behalf of the plaintiff that since there were, admittedly, no moneys owed or owing by Mr. and Mrs. Fraser jointly to the third defendant, the subject mortgage had no relevant effect since, on its true construction, it was a mortgage to secure debts (owed by Mr. and Mrs. Fraser jointly to the third defendant) which did not exist.

In my opinion, as stated above, these submissions on behalf of the plaintiff are correct and should be upheld.

It was submitted on behalf of the defendants that the provisions of clause 1.(2) of the Memorandum incorporated in the subject mortgage produced the result, contrary to my opinion as stated above…

"Every covenant, agreement, condition and acknowledgment expressed or implied herein on the part of more persons than one shall bind such persons jointly and each of them severally ... AND words importing the singular number where used shall include the plural number and vice versa ...".

In my opinion, this clause 1.(2) on its true construction operates to require every covenant in the subject mortgage by the "MORTGAGOR", (namely, Mr. and Mrs. Fraser) to be construed as "the MORTGAGOR jointly and each of them severally", but, in my opinion, the effect of doing this in relation to the clause *"Sixthly"* produces the result that that clause is to be construed as if it read as follows:-

"Mr. and Mrs. Fraser jointly and each of them severally hereby covenant with the Mortgagee that Mr. and Mrs. Fraser jointly and each of them severally will duly and punctually pay to the Mortgagee all moneys which are or which may hereafter become owing or payable by Mr. and Mrs. Fraser jointly to the Mortgagee under any present or future Collateral Security as defined in the said Memorandum and will duly and punctually observe and perform every other obligation on the part of the Mortgagor contained or implied in any such Collateral Security."

In my opinion, this construction gives full effect to the requirements of clause 1.(2) of the Memorandum by construing the covenant by Mr. and Mrs. Fraser as being a covenant by them jointly and each of them severally, but the subject matter of the covenant remains, nevertheless, a covenant to pay to the "Mortgagee" all moneys which are or which might hereafter owing or payable by Mr. and Mrs. Fraser jointly to the "Mortgagee" under any present or future "Collateral Security".

Clause 1.(1)(a) of the Memorandum is in the following terms:-

> *"1. INTERPRETATION*
>
> *The under mentioned expressions wherever occurring in this Mortgage shall, unless the context otherwise requires, have the following respective meanings ... MONEYS HEREBY SECURED means –*
>
> > *(a) All moneys which are or which may become owing (whether actually or contingently) or payable to the Mortgagee by*
> >
> > *(i) the Mortgagor either alone or with any other person under or pursuant to this Mortgage or any other document; or*
> >
> > (ii) *the Mortgagor and/or any other person under or pursuant to any Collateral Security of a kind referred to in paragraph (a) of the definition of "Collateral Security" herein contained ...".*

In my opinion, the application of this provision in the Memorandum requires the relevant words "MONEYS HEREBY SECURED" to be construed as meaning:-

> *"All moneys which are or which may become owing (whether actually or contingently) or payable to the Mortgagee by –*
>
> *(i) Mr. and Mrs. Fraser jointly either alone or with any other person under or pursuant to this Mortgage or any other document; or*
>
> *(ii) Mr. and Mrs. Fraser jointly and/or any other person under or pursuant to any Collateral Security of a kind referred to in paragraph (a) of the definition of 'Collateral Security' herein contained ...".*

So read, as the relevant words should be, in my opinion, the words "MONEYS HEREBY SECURED" include only moneys payable by Mr. and Mrs. Fraser jointly, and the words in subparagraph (i) "either alone or with any other person" and in subparagraph (ii) "and/or any other person", produce no different result.

4. Section 66G of the Conveyancing Act

When a mortgage over the share of one co-owner is to be enforced the Court makes an order for Judicial Sale under s66G of the Conveyancing Act for the appointment of trustees for the sale (*Penny Nominees Pty Ltd v Fountain* (No 3) (1990) 5 BPR 11284). The solicitor for the mortgagee should arrange for two trustees – another solicitor who does not act for the mortgagee (from another firm) and a real estate agent. The orders sought should be as follows. Note that the Defendants are the registered proprietors and the First Defendant owns the charged portion and the Second Defendant the uncharged portion:

1. An order that the agreement between the Plaintiff and the First Defendant in the form of a mortgage dated *** be specifically performed by the First Defendant giving to the Plaintiff possession of the Land.

2. An order that, by way of enforcement of order 1, judgment to the Plaintiff as against the First and Second Defendants for possession of the Land, and leave to issue a writ of possession forthwith.

3. An order that [name of real estate agent] of [address of real estate agent]**,** licensed real estate agent, and Rex Alan Bayliss, Solicitor, of 29/30 Gadigal Avenue ZETLAND NSW 2017, Solicitor, be appointed trustees for sale of the Land (hereafter, the Trustees).

4. An order that the Land be vested in the Trustees subject to any encumbrances affecting the entirety of the Land, but free from encumbrances affecting any undivided share or shares therein, to be held by the Trustees upon statutory trust for sale pursuant to Division 6 of the *Conveyancing Act* 1919.

5. An order that upon sale of the Land, the sale proceeds are to be applied in discharge of any encumbrances over the entirety of the Land and the discharge of the Plaintiff's charge over the First Defendant's share of the Land in the same order of priority as would exist if Order 4 had not been made.

6. An order that the First and Second Defendants deliver to the Trustees vacant possession of the Land within 14 days of the making of this Order.

7. An order that the Land be sold by the Trustees in such a manner and on such terms as the Court may in these Orders and from time to time direct, but except to the extent of such direction, as the Trustees see fit.

8. A direction that the Trustees are to act at all times in relation to the selling of the Land in accordance with the duties owed by a mortgagee in exercising a mortgagee's power of sale.

9. An order that the Trustees be appointed to transfer the Land to the purchaser or purchasers of the Land to effectuate sale of the Land.

G. Non existent mortgagors

When a party deals with a mortgagor that does not exist the common law states that the mortgage is a nullity. This much is certain and follows because the legal title would remain vested in the real owner's name – the conveyance having failed. So far as the position of a registered mortgagee is concerned the situation is somewhat uncertain and is tied up in the dispute between deferred and immediate indefeasibility.

The story begins with the *Gibbs v Messer* [1891] AC 248, one of the earliest cases to consider Torrens Title and the concept of indefeasibility. In that case the registered proprietor and purported mortgagor did not exist being an entirely fictitious person. The Privy Council held that the mortgagee's title was void because it had been immediately derived from the first false link in the chain of title. This doctrine came to be known as deferred indefeasibility. It is to be contrasted with the competing view that registration (even when based on a void instrument) immediately confers indefeasibility.

For many years, following *Gibbs v Messer*, the doctrine of deferred indefeasibility was considered law in Australia[25]. Finally relief came in the form of an new Privy Council decision of *Frazer v. Walker* (1967) 1 AC 569 which distinguished *Gibbs* and adopted immediate indefeasibility. Lord Wilberforce holding at p 580:

> It is in fact the registration and not its antecedents which vests and divests title.

Adopting this authority the High Court then came down heavily in favour of immediate indefeasibility in *Breskvar v Wall* (1971) 126 CLR 376. Barwick CJ at 385 noting:

> The Torrens system of registered title of which the Act is a form is not a system of registration of title but a system of title by registration…The title it certifies is not

[25] Although when the High Court considered the question in 1934 in the case of Clements vs Ellis (1934) 51 CLR 217 they were evenly split on the question.

> historical or derivative. It is the title which registration itself has vested in the proprietor. Consequently, a registration which results from a void instrument is effective according to the terms of the registration. It matters not what the cause or reason for which the instrument is void. The affirmation by the Privy Council in Frazer v. Walker (1967) 1 AC 569 …now places that conclusion beyond question.

Against this background Young J (as he then was) in *ANZ Banking Group v Barns* [1995] ANZ ConR 123 resurrected *Gibbs v Messer* in the context of a mortgage given by a non-existent mortgagee. In Barns the mortgage purported to be given by a deregistered company. His Honour finding:

> So far as the 1989 mortgage is concerned, under the general law it would be a complete nullity. It is, however, registered under the Real Property Act. There is authority that if a forged mortgage is registered under the Real Property Act then despite the fact that it would be a nullity under the general law, it obtains indefeasible status…
>
> However, a … situation that has not been completely covered by the authorities is where there is a mortgage by a non-existent person. This situation was dealt with by the Privy Council in Gibbs v Messer [1891] AC 248, where at 253 Lord Watson, giving the decision of the Privy Council said, "It is clear that the registration of... a fictitious and non-existing transferee cannot impede the right of the true owner... to have her name restored to the register." At 255, Lord Watson said that the alleged registered proprietor "was the only name on the register, and, having no existence, he could neither execute a transfer nor a mortgage"…
>
> Gibbs v Messer has undergone quite a considerable buffeting in the authorities over the past century. However, it is usually distinguished on the basis that it does not apply to a forgery and as far as I know has never been overruled in connection with non-existent persons. Indeed, what Lord Watson says must stand to reason. If the register says that a non-existent person is the registered proprietor of an interest, there is not a registered proprietor because the alleged registered proprietor does not exist.
>
> Accordingly, any statement that that proprietor's title is indefeasible is a nonsense. One can get the situation where a person is the legal proprietor of land, yet is not the registered proprietor of land such as the situation where the registered proprietor is dead and a legal interest in the land has become vested in another person…
>
> At the time of the 1989 mortgage, the effect of deregistration was to vest in the Corporate Affairs Commission or its successor. Thus the proprietor of the land, though not the registered proprietor at the time when the 1989 mortgage was given, was the Corporate Affairs Commission. The registered proprietor did not exist having been dissolved.
>
> Accordingly, as the bank's mortgage was given neither by the registered proprietor nor by the proprietor of an interest in the land, it, despite registration, confers no interest at all in the bank.

With respect to His Honour the final paragraph of the above extract focuses on who gave the bank its mortgage ie: its derivation – not on the fact of its registration. Accordingly this reasoning would seem to be odds with Barwick CJ's determination that:

> The title it certifies is not historical or derivative. It is the title which registration itself has vested in the proprietor. Consequently, a registration which results from a void instrument is effective according to the terms of the registration. It matters not what the cause or reason for which the instrument is void.

H. Subrogation

If the security fails due to a lack of power on the part of the purported mortgagor to give the security all is not always lost. In many instances

The doctrine of subrogation was defined in *Burston Finance Ltd. v. Speirway Ltd*. [1974] 1 W.L.R. 1648, 1652 by Walton J., who, stated:

> … where one person advances money on the understanding that he is to have certain security for the money he has advanced, and, for one reason or another, he does not receive the promised security. In such a case he is nevertheless to be subrogated to the rights of any other person who at the relevant time had any security over the same property and whose debts have been discharged, in whole or in part, by the money so provided by him, but of course only to the extent to which his money has, in fact, discharged their claims.

In *Cochrane v. Cochrane* [1985] 3 NSWLR 403 at 405 Kearney J wrote:

> These cases deal, of course, with the position of a third party paying off a mortgage. The principle emerging from the Privy Council decision in *Ghana Commercial Bank v Chandiram* [1960] AC 732 is that in such case the third party is presumed, unless the contrary appears, to intend that the mortgage shall be kept alive for his benefit. This involves, of course, that in order to determine whether the presumption applies in any given case the circumstances of the case have to be looked at. I accept that in accordance with this principle, it must be shown that the circumstances are such as to displace such a presumption in the case of a third person.
>
> This principle is based on equity's concern to prevent one party obtaining an advantage at the expense of another which in the circumstances of the case is unconscionable. Hence, there is a common thread running through there relevant cases to the effect that the conscience of the mortgagor should be affected so as to cause the mortgage to be kept alive. This is illustrated in the text book examples first, of a third party not being entitled to a right by way of subrogation where he simply lends the money on an unsecured basis to the mortgagor who then uses such funds to pay off the mortgage; and secondly, of a third party being so entitled where he advances the money to pay out the mortgage on the understanding that security would be provided for such advance upon the mortgage being paid out.

As Young CJ in Eq noted in *Bofinger v Rekley Pty Ltd* [2007] NSWSC 1138

> All parties have acknowledged that the right of subrogation is an equitable right. If authority is needed for it, more than one member of counsel cited to me the words of Powell J in *McColl's Wholesale Pty Ltd v State Bank of New South Wales* [1984] 3 NSWLR 365, 378. Although English authorities have recently flirted[26] with the idea of subrogation having something to do with restitution and unjust enrichment, the law in New South Wales remains that it is based on unconscionable conduct; see eg *Highland v Exception Holdings Pty Ltd* (2006) 60 ACSR 223.[27]

This position fortified by the words of Bryson J in *Challenger Managed Investments Ltd v Direct Money Corp. P/L* [2003] NSWSC 1072:

> To my mind it is enough to see subrogation as an entitlement which equity accords to the payer, firmly established by judicial decisions notwithstanding that a satisfactory doctrinal basis is difficult to identify, and notwithstanding that classification of the mortgagor's position as unconscionable seems very attenuated.

In *Exception Holdings Pty Ltd v Albarran* (No 2) [2005] NSWSC 981 Young CJ in Eq held that where a security was merely voidable – not void subrogation did not apply. This could be considered as authority for the proposition that subrogation in the case of minors is not available in NSW – but this does not seem to have been explored.

I. Bankrupts

1. Generally a mortgagee has priority over unsecured creditors

Unsecured creditors of a bankrupt rank in priority below all secured creditors of the bankrupt. There is, however, a statutory ability conferred on a trustee of a bankrupt in limited situations to set aside certain past dealings with the bankrupt's property to the extent that those dealings would otherwise affect the trustee. If a mortgage (or part or all of the debt secured by a mortgage) was set aside by this means, the mortgagee would not only lose (or lose in part) its priority over the unsecured creditors, but could then effectively rank behind the unsecured creditors, in whole or in part.

2. However mortgages can be set aside as against the trustee in bankruptcy

The sections of the Bankruptcy Act that could result in the setting aside of a mortgage as against a trustee are considered below:

Sections 120 and 121

Sections 120 and 121 of the Bankruptcy Act permits the trustee of a bankrupt to make void certain transfers of property (the definition of which includes the grant of a mortgage) if full value was not given by the transferee. In order to take advantage of these sections, however, the trustee has to repay to the transferee all consideration that the transferee gave to the bankrupt. As the granting of a secured loan almost by definition presupposes the lender giving full value for the creation of the mortgage interest in the security property (even if the loan secured is an old one, then the mortgagee is presumably giving consideration in the form of forbearance to sue or extension of a loan facility), it is difficult to imagine a situation in which these sections could cause any difficulty for a mortgagee.

[26] Banque Financière De La Cité v. Parc (Battersea) Limited [1998] 1 All ER 737
[27] At paragraph 28.

Section 122: unfair preference

S 122 provides that transfers of property by an insolvent person in favour of a creditor is void against the trustee if the transfer "had the effect of giving the creditor a preference, priority or advantage over other creditors" and was made with the prescribed period. In the case of a bankruptcy resulting from a creditor's petition, the prescribed period commences six months prior to the presentation of the petition and ends on the day the bankruptcy order is made. Subsection (2) (a), however, protects from the operation of this section "a purchaser, payee or encumbrancer in the ordinary course of business who acted in good faith and who gave consideration at least as valuable as the market value of the property". Subsection 4 (c) provides that "good faith" is deemed not to exist if:

> the transfer of property was made under such circumstances as to lead to the inference that the creditor knew, or had reason to suspect:
>
> (i) that the debtor was unable to pay his or her debts as they became due from his or her own money; and
>
> (ii) that the effect of the transfer would be to give him or her a preference, priority or advantage over other creditors.

In most mortgage transactions no preference will exist as the mortgagee will not be a pre-existing creditor of the mortgagor. If, however, a mortgage is granted to secure a formerly unsecured debt or a mortgage is granted which secures both an old unsecured debt and a new advance, then the mortgagee will have been preferred over other creditors to the extent that the formerly unsecured debt is now secured. Although a sub-section (2)(a) defence would be potentially open to the mortgagee in such a case, the fact that the creditor saw the need to secure the formerly unsecured debt might be taken by the court to suggest that the creditor had a suspicion that the debtor could not pay the former debt from his own monies, and thus "good faith" would not be made out. An example of a mortgage being set aside (but only to the extent it secured a prior unsecured loan).

Section 123: protection from relation back

S 123 protects, subject to certain earlier provisions, including sections 120 to 122, from being invalidated by the doctrine of relation back certain transactions, the specification of which would include the grant of a mortgage. Such transactions are protected if they took place before the actual sequestration order was made; the person other than the debtor (in the present case the mortgagee) had no knowledge of the presentation of a petition against the debtor; and the transaction "was in good faith and in the ordinary course of business". Subsection (2) provides that the mere knowledge by the other person (ie mortgagee) of the commission of an act of bankruptcy by the debtor (such as failure to meet a bankruptcy notice with payment) does not deem a transaction not to be in good faith and the ordinary course of business.

Thus if a mortgage is granted after an act of bankruptcy occurs, and a creditor's petition is presented within 6 months after the act of bankruptcy, and that petition ultimately results in a sequestration order being made, then the mortgage will be invalidated by the doctrine of relation back (which holds that from the relation back date the debtor is deemed not to have owned his property but for it to have been vested in the trustee), unless the mortgagee can establish the defence of "good faith and the ordinary course of business". In the context of s 123, "good faith" refers to the fact that valuable consideration is given, there was no collusive arrangement with the debtor, and there was otherwise no intent to defraud. The

words “in the ordinary course of business” mean, essentially, that the non-debtor party is treating the transaction as any other normal transaction, and it is not entered into with suspected bankruptcy in view.

One would expect that the great majority of mortgage transactions would satisfy both tests of “good faith” and “in the ordinary course of business”, but nonetheless there is still the potential for expense and delay in recovery caused by having to establish these matters if a trustee attempted to set aside the mortgage. Further, it should be borne in mind that if a creditor’s petition is known by the mortgagee (or his agent) to have been presented then the defence of “good faith and in the ordinary course of business” is no longer available.

It is clear from the High Court’s analysis on p 106 of the previously-cited *Burns v Stapleton* that mortgages are not immune from being set aside under the doctrine of relation back. In that analysis, the Court rules on the argument that the legal mortgage- which was entered into within the relation-back period- was invalidated *in toto* by reason that relation back of the bankruptcy meant that the bankrupt had no title to grant the mortgage at the time he purported to do so. The Court determines that the legal mortgage is not invalidated by the doctrine of relation back, but only because the security was previously subject to an equitable mortgage in favour of the creditor, and all that occurred during the relation back period was the transformation of an equitable mortgage into a legal mortgage.

3. Is it Better Not to Perform a Bankruptcy Search?

If a bankruptcy search is never performed, then the mortgagee has much less chance of realizing that a creditors petition has been presented (if that be the case) and thus will not have a s 123 defence invalidated by knowledge of the same. On the other hand, a deliberate policy of refusing to make bankruptcy searches in case one discovered a creditor’s petition might negative the “good faith” component of the defence of “good faith and in the ordinary course of business”. Further, without a bankruptcy search the risk is always run that a sequestration order has in fact been made against the mortgagor prior to the mortgage being executed, which would invalidate the mortgage as against the trustee notwithstanding the lack of knowledge (although the lender would be protected by the indefeasibility provisions if the mortgage was not an all monies mortgage). It is thus prudent for a prospective mortgagee to make bankruptcy search shortly before the mortgagee commits itself to the loan, and then to refuse to lend if the search reveals that a creditor’s petition has been presented and is still current (or, of course, if the mortgagor is an undischarged bankrupt). If the bankruptcy search revealed a bankruptcy notice had been issued and not lapsed or been satisfied (or an act of bankruptcy by the debtor was known by some other means), then the possible complications if bankruptcy resulted might again induce a mortgagee not to lend, although the risks are far less than if a creditor’s petition was known to have already been presented.

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