

NSW LAW REFORM COMMISSION

## REPORT 107

### Guaranteeing someone else's debts

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# NEW SOUTH WALES LAW REFORM COMMISSION

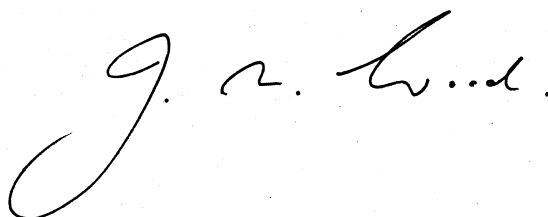
## Letter to the Attorney General

To the Honourable Bob Debus MP  
Attorney General for New South Wales

Dear Attorney

### Guaranteeing someone else's debts

We make this Report pursuant to the reference to this Commission received 2 March 1999.

A handwritten signature in black ink, appearing to read 'J. Wood', is centered on the page. The signature is written in a cursive style with a large initial 'J' and a period after the name.

The Hon James Wood AO QC  
Chairperson

Justice Michael Adams  
Master Joanne Harrison  
Justice David Hodgson  
Professor Michael Tilbury  
November 2006

## TABLE OF CONTENTS

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Terms of reference .....	xi
Participants .....	xii
Previous publications .....	xiii
Outline of this Report .....	xiv
RECOMMENDATIONS .....	xvii
<b>1. INTRODUCTION .....</b>	<b>1</b>
NATURE AND CONTEXT OF GUARANTEES .....	2
Definition .....	2
A secondary obligation .....	3
Functions .....	3
Incidence .....	4
WHAT MAKES CONTRACTS OF GUARANTEE SO PROBLEMATIC? .....	5
<b>2. GUARANTEES IN NEW SOUTH WALES LAW AND PRACTICE .....</b>	<b>9</b>
GENERAL LAW .....	10
Unconscionability .....	11
Undue influence .....	12
Yerkey and Garcia .....	14
Other doctrines .....	17
STATUTORY REGULATION .....	18
Unjust contracts and unconscionable conduct .....	20
Misleading or deceptive conduct .....	24
Relief available .....	24
Limitations on the reach of statutory regulatory regimes .....	27
REGULATION OF GUARANTEES UNDER THE	
CONSUMER CREDIT CODE .....	29
OTHER PARTICULAR STATUTORY REGULATION .....	30
Anti-Discrimination Act .....	30
Farm Debt Mediation Act .....	31
Controlling contractual terms .....	31
INDUSTRY PRACTICE .....	32
AN OVERVIEW .....	34
<b>3. GUARANTEES IN HISTORICAL AND COMPARATIVE PERSPECTIVE .....</b>	<b>35</b>

BAN ON WOMEN AS SURETIES.....	36
Roman law.....	36
Later development.....	38
HUMAN RIGHTS AND EQUAL OPPORTUNITY .....	38
Effect of the German Basic Law .....	39
United States Equal Credit Opportunity Act.....	41
LIMITING THE USE OF PARTICULAR	
PROPERTY AS SECURITY.....	46
United States homestead laws .....	46
Canadian homestead laws .....	49
New Zealand homestead laws.....	50
New South Wales homestead laws .....	51
REGULATING TRANSACTIONS .....	53
European Community Directives .....	53
United States Trade Commission Regulations .....	58
Consent requirements in Canadian homestead laws .....	59
<b>4. REFORMING THE LAW.....</b>	<b>61</b>
INTRODUCTION.....	62
POLICY OBJECTIVES.....	62
Protecting third party guarantors from unfairness.....	62
Promoting commercial certainty for lenders.....	65
Accommodating the interests of guarantors and lenders.....	65
INADEQUACIES OF THE PRESENT LAW .....	66
A regulatory mosaic.....	66
Reactive regulation .....	67
Uncertainty .....	68
Inapplicability of preventive regulation to business loans .....	69
Failure to endorse industry standards.....	70
RULING OUT SOME REFORM OPTIONS .....	71
Prohibiting third party guarantees.....	71
Restricting the use of the family home.....	73
Leaving regulation solely to the financial industry.....	74
HOW TO ACHIEVE REFORM .....	76
Amending the Consumer Credit Code.....	78

Enacting a NSW statute to exist alongside the Consumer Credit Code .....	79
Pursuing a uniform law initiative .....	80
Improving industry codes of practice .....	81
The Model Law and the general law .....	82
<b>5. SCOPE OF THE MODEL LAW .....</b>	<b>83</b>
GUARANTEES SUPPORTING CREDIT CONTRACTS .....	84
NOT-FOR-PROFIT LENDERS.....	85
GUARANTEES RELATING TO BUSINESS LOANS.....	86
Small businesses and consumer law.....	87
Defining "small business".....	90
Guarantees relating to other business loans .....	93
ARTIFICIAL PERSONS .....	93
COMPANY DIRECTORS AS GUARANTORS .....	94
RELATED CONTRACTS .....	96
Indemnity .....	96
Third party mortgages.....	99
CONTRACTING OUT .....	101
<b>6. ENTERING INTO THE CONTRACT.....</b>	<b>105</b>
INTRODUCTION.....	106
PRE-CONTRACTUAL DISCLOSURE.....	106
Current requirements.....	106
Privacy.....	110
Submissions .....	115
Conclusion .....	118
INDEPENDENT LEGAL AND FINANCIAL ADVICE.....	121
Current requirements.....	122
Submissions .....	124
Empirical background .....	130
Conclusion .....	135
SIGNING THE DOCUMENTS.....	139
Empirical background .....	140
Conclusion .....	140
<b>7. FORM OF THE CONTRACT .....</b>	<b>143</b>

INTRODUCTION.....	144
SHOULD A GUARANTEE BE IN WRITING? .....	145
PLAIN ENGLISH AND LEGIBILITY OF DOCUMENTS.....	147
The common law .....	147
Consumer Credit Code .....	148
Contracts Review Act .....	149
Empirical background .....	150
SUBMISSIONS TO ISSUES PAPER 17 .....	152
Technical specifications .....	152
Consequences of failure to comply with formalities .....	153
CONCLUSION .....	153
<b>8. TERMS OF THE CONTRACT .....</b>	<b>155</b>
“ALL MONEYS” CLAUSES .....	156
Definition.....	156
The common law .....	157
Consumer Credit Code .....	157
Codes of practice.....	158
Empirical background .....	159
Submissions to Issues Paper 17 .....	160
Conclusion .....	164
THE PRINCIPLE OF CO-EXTENSIVENESS.....	167
CONCLUSIVE EVIDENCE CLAUSES .....	171
<b>9. ASPECTS OF THE LIFE OF THE CONTRACT .....</b>	<b>177</b>
COOLING OFF PERIOD.....	178
Current law and industry standards .....	178
Empirical background .....	179
Arguments for and against.....	180
The Commission's conclusion .....	180
DISCLOSURE OF INFORMATION.....	181
Empirical background .....	181
Obligations and liabilities .....	182
Information on the status of the guaranteed loan .....	183
Notice of the Borrower's Default .....	187
Guarantor's access to information and the Privacy Act 1988 (Cth) .....	187

CHANGES TO OBLIGATIONS .....	188
Increase in liabilities.....	189
Changes by agreement .....	191
Unilateral changes .....	193
<b>10. TERMINATION AND ENFORCEMENT .....</b>	<b>195</b>
INTRODUCTION.....	196
TERMINATION BY EARLY REPAYMENT .....	196
General law .....	196
Consumer Credit Code .....	196
Industry codes of practice.....	198
The Commission's conclusion .....	198
NOTICE OF THE BORROWER'S DEFAULT.....	199
The Commission's position.....	200
Remedying the borrower's default .....	202
PURSUING THE BORROWER BEFORE THE GUARANTOR .....	202
The current law .....	202
Arguments for and against reform .....	204
The Commission's conclusion .....	205
ENFORCEMENT COSTS .....	207
Empirical background .....	207
What are enforcement expenses? .....	208
Credit provider's internal costs .....	209
Reasonably incurred and reasonable amount? .....	210
Excessive enforcement expenses .....	211
The Commission's conclusion .....	212



<b>11. UNJUST GUARANTEES.....</b>	<b>213</b>
INTRODUCTION.....	214
POWER TO REOPEN UNJUST GUARANTEES.....	217
Unjust guarantees .....	217
Time.....	218
Interrelated arrangements .....	220
GENERAL MATTERS TO BE CONSIDERED BY THE COURT .....	220
Public interest .....	221
All the circumstances of the case .....	222
SPECIFIC MATTERS TO BE CONSIDERED BY THE COURT.....	223
General discussion .....	223
Consequence of compliance or noncompliance .....	224
Relative bargaining power .....	225
Whether provisions were subject of negotiation .....	225
Capacity and willingness to negotiate.....	226
Unreasonable or unnecessary provisions.....	227
Age, or physical or mental condition.....	227
Form and intelligibility of the guarantee .....	228
Independent or other expert advice .....	228
Accurate explanation and degree of understanding .....	229
Unfair pressure, undue influence or unfair tactics.....	230
Ensuring an understanding of the nature and implications of the guarantee.....	231
Capacity to satisfy the debt.....	231
Justification of terms and conduct in light of the risks undertaken by the lender .....	232
Comparable guarantee transactions.....	232
Any other relevant factor.....	234
Other factors not covered by the Consumer Credit Code .....	234
GRANTING RELIEF.....	239
Justification for a statutory regime .....	239
Principal relief .....	240
Ancillary or consequential relief .....	242
Relevance of parties' conduct after the contract was entered into.....	244

<b>12. DISPUTE RESOLUTION</b> .....	<b>245</b>
INTRODUCTION.....	248
EMPIRICAL BACKGROUND .....	248
NEGOTIATION.....	249
Postponement by parties .....	250
Court-ordered postponement.....	251
The Commission's conclusions .....	252
TRIBUNAL PROCEEDINGS .....	253
MEDIATION .....	256
INDUSTRY-BASED DISPUTE RESOLUTION SCHEMES .....	260
Banks.....	261
Credit Unions and Building Societies.....	262
The Commission's conclusions .....	263
<b>APPENDIX</b> .....	<b>265</b>
Submissions .....	266
<b>TABLES</b> .....	<b>267</b>
Table of legislation.....	277
Table of cases .....	268
<b>BIBLIOGRAPHY</b> .....	<b>290</b>
<b>INDEX 298</b> .....	

## Terms of reference

On 2 March 1999, the Attorney General, the Hon Jeff Shaw QC MLC, asked the Commission:

*[T]o inquire into and report on the legal framework for the protection of guarantors of small business and other loans and in particular, to consider:*

- 1. whether the present legal framework adequately protects the interests of personal guarantors of small business and other loans;*
- 2. whether there is a reasonable level of satisfaction in the community with the operation and application of the existing laws protecting guarantors of small business and other loans, in particular, whether those guarantors, financiers and principal borrowers are satisfied with the present legal framework;*
- 3. whether there are more practical and effective strategies for the provision of personal guarantees of small business and other loans that would enhance the development of conscientious lending practices while not placing undue constraints on small business lending; and*
- 4. any related matters.*

In carrying out its review the Commission is to have regard to:

*The report of the Expert Group on Family Financial Vulnerability “Good Relations: High Risks - Financial Transactions Within Families and Between Friends” released by the Commonwealth Attorney General in February 1996, and any other relevant reviews;*

*The effectiveness of current New South Wales legislation with particular reference to the Contracts Review Act 1980 and the Fair Trading Act 1987; and*

*The need to ensure that any legal framework governing this issue adequately and effectively protects the interests of personal guarantors; promotes commercial stability and certainty; and does not unduly restrain small business lending.*

## Participants

Pursuant to s 12A of the *Law Reform Commission Act 1967* (NSW) the Chairperson of the Commission constituted a Division for the purpose of conducting the reference. The members of the Division are:

Justice Michael Adams

Associate Justice Joanne Harrison

Justice David Hodgson

Professor Michael Tilbury\*

Hon James Wood AO QC

(\* denotes Commissioner-in-Charge)

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## Previous publications

### *Issues Paper 17*

In May 2000, the Commission released Issues Paper 17, *Guaranteeing someone else's debts*. It raised questions on issues relating to third party guarantees. The Commission received 21 submissions in response to the Issues Paper. The Appendix contains a full list of individuals and organisations that made submissions. The Commission has taken account of the views expressed in submissions in formulating the recommendations in this Report.

### *Research Report 11*

Between 2000 and 2003, the Law Reform Commission and the Faculty of Law at the University of Sydney conducted the first comprehensive Australian empirical research into the law and practices governing third party guarantees. An Australian Research Council Strategic Partnerships in Industry, Research and Training Grant funded the project.

The research was aimed at finding out more about the experiences of people who guarantee the loans of others, including why they agree to be guarantors; how they get into trouble in those transactions; and what might have assisted them in avoiding such difficulties.

The researchers sought demographic information about guarantors (for example, their sex, age and cultural backgrounds) and about their relationship with the borrower. They also obtained information relating to the formation and execution of the transaction, such as how the transaction was executed; who organised the guarantee; where it was signed; who was present, what information the guarantor had; and the guarantor's understanding of the transaction at the time the guarantee was signed. Further, they elicited information on how guarantors discovered that there were problems with the transaction; what they did; who they sought assistance from; and what kind of dispute resolution mechanism, if any, they pursued.

The researchers gathered data primarily by interviewing guarantors. They also sought information from legal advisers who had acted for guarantors during the transaction and those who had acted for either guarantors or lenders when post-transaction difficulties arose. Further, they obtained the views of barristers and judges about the litigation phase of guarantee disputes. Finally, they surveyed judgments of litigated guarantee cases.

The results of the study were published in 2003 as Research Report 11, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales*. This study is referred to in this Report as "Lovric and Millbank", after its authors.

The Lovric and Millbank study was circulated widely to relevant individuals and organisations. The Australian Bankers' Association made a submission to the Commission in response to the Lovric and Millbank study.

The results of the study have greatly assisted the Commission in identifying specific problems relating to guarantees, as well as in formulating recommendations to address the problems. Relevant aspects of the study are discussed throughout this Report.

## Outline of this Report

This Report consists of 12 chapters:

**Chapter 1** (Introduction) discusses the legal nature of the contract of guarantee, the purposes it serves and its incidence. It also explores why contracts of guarantee are so problematic for the law.

**Chapter 2** (Guarantees in New South Wales Law and Practice) surveys the current law and practice relating to contracts of guarantee. It considers the ways in which guarantees are regulated generally at common law, by statute and by industry codes of practice. It also considers more particular statutory regulatory schemes.

**Chapter 3** (Guarantees in Historical and Comparative Perspective) canvasses approaches that various legal systems have taken to address the problems presented by guarantees. These approaches range from placing a ban on women entering guarantees and placing particular assets beyond the reach of creditors who seek to enforce a guarantee, to more holistic attempts at ensuring equality of bargaining power or fair dealing on the part of lenders.

**Chapter 4** (Reforming the Law) identifies the policy objectives underlying contracts of guarantee as protecting guarantors from unfairness and providing commercial certainty for lenders. It then examines the extent to which the current law fails to achieve these objectives. It notes various suggested reform options that are considered incompatible with the achievement of the identified objectives. Finally, it specifies the most effective means of achieving reform, recommending that New South Wales initiate discussions with other Australian jurisdictions to develop a uniform law relating to guarantees. The proposed uniform law is referred to as the "Model Law".

**Chapter 5** (Scope of the Model Law) identifies the types of guarantees to which the Model Law should apply. Accepting that the Commission's terms of reference restrict our recommendations to guarantees in support of "credit contracts", the Chapter discusses whether the Model Law should apply where the credit provider is not in the business of providing credit; where guarantees are given in support of a loan for the purposes of small businesses; where either the borrower or the guarantor are not natural persons; and where company directors guarantee a loan to the company. This chapter also addresses the extent to which the Model Law should apply to indemnities and third party mortgages. Finally the chapter considers the extent to which parties should be able to contract out of the Model Law.

**Chapter 6** (Entering into the Contract) considers issues that arise prior to and at the signing of a guarantee, in particular:

- the types of information that lenders should be required to disclose to assist a prospective guarantor in making an informed decision about the transaction;
- the merits of requiring a "cooling off" period between the time when the lender discloses the required information to a prospective guarantor and the signing of the guarantee;

- the desirability of requiring lenders to advise every prospective guarantor to obtain independent legal and financial advice; and
- whether the borrower should be absent when the guarantor signs the guarantee, as a measure to prevent undue pressure or influence.

**Chapter 7** (Form of the Contract) discusses the need to ensure that the guarantee is in a form that a prospective guarantor can easily understand. It considers whether every guarantee should be in writing, and how it should be expressed and presented.

**Chapter 8** (Terms of the Contract) examines three topics that relate to the terms of guarantees: “all moneys clauses”, which extend a guarantor’s liability to secure future credit for the borrower; clauses that modify the operation of the “co-extensiveness” principle, which makes the liability of a guarantor co-extensive with that of the borrower; and conclusive evidence clauses.

**Chapter 9** (Aspects of the Life of the Contract) deals with the following issues that arise subsequent to the execution of a guarantee:

- whether guarantors should have a right to a post-contract “cooling off” period, that is, a specific time frame within which they should be allowed to withdraw unilaterally from the contract;
- the types of information a guarantor should be entitled to receive from the credit provider during the life of the contract; and
- the rights and obligations of the parties when there are changes to the contract of guarantee or to the principal contract to which the guarantee relates.

**Chapter 10** (Termination and Enforcement) analyses the issues that relate to the termination and enforcement of guarantees, namely:

- whether guarantors should be allowed to pay out the guaranteed loan early as a means of discharging the guarantee;
- whether credit providers should be obliged to notify guarantors of default by the borrower, and in particular, whether this should be a prerequisite to the commencement of legal proceedings to enforce the guarantee;
- whether credit providers should be required to exhaust their remedies against borrowers prior to the enforcement of guarantees; and
- the extent to which credit providers should be allowed to recover from guarantors the costs incurred in enforcing the guarantee.

**Chapter 11** (Unjust guarantees) examines the extent to which the Model Law should give courts power to deal with guarantees that are, in the circumstances, unjust and, if so, what the criteria of “unjustness” should be and what relief the courts may grant.

**Chapter 12** (Alternative Dispute Resolution) surveys means of resolving disputes other than through court proceedings, in particular: by postponement of court proceedings to

facilitate settlement; through proceedings before the Consumer, Trader and Tenancy Tribunal of NSW; by mediation; and through industry-based dispute resolution schemes.



## LIST OF RECOMMENDATIONS

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### RECOMMENDATION 4.1 – see page 81

New South Wales should initiate discussions with other Australian jurisdictions to develop and enact a uniform law (the “Model Law”) relating to contracts guaranteeing another’s debt. The Model Law should implement the recommendations in this Report.

### RECOMMENDATION 4.2 – see page 82

Sectors of the finance industry that use guarantees should adopt codes of practice that are consistent with applicable recommendations in this Report.

### RECOMMENDATION 4.3 – see page 82

The Model Law should not derogate from rights and remedies that exist apart from the Model Law.

### RECOMMENDATION 5.1 – see page 85

The Model Law should apply to guarantees that relate to a “credit contract”, defined as a contract under which credit is or may be provided. “Credit” is provided if under a contract: (a) payment of a debt owed by one person (the borrower) to another (the lender) is deferred; or (b) one person (the borrower) incurs a deferred debt to another (the lender).

### RECOMMENDATION 5.2 – see page 86

The Model Law should apply to guarantees relating to the provision of credit if:

- a charge is made or may be made for providing the credit; and
- the lender provides the credit in the course of a business of providing credit or as part of or incidentally to any other business of the lender.

### RECOMMENDATION 5.3 – see page 92

The Model Law should apply to every guarantee that secures credit provided, or intended to be provided, wholly or predominantly for personal, domestic or household purposes, or for the purpose of a trade or business carried on by a small business.

“Small business” means a business that employs fewer than 20 full time (or equivalent) people and that is not a publicly listed company, unincorporated cooperative or incorporated association, or a subsidiary of another company.

### RECOMMENDATION 5.4 – see page 94

The Model Law should apply to guarantees whether or not the borrower and guarantor are natural persons.

### RECOMMENDATION 5.5 – see page 96

Recommendations 6.1, 6.2, 6.3, 6.6, 6.8, 9.1 and 9.2 do not apply to a sole director guarantor.

### RECOMMENDATION 5.6 – see page 99

Except in relation to the matters covered by Recommendations 8.2 and 10.4, the Model Law should apply to contracts of indemnity.

**RECOMMENDATION 5.7** – see page 103

The Model Law should render void contractual terms that seek to exclude or modify its effect. The Law should be expressed in terms similar to s 169 of the *Consumer Credit Code* and should include a provision for the recovery by the guarantor of any money paid or property transferred under a contract containing such provisions.

**RECOMMENDATION 6.1** – see page 120

The Model Law should provide that a lender must make available to the prospective guarantor the financial information concerning the borrower's circumstances that the lender treats as relevant to the borrower's risk. The prospective guarantor should be provided with copies of:

- any related credit contract, together with a list and description of any related security contract (and a copy of that security contract if requested by the prospective guarantor);
- any related credit report from a credit reporting agency;
- any current credit-related insurance contract concerning the borrower in the lender's possession;
- the latest statement of account relating to the credit facility, and financial accounts or statement of financial position of the borrower from the previous two years;
- any unsatisfied notice of demand made in relation to the credit facility in the previous two years;
- the final letter of offer; and
- the loan application.

If the loan application does not set out the assets and liabilities, income and expenditure (or the equivalent corporate documents) of the borrower, the documents provided with the loan application that contain this information should also be provided to the prospective guarantor.

**RECOMMENDATION 6.2** – see page 121

The Model Law should provide that the lender must notify the prospective guarantor of:

- any notice of demand made by the lender on the borrower, or any dishonour on any facility the borrower has (or has had) with the lender, in the previous 2 years; and
- any excess or overdrawing on any facility the borrower has (or has had) with the lender in the previous six months. The lender must provide a list of any such excesses or overdrawings.

The lender must tell the prospective guarantor if the loan will not be made if the guarantee is not provided.

**RECOMMENDATION 6.3** – see page 121

The Model Law should provide that failure to comply with the requirements set out in Recommendations 6.1 and 6.2 renders the guarantee unenforceable.

**RECOMMENDATION 6.4** – see page 139

The Model Law should provide that the contract of guarantee should contain a warning in the terms of Form 4 of the *Consumer Credit Regulation*, with the modifications set out below.

The warning should appear directly above the place where the guarantee is to be signed, be printed in bold and in a larger font than the rest of the document, and in all other respects comply with s 20 of the *Consumer Credit Regulation*.

The words “You should obtain independent legal advice” and “You should also consider obtaining independent financial advice” currently appearing in Form 4 should be replaced by “You are strongly advised to obtain independent legal and financial advice, in the absence of the borrower”.

**RECOMMENDATION 6.5** – see page 139

The Model Law should provide that the lender must give to the prospective guarantor an information statement in the form of Form 5A of the *Consumer Credit Regulation*.

**RECOMMENDATION 6.6** – see page 139

The Model Law should provide that a guarantee should not be signed before the expiry of one business day following the provision of the information and documentation referred to in Recommendation 6.1.

**RECOMMENDATION 6.7** – see page 139

The Model Law should provide that a guarantee is not enforceable unless the requirements set out in Recommendations 6.4, 6.5 and 6.6 have been complied with.

**RECOMMENDATION 6.8** – see page 141

The Model Law should provide that the warning in the form of Form 4 of the *Consumer Credit (New South Wales) Regulation* should include the following words:  
“You are advised to sign the guarantee and any supporting security in the absence of the borrower.”

**RECOMMENDATION 7.1** – see page 147

The Model Law should adopt the provisions of s 50 of the Consumer Credit Code requiring a guarantee to be in writing.

**RECOMMENDATION 7.2** – see page 154

The Model Law should adopt the requirements in s 162 of the *Consumer Credit Code* and s 39 and 39A of the *Consumer Credit Regulations* relating to the legibility and language of guarantees and notices.

**RECOMMENDATION 8.1** – see page 167

The Model Law should adopt the provisions of s 54 of the *Consumer Credit Code* relating to “all moneys” clauses.

The copy of the proposed future credit contract given to the guarantor pursuant to the adapted s 54 of the *Consumer Credit Code*, should contain a notice, in plain language, explaining that the extension of credit will extend the guarantor’s liability under the guarantee.

In addition to giving the guarantor a copy of the proposed future credit contract, the lender should provide the guarantor with information in writing on the current status of the original credit contract, including the current balance of the debtor’s account; any amounts currently overdue and when each such amount became due; and any amount currently payable and the date it became due.

**RECOMMENDATION 8.2** – see page 171

The Model Law should adopt the provisions of s 55 of the *Consumer Credit Code* so that the guarantor's liability cannot exceed that of the borrower (except where the borrower has died, is insolvent or incapacitated).

**RECOMMENDATION 8.3** – see page 176

The Model Law should provide that a term of a guarantee to the effect that a certificate, statement or opinion of any person is to be received as conclusive evidence of any fact contained therein should be construed to mean only that such certificate, statement or opinion is to be received as prima facie evidence of that fact.

**RECOMMENDATION 9.1** – see page 181

The Model Law should provide that a guarantor should be allowed to withdraw from a guarantee within one clear business day from the execution of such contract.

**RECOMMENDATION 9.2** – see page 183

The Model Law should contain requirements (similar to those found in s 52 of the *Consumer Credit Code*) that a lender must, not later than 14 days after a guarantee is signed and given to the lender, give the guarantor: (a) a copy of the guarantee signed by the guarantor; and (b) a copy of the credit contract.

**RECOMMENDATION 9.3** – see page 183

The Model Law should contain requirements (similar to those found in s 163 of the *Consumer Credit Code*) that the lender give the guarantor, at the written request of the latter, during the life of the contract, a copy of the credit contract or guarantee.

**RECOMMENDATION 9.4** – see page 187

The Model Law should provide that guarantors should have a right to obtain information from lenders during the life of the guarantee, in terms similar to s 34 of the *Consumer Credit Code*. Further, the Model Law should contain a provision (similar to s 35 of the *Consumer Credit Code*) that, if a lender fails to give a statement within the time required, the court may, on application by the guarantor, order the lender to provide the statement or itself determine the amounts in relation to which the statement was sought.

**RECOMMENDATION 9.5** – see page 191

The Model Law should contain provisions governing increases in liabilities similar to those in s 56 of the *Consumer Credit Code*, subject to some clarifications. First, the lender must give the guarantor, in addition to a copy of the proposed revised contract, a written notice explaining in plain language all the material facts concerning the proposed changes in the loan transaction to which the guarantee relates. Secondly, the lender must comply with these requirements before the changes have been settled with the borrower. Finally, failure by the lender to comply with these requirements should result in the guarantor not being liable for the increased amount although remaining liable for the amount originally guaranteed.

**RECOMMENDATION 9.6** – see page 193

The Model Law should adopt s 65 of the *Consumer Credit Code* concerning the notice requirement in relation to changes by agreement to the credit contract or guarantee. It should, however, state that in every case the written notice must explain in plain language all the material facts concerning the changes.

**RECOMMENDATION 9.7** – see page 194

The Model Law should contain provisions regulating unilateral changes by the lender to the terms of the guarantee, similar to those found in s 63 of the *Consumer Credit Code*. It should, however, clarify that the written notice should explain in plain language all the material facts concerning the proposed changes.

**RECOMMENDATION 10.1** – see page 199

The Model Law should give guarantors within its ambit the right to pay out the guaranteed loan as a means of discharging the guarantee, in terms similar to s 75-77 of the *Consumer Credit Code*.

**RECOMMENDATION 10.2** – see page 202

The Model Law should provide that lenders be required to notify guarantors regarding the borrowers' default. The notice, which should be accompanied by a copy of the default notice given to the borrower, should explain in plain language the effects on the guarantee of the borrower's default. It should be given simultaneously with the service of the default notice on the borrower. The Model Law should provide that the notice is a pre-condition to the commencement of legal proceedings to enforce the guarantee.

**RECOMMENDATION 10.3** – see page 202

The Model Law should adopt s 81 of the *Consumer Credit Code* concerning the consequences of the exercise by a guarantor of his or her right to remedy the borrower's default.

**RECOMMENDATION 10.4** – see page 207

The Model Law should require a lender to proceed against the borrower before enforcing the guarantee. Such requirement should be in terms similar to the provisions contained in s 138 of the *Credit Act 1984* (NSW).

**RECOMMENDATION 10.5** – see page 212

The Model Law should regulate enforcement expenses, in terms similar to s 99 of the *Consumer Credit Code*. However, it should clarify that lenders may recover only enforcement expenses that have been reasonably incurred and in amounts that are reasonable under the circumstances.

**RECOMMENDATION 11.1** – see page 218

Where the Court considers that a guarantee or a provision of a guarantee is, in the circumstances, unjust, the court should be able to reopen it.  
"Unjust" should include "unconscionable, harsh or oppressive".

**RECOMMENDATION 11.2** – see page 219

The Model Law should provide that, in determining whether a guarantee or a provision of a guarantee is unjust, the court is to have regard to the guarantee at the time when it was entered into or changed.

**RECOMMENDATION 11.3** – see page 219

The Model Law should provide that, in determining whether a guarantee or a provision of a guarantee is unjust, the court is not to have regard to any injustice arising from circumstances that were not reasonably foreseeable when the guarantee was entered into or changed.

**RECOMMENDATION 11.4** – see page 220

The Model Law should provide that, in determining whether a guarantee or a provision of a guarantee is unjust, the court may have regard to any arrangements consisting of an inter-related combination or series of contracts involving the guarantor where the guarantee being considered is a part of those arrangements.

**RECOMMENDATION 11.5** – see page 223

In determining whether a guarantee or a provision of a guarantee is unjust, the court is to have regard to the public interest and to all the circumstances of the case.

**RECOMMENDATION 11.6** – see page 236

In determining whether a guarantee or a provision of a guarantee is unjust in the circumstances relating to it at the time it was entered into or changed, the court should have regard to the public interest and to all the circumstances of the case, including such of the following as it considers relevant:

- (a) the consequences of compliance, or noncompliance, with all or any of the provisions of the guarantee;
- (b) the relative bargaining power of the parties;
- (c) whether or not, prior to, or at the time the guarantee was entered into or changed, its provisions were the subject of negotiation;
- (d) whether or not it was reasonably practicable for the guarantor to negotiate for the alteration of, or to reject, any of the provisions of the guarantee or the change, including the extent to which the lender was willing to negotiate the relevant terms and conditions;
- (e) whether or not any of the provisions of the guarantee or change impose conditions that are unreasonably difficult to comply with, or not reasonably necessary for the protection of the legitimate interests of the lender;
- (f) whether or not the guarantor, or a person who represented the guarantor, was reasonably able to protect the interests of the guarantor because of his or her age or physical or mental condition; (A person is taken to have represented a guarantor if the person represented the guarantor, or assisted the guarantor to a significant degree, in the negotiation process prior to, or at, the time the guarantee was entered into or changed.)
- (g) the relative economic circumstances, educational background and literacy of the parties to the guarantee, and of any person who represented any of the parties to the guarantee;
- (h) the form of the guarantee and the intelligibility of the language in which it is expressed;
- (i) whether or not, and under what circumstances, the guarantor was given the opportunity to seek legal or other expert advice;
- (j) whether or not, and if so when, the guarantor obtained independent legal or other expert advice;
- (k) the extent to which any person accurately explained the provisions of the guarantee or change, and their legal and practical effect, to the guarantor and whether or not the guarantor understood those provisions and their effect;
- (l) whether the lender or any other person exerted or used unfair pressure, undue influence or unfair tactics on the guarantor and, if so, the nature and extent of that unfair pressure, undue influence or unfair tactics;
- (m) whether the lender took measures to ensure that the guarantor understood the nature and implications of the guarantee and, if so, the adequacy of those measures;
- (n) whether at the time the guarantee was entered into or changed, the lender knew, or could have ascertained by reasonable inquiry of the borrower at the time, that the

- borrower could not pay in accordance with the terms of the guaranteed loan or could only do so with substantial hardship;
- (o) whether the terms of the guarantee or the conduct of the lender are justified in the light of the risks undertaken by the lender;
  - (p) the terms of other comparable guarantees involving other lenders and, if the injustice is alleged to result from excessive interest rates or other charges, the annual percentage rate or rates or other charges for which guarantors might become liable in comparable cases;
  - (q) the requirements of (i) any applicable industry code, or (ii) any other industry code with which the guarantor reasonably believed the lender would comply;
  - (r) whether, in entering the guarantee, the parties complied with the provisions of the Model Law or any other relevant statute;
  - (r) the conduct of the parties to the proceedings in relation to similar contracts or courses of dealing to which any of them has been a party; and
  - (s) any other relevant factor.

**RECOMMENDATION 11.7** – see page 242

The Model Law should provide that, in reopening a guarantee, and in order to avoid as far as practicable an unjust consequence or result, the court may do any one or more of the following, despite any settlement of accounts or any agreement purporting to close previous dealings and create a new obligation—

- (a) reopen an account already taken between the parties;
- (b) refuse to enforce any or all of the provisions of the guarantee;
- (c) set aside any provision of the guarantee in whole or in part,
- (d) vary any provision of the guarantee in whole or in part;
- (e) relieve a guarantor from payment of any amount in excess of such amount as the court, having regard to the risk involved and all other circumstances, considers to be reasonably payable;
- (f) in relation to a land instrument given by the guarantor, make an order for or with respect to requiring the execution of an instrument that:
  - (i) varies, or has the effect of varying, the provisions of the land instrument, or
  - (ii) terminates or otherwise affects, or has the effect of terminating or otherwise affecting, the operation or effect of the land instrument.

**RECOMMENDATION 11.8** – see page 244

The Model Law should provide that the court may also make such orders as may be just in the circumstances for or with respect to any consequential or related matter, including any of the following:

- (a) the making of any disposition of property,
- (b) the payment of money (whether or not by way of compensation) to a party to the guarantee,
- (c) the compensation of a person who is not a party to the guarantee and whose interest might otherwise be prejudiced by a decision or order under the Model Law,
- (d) the sale or other realisation of property,
- (e) the disposal of the proceeds of sale or other realisation of property,
- (f) the creation of a charge on property in favour of any person,
- (g) the enforcement of a charge so created,
- (h) the appointment and regulation of the proceedings of a receiver of property,
- (i) the rescission or variation of any order of the court under this clause, and

- (j) the submission of any aspect of the matter in dispute to mediation, and such other orders or relief in connection with the proceedings as may be just in the circumstances.

**RECOMMENDATION 11.9** – see page 245

The Model Law should provide that, in deciding whether to grant relief, the court may have regard to the conduct of the parties to the proceedings in relation to the guarantee since it was entered into.

**RECOMMENDATION 12.1** – see page 253

The Model Law should contain provisions similar to s 86-89 of the *Consumer Credit Code*, which provide for the postponement of court proceedings to allow the parties to negotiate a settlement. It should, however, additionally provide that the right to negotiate a postponement of proceedings only applies to credit contracts in respect of which the maximum amount of credit that is or may be provided is \$500,000 or less, or such other amount as may be prescribed by the regulations.

**RECOMMENDATION 12.2** – see page 256

The Model Law should grant jurisdiction to the Consumer, Trader and Tenancy Tribunal to resolve matters arising out of its provisions. Its jurisdiction should, however, be limited to cases where the amount claimed does not exceed \$500,000 or any other figure prescribed by the regulations.



# 1. Introduction

- Nature and context of guarantees
- What makes contracts of guarantee so problematic?

1.1 This Report marks the final stage of the Commission's investigation of the law relating to the guarantee by one person of a loan to another person. This situation typically involves a loan made by a financial institution, such as a bank, to a person who is in a family relationship with the guarantor. For example, the guarantor may be the borrower's parent or spouse. Typically too, the loan will be made to support the business activities of the borrower. The Commission and the Faculty of Law at the University of Sydney conducted the first comprehensive empirical study in Australia into this situation between 2000 and 2003.<sup>1</sup> Drawing on this study as well as on submissions made to this reference, the Report contains recommendations for the reform of the law. For reasons explained in Chapter 4, reform of this area of financial law can only sensibly be undertaken as a uniform initiative involving all Australian jurisdictions.

1.2 This chapter discusses the legal nature of the contract of guarantee, the purposes it serves and its incidence. It also explores why contracts of guarantee are so problematic for the law.

## NATURE AND CONTEXT OF GUARANTEES

### Definition

1.3 A guarantee is a contract in which the guarantor promises to answer to the person in whose favour the guarantee is given ("the creditor") for a debt or obligation of a principal debtor if the debtor defaults.<sup>2</sup>

1.4 Guarantees may be used to support a variety of obligations other than the payment of a debt. This reference is concerned only with guarantees in the context of loans. The principal debtor ("the borrower") borrows money from a creditor ("the lender"). The borrowing results in a contractual relationship between the borrower and the lender. The lender may also enter into a further contract, known as a contract of guarantee, with a person other than the borrower who guarantees that he or she will repay the loan if the borrower cannot or will not do so.

1.5 Guarantors are also sometimes referred to as "third party guarantors". The latter expression is used because the guarantor is not a party to the loan contract between the borrower and the lender.

1.6 Guarantors usually do not benefit from the loan. They may, however, provide a mortgage or charge over property as security for the guarantee.

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1. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* (NSW Law Reform Commission and University of Sydney, Research Report 11, 2003) ("Lovric and Millbank").
  2. See *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245 at 254 (Mason CJ); *Direct Acceptance Finance Ltd v Cumberland Furnishing Pty Ltd* [1965] NSWLR 1504 at 1509 (Walsh J); *Total Oil Products (Aust) Pty Ltd v Robinson* [1970] 1 NSWLR 701 at 703 (Asprey JA).

## A secondary obligation

1.7 The essential distinguishing feature of a contract of guarantee is the secondary, or ancillary, nature of the obligation that the guarantor assumes.<sup>3</sup> The guarantor's liability is secondary in the sense that it depends upon the principal debtor's continuing liability and, ultimately, the debtor's default.<sup>4</sup> The guarantor is not liable unless and until the principal debtor has failed to perform his or her obligations.<sup>5</sup>

1.8 At common law, the secondary liability of the guarantor does not prevent the creditor from enforcing the guarantee before instituting proceedings against the principal debtor. In other words, subject to legislative or contractual provision to the contrary, once the principal debtor is in default, the creditor may sue the guarantor instead of the debtor for the amount owed.<sup>6</sup>

## Functions

1.9 Guarantees are used in a broad range of situations. For example:

- The borrower has no substantial credit record, such as where the borrower is a young person or a recently formed company.
- The borrower, although credit-worthy, does not have sufficient assets to use as security for the loan.
- The borrower is a company and the lender needs security to meet the potential risks not only in the company's business but also those associated with the use of a corporate structure to operate the business. For example, to avoid its financial obligations to lenders, a company may divert funds and assets to its shareholders, related companies or beneficiaries. In the case of a company with a small paid-up capital, the lender may require its directors to give a personal guarantee as a security in case the limited liability of the company has the effect of it not meeting its financial obligations.
- A group of companies borrow from one financial institution. Each may be required to give a guarantee covering the debts of the others. This achieves group liability even though each company is a separate legal entity with potentially limited liability.

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3. See *McDonald v Dennys Lascelles Ltd* (1933) 48 CLR 457 at 479-80 (Dixon J) (suretyship).
  4. *Commercial Banking Co of Sydney Ltd v Patrick Intermediate Acceptances Ltd (in liq)* (1978) 52 ALJR 404 at 406 (Lord Diplock); *Guild & Co v Conrad* [1894] 2 QB 885 at 895 (Lopes LJ), 896 (Davey LJ).
  5. *Lakeman v Mountstephen* (1874) LR 7 HL 17 at 24 (Lord Selbourne); *Guild & Co v Conrad* [1894] 2 QB 885 at 895 (Lopes LJ); *Sampson v Burton* (1820) 129 ER 891 at 894 (Burrough J).
  6. *Yeoman Credit Ltd v Latter* [1961] 1 WLR 828 at 830-831 (Pearce LJ); *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245 at 255 (Mason CJ); *Jackson v Digby* (1854) 2 WR 540; *Moschi v Lep Air Services Ltd* [1973] AC 331 at 348 (Lord Diplock). Section 82 of the *Consumer Credit (New South Wales) Code 1995* (NSW) has modified this common law principle with respect to guarantees that relate to consumer loans: see para 10.24-10.25.

- The borrower has jointly owned property, which he or she wants to use as security. A guarantee from the co-owners coupled by a mortgage over the entire property in support of the guarantee relieves the lender of the need to ascertain the proportion of the property to which the debtor is entitled.<sup>7</sup>

1.10 Lenders use guarantees as a risk-minimisation device. They protect the lender's money in cases where the borrower does not have good credit or enough assets to use as security. Guarantees are also useful in loans made to businesses that are considered risky. By reducing lenders' exposure to risk, as well as the lenders' costs associated with risk assessments, they assist in making credit reasonably accessible and less costly. Without guarantees, many businesses may not be able to obtain credit. Additionally, credit would be more expensive since lenders impose higher interest rates and charges as the price for insufficient security for credit risks.<sup>8</sup>

## Incidence

1.11 There are no reliable or comprehensive statistics on the incidence of third party guarantees in Australia. Some financial institutions provided estimates of such guarantees to the empirical inquiry conducted by the Commission and the Faculty of Law at the University of Sydney.<sup>9</sup> These estimates relate to guarantees in the context of business loans. Lenders claimed that this type of guarantee is far more common than guarantees in support of consumer borrowing. They attribute this to the fact that businesses are often undercapitalised and do not have sufficient assets to provide security in their own right, which leads them to obtain guarantees and other forms of security quite frequently. The lenders also speculated that the requirements imposed by the *Consumer Credit (New South Wales) Code* on guarantees related to consumer loans might explain, in part, the infrequent use of this type of guarantee.<sup>10</sup>

1.12 One bank estimated that 75% of its small business loans are supported by a guarantee. This is consistent with one peak lending body's estimate that in business lending, guarantees are required in more than 70% of cases. Submissions asserted that most smaller lenders in the business finance market require guarantees from directors in relation to company loans. One small lender said that it required guarantees in 39% of its small business loans. However, another estimated that it requires a guarantee in only approximately 5% of small business loans.<sup>11</sup>

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7. A J Duggan, *The Law of Guarantee in Australia* (4th edition, Australian Finance Conference Limited and Australian Equipment Lessors Association Inc, Sydney, 1998) at para 1.1; Australia, Expert Group on Family Financial Vulnerability, *Good Relations, High Risks: Financial Transactions Within Families and Between Friends* (Report, 1996) at 13; R Jukic, *Till Debt us do Part* (Consumer Credit Legal Service, Melbourne, 1994) at 13.
  8. See Australia, Trade Practices Commission, *Guarantors: Problems and Perspectives* (Discussion Paper, 1992) at 16-18.
  9. Lovric and Millbank at para 4.48.
  10. Lovric and Millbank at para 4.51.
  11. Lovric and Millbank at para 4.49-4.50.

## WHAT MAKES CONTRACTS OF GUARANTEE SO PROBLEMATIC?

1.13 Guarantees have generated an enormous volume of litigation in the past 20 years. Unsurprisingly, they have formed the subject of a number of investigations, including a report published in 1996 by the Expert Group on Family Financial Vulnerability.<sup>12</sup>

1.14 Guarantees are highly susceptible to unfair dealings for a number of reasons. They are generally not well understood in the community. Some guarantors, for example, sign a guarantee in the belief that that they are acting simply as a referee for the borrower.<sup>13</sup> Even when they know of their potential liability, many guarantors think they will never be called on to repay the loan. Many believe guarantees pose little or no financial risk.<sup>14</sup>

1.15 A recurring and highly significant theme in guarantee transactions is the personal relationship between the borrower and guarantor. Many guarantors are spouses (usually wives),<sup>15</sup> parents, other relatives or close friends of the borrower. If the borrower is in default, the creditor will usually attempt to recover the money from the guarantor. Hence, this phenomenon has been called “sexually transmitted debt”, “emotionally transmitted debt”<sup>16</sup> or “relationship debt”.<sup>17</sup>

1.16 On the one hand, the emotional relationship between the borrower and guarantor means the guarantor is vulnerable to unfair conduct on the part of the borrower and/or

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12. Australia, Expert Group on Family Financial Vulnerability, *Good Relations, High Risks: Financial Transactions Within Families and Between Friends* (Report, 1996). Other reports on guarantees include: Australia, Trade Practices Commission, *Guarantors: Problems and Perspectives* (Discussion Paper, 1992); Australia, House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change: Banking and Deregulation* (AGPS, Canberra, 1991); Australian Law Reform Commission, *Equality Before the Law: Women's Equality* (Report 69, Part 2, 1994); R Jukic, *Till Debt do us Part* (Consumer Credit Legal Service, Melbourne, 1994); S Singh, *For Love Not Money: Women, Information and the Family Business* (Consumer Advocacy and Financial Counselling Association of Victoria Inc, Melbourne, 1995).
  13. A J Duggan, *The Law of Guarantee in Australia* (4th edition, Australian Finance Conference Limited and Australian Equipment Lessors Association Inc, Sydney, 1998) at para 1.1; Lovric and Millbank at para 3.71-3.73.
  14. Lovric and Millbank at para 3.44-3.49.
  15. Third party guarantees impact on women more significantly than on men: Australian Law Reform Commission, *Equality Before the Law: Women's Equality* (Report 69, Part 2, 1994) at 239. See also *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395 at 403-404 (Gaudron, McHugh, Gummow and Hayne JJ); *Barclays Bank plc v O'Brien* [1994] 1 AC 180 at 188 (Lord Browne-Wilkinson).
  16. Australian Law Reform Commission, *Equality Before the Law: Women's Equality* (Report 69, 1994) at 240 – drawing upon Paula Baron's coining of that term: see P Baron “The Free Exercise of Her Will: Women and Emotionally Transmitted Debt” (1995) 13 *Law in Context* 23.
  17. Australian Banking Industry Ombudsman Ltd, *Report on Relationship Debt* (Bulletin No 22, 1999).

lender. A significant number of guarantors have reported that they did not understand what they were doing at the time of the transaction.<sup>18</sup> Many do not engage in the usual inquiries that a person entering a business arrangement would undertake. Quite often, they do not receive information needed to understand the nature of the transaction and the risks involved.

1.17 On the other hand, many guarantors in a close relationship to the borrower agree to guarantee the borrower's indebtedness even where they fully comprehend the nature of the risks associated with the transaction into which they are entering. They do so simply because they do not want to damage their relationship with the borrower by refusing to act as a guarantor, viewing themselves as having no real choice about providing security for the underlying loan.<sup>19</sup> Speaking of the vulnerability of parents as guarantors for the debts of their children, Chief Justice Higgins and Justice Crispin recently said:

*[T]he real vulnerability of parents usually stems not from a failure to comprehend the nature of the transactions in which they have been asked to participate or from insufficient information concerning their implications. It stems from the love of their children. Their desire to help and protect them, to advance their interests, to maintain a close relationship, to avoid causing disappointment, hurt or distress, to maintain the relationship may all make it difficult to say "no".<sup>20</sup>*

1.18 Regardless of the guarantor's motives for entering into the contract, it is important to remember that guarantees are contracts with significant legal and financial implications. The financial risks can be great because a guarantee is usually accompanied by a mortgage over property, commonly the guarantor's family home.<sup>21</sup> Guarantors therefore undertake huge risks, including the possibility of losing their family home, without necessarily obtaining any financial benefit from the loan taken out by the borrower. It is apparent, therefore, that the legal system needs to protect guarantors as far as it reasonably can, especially from unfair conduct by lenders and borrowers.

1.19 That protection must, however, recognise that guarantees are an essential tool in facilitating access to credit. Reform measures intended to protect guarantors must, therefore, take into account the interests of lenders and borrowers and ensure that the utility and convenience of guarantees as a credit risk-minimising device remain largely undiminished.

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18. Lovric and Millbank at para 3.36.

19. Lovric and Millbank at para 2.8-2.12.

20. *Watt v State Bank of New South Wales* [2003] ACTCA 7 at para 22.

21. Title to the family home is increasingly jointly held by husbands and wives and, as the main significant asset of the parties, it is often used as security for a loan for a business over which the husband has the predominant control: B Fehlberg, *Sexually Transmitted Debt: Surety Experience and English Law* (Clarendon Press, Oxford, 1997) at 9-10. Equity in owner-occupied housing accounts for more than 50 per cent of women's total wealth in Australia and New Zealand, notably more than for men: Yann Campbell Hoare Wheeler, *Women's Economic Status: "Equal Worth" – Final Report*: Output 4 (Job No 32056, for the Australian Commonwealth/State and New Zealand Standing Committee of Advisers for the Status of Women, 1999) at ch 1; Executive Summary at 27.

## 2. Guarantees in New South Wales law and practice

- General law
- Statutory regulation
- Regulation of guarantees under the Consumer Credit Code
- Other particular statutory regulation
- Industry practice
- An overview

2.1 Statute, common law and industry codes of practice all regulate aspects of guarantees, or particular types of guarantee, in New South Wales.<sup>1</sup> This chapter identifies the nature and scope of regulation provided by each of these sources.

## GENERAL LAW

2.2 In general, the common law of contract attaches no special rules to contracts of guarantee. This is different from, for example, contracts of insurance, which are classified as contracts of "utmost good faith". Thus, persons seeking insurance must disclose to the proposed insurer all matters within their knowledge that are material to the risk.<sup>2</sup> In contrast, a lender has no general duty to disclose to the guarantor all material facts within the lender's knowledge.<sup>3</sup> Nor does the common law place limitations on the terms that may form part of a guarantee.

2.3 It has been said that the common law has a special rule for the interpretation of guarantees, namely, that where the terms of the guarantee are ambiguous, they should be construed in favour of the guarantor.<sup>4</sup> This rule of interpretation will no doubt apply to most of the guarantees considered in this Report because they will have been drawn up by the lender. However, since it may be no more than a manifestation of the general rule of interpretation that a document is construed against the party who prepared it,<sup>5</sup> the "special rule" may not apply to all guarantees.<sup>6</sup>

2.4 The most important impact of the general law on guarantees occurs where the circumstances, particularly those surrounding the formation of the contract, allow the guarantor to set aside, or resist the enforcement of, a contract impaired by the presence of some vitiating factor. These vitiating factors find expression in general equitable and common

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1. Using "regulation" widely to encompass private law as a regulatory mechanism: see further H Collins, *Regulating Contracts* (OUP, Oxford, 1999) ch 4.
  2. See K Sutton, *Insurance Law in Australia* (3rd edition, LBC Information Services, Sydney, 1999) ch 3, especially at 179-181.
  3. J O'Donovan and J Phillips, *The Modern Contract of Guarantee* (3rd edition, LBC Information Services, Sydney, 1996) at 33. See also para 6.3
  4. See *Ankar Pty Ltd v National Westminster Finance (Aust) Ltd* (1987) 162 CLR 549 at 561 (Mason ACJ, Wilson, Brennan, and Dawson JJ).
  5. That is, *contra proferentem*.
  6. See, generally, J O'Donovan and J Phillips, *The Modern Contract of Guarantee* (3rd edition, LBC Information Services, 1996) at 218; G Andrews and R Millett, *Law of Guarantees* (4th edition, Sweet & Maxwell, London, 2005) at 90-91. In Canada, the courts differentiate between accommodation sureties, who undertake a guarantee with no expectation of personal gain, and compensated sureties, who undertake surety contracts for profit, such as bonding companies. Courts treat accommodation sureties more benignly than compensated sureties. Hence, rules designed for the benefit of accommodation sureties, such as the *contra proferentem* rule in the construction of contracts, are not generally applied to compensated sureties: *Citadel General Assurance Co. v Johns-Manville Canada Inc* (1983) 147 DLR (3d) 593. See also P Devonshire, "The Liability of Original Mortgagors and Sureties Upon Default by a Mortgagor by Assumption" (2006) 39 *University of British Columbia Law Review* 185 at 197.



law doctrines,<sup>7</sup> of which the most relevant for this Report are unconscionability, undue influence and the principle in *Yerkey v Jones* and *Garcia v National Australia Bank*.

## Unconscionability

2.5 The equitable principle of unconscionability, firmly established in the jurisprudence of the High Court,<sup>8</sup> is concerned with setting aside transactions where one party has taken unconscientious advantage of the special disadvantage or disability of the other. While the circumstances or conditions of special disadvantage are not capable of exhaustive enumeration, they include “poverty or need of any kind, sickness, age, sex, infirmity of body or mind, drunkenness, illiteracy or lack of education, lack of assistance or explanation where assistance or explanation is necessary”.<sup>9</sup> Their common characteristic “seems to be that they have the effect of placing one party at a serious disadvantage vis-à-vis the other”.<sup>10</sup>

2.6 The decision of the High Court in *Commercial Bank of Australia Ltd v Amadio*<sup>11</sup> illustrates the application of this principle to a contract in which a person guarantees the loan of another. An elderly couple of Italian origin executed a guarantee and mortgage as security for a loan their son was seeking from the bank to support his business. The guarantors’ advanced age and limited English, their lack of understanding of the contents of the guarantee and their lack of knowledge about the true financial position of their son’s business all contributed to their “special disability”, or disadvantaged position relative to the bank, when they signed the guarantee and mortgage. The bank, for its part, was privy to the business affairs and financial instability of the son’s business. It was aware that the son’s company had, for some time, been unable to meet its debts as they fell due. It was also aware of the state of the business’s two overdrawn accounts with it and of past failures to observe agreed borrowing limits. Moreover, the bank officer dealing with the relevant transactions was cognisant of the personal circumstances of Mr and Mrs Amadio and their reliance on their son whom the bank officer described as the “dominant member of the family”. The High Court set aside the transaction on the ground of unconscionability.

2.7 Justice Deane explained that the principle comes into play where:

*(i) a party to a transaction was under a special disability in dealing with the other party with the consequence that there was an absence of any reasonable degree of equality between them and (ii) that disability was sufficiently evident to the stronger party to make it prima facie unfair or “unconscientious” that he procure, or accept, the weaker party’s assent to the impugned transaction in the circumstances in which he procured or accepted it. Where such*

7. See especially J Paterson, A Robertson and P Heffey, *Principles of Contract Law* (2nd edition, Lawbook Co, Sydney, 2005) Pt 10.

8. Especially *Blomley v Ryan* (1956) 99 CLR 362; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *Louth v Diprose* (1992) 175 CLR 621; *Bridgewater v Leahy* (1998) 194 CLR 457. See also *Australian Competition and Consumer Commission v C G Berbatis Holdings Pty Ltd* (2003) 214 CLR 51.

9. *Blomley v Ryan* (1956) 99 CLR 362 at 405 (Fullagar J), 415 (Kitto J).

10. *Blomley v Ryan* at 405 (Fullagar J).

11. (1983) 151 CLR 447.

*circumstances are shown to have existed, an onus is cast upon the stronger party to show that the transaction was fair, just and reasonable ...*<sup>12</sup>

## Undue influence

2.8 Parties to a contract who seek to set it aside on the ground of undue influence are asserting that the other party exploited the situation leading up to the formation of the contract to influence their mind or judgment to such an extent that they did not bring a free will to its execution. The doctrine thus focuses on the quality of consent, unlike the doctrine of unconscionable conduct which allows a contract to be set aside because one party has unconscientiously taken advantage of the other party's position of special disadvantage, whether or not the disadvantaged party's mind is free and independent.<sup>13</sup> The two doctrines are, however, closely connected and the facts of a case may call both into play.<sup>14</sup>

2.9 Undue influence is established by proof that a party to the contract overbore the will of the other party ("actual undue influence").<sup>15</sup> Alternatively, undue influence can be established by relying on a presumption of undue influence resulting from a pre-existing relationship between the parties ("presumed undue influence"). Presumed undue influence arises in the context of relationships that occur where one of the parties occupies or assumes against the other a position naturally involving ascendancy, influence, dependency or trust.<sup>16</sup> Where the presumption applies, the party relying on the contract must affirmatively prove that the contract was the "pure, voluntary, well-understood act of the mind" of the other party.<sup>17</sup> Two categories of case need to be distinguished:

- Where the relationship falls within a class that of itself imports influence. Examples are parent and child, guardian and ward, trustee and beneficiary, solicitor and client, physician and patient, and religious adviser and disciple.<sup>18</sup> Relevantly for this Report, such relationships do not include that between husband and wife,<sup>19</sup> adult child and elderly parent,<sup>20</sup> and financial adviser and client.<sup>21</sup>

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12. (1983) 151 CLR 447 at 474 .

13. *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 461 (Mason J), 474 (Deane J).

14. See *Louth v Diprose* (1992) 175 CLR 621 at 626-628 (Brennan J).

15. See *Johnson v Buttress* (1936) 56 CLR 113. For an example of actual undue influence in the context of a guarantee, see *Bank of Credit and Commerce International SA v Aboody* [1990] 1 QB 923.

16. *Johnson v Buttress* (1936) 56 CLR 113 at 134-5 (Dixon J). Justice Dixon added that "[o]ne occupying such a position falls under a duty in which fiduciary characteristics may be seen".

17. See *Huguenin v Baseley* (1807) 14 Ves 273 at 295-6, 33 ER 526 at 535 (Lord Eldon); *Johnson v Buttress* (1936) 56 CLR 113 at 119 (Latham CJ).

18. See *Johnson v Buttress* (1936) 56 CLR 113 at 119 (Latham CJ), 134 (Dixon J). See also *Jenyns v Public Curator* (1953) 90 CLR 113 at 133 (Dixon CJ, McTiernan and Kitto JJ); *Louth v Diprose* (1992) 175 CLR 621 at 628 (Brennan J); *Hillston v Bar-Mordecai* [2003] NSWSC 89 at para 32-37 (Bryson J).

19. See, eg, *Yerkey v Jones* (1939) 63 CLR 649 at 675 (Dixon J).

20. *George v Paul George Pty Ltd* (NSW, Supreme Court, 2575/1993, Santow J, 29 February 1996, unreported) at 31-32.

21. *Bank of New South Wales Ltd v Rogers* (1941) 65 CLR 42 at 60 (McTiernan J).

- Where the facts establish that the relationship, even though not within one of the traditional classes, is susceptible to undue influence.<sup>22</sup> For example, a relationship between an adult child and his or her elderly parent will give rise to a presumption of undue influence where the facts establish that the child assumed a position in relation to that parent that naturally involved ascendancy, influence, dependency or trust.<sup>23</sup>

2.10 In the case of a third party guarantee, it is usually the borrower who exercises undue influence over the guarantor, as in *Amadio's* case where the son influenced his parents to sign the guarantee and mortgage in favour of the lender (the bank). In such cases, the lender is liable for undue influence only if:<sup>24</sup>

- the borrower has obtained the guarantee as agent of the lender,<sup>25</sup> or
- the lender has, in the circumstances, such notice of the circumstances of undue influence that the lender should have taken steps to ensure that the guarantor's entry into the guarantee was independent and voluntary, but failed to do so.<sup>26</sup>

2.11 Thus, the elderly parents in *Amadio's* case could, in principle, have opposed the bank's attempted enforcement of the guarantee on the basis that their son had unduly influenced them, either actually or presumed (by reason of his position of ascendancy); that the bank had notice of the son's undue influence; and that the bank had failed to take any steps to ensure that their consent to the guarantee was relevantly immune from the son's undue influence.<sup>27</sup>

## Yerkey and Garcia

2.12 *Yerkey v Jones*,<sup>28</sup> a High Court decision of 1939, embodies an equitable principle that applies specifically to married women who guarantee their husbands' loans. Provided that the lender has notice of the marriage relationship,<sup>29</sup> the principle allows a wife, who obtains no benefit from the undertaking that is the subject of the guarantee,<sup>30</sup> to set the guarantee aside:

- if her consent was obtained by undue influence, unless she has received independent advice; or

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22. See *Johnson v Buttress* (1936) 56 CLR 113 at 119 (Latham CJ), 134-135 (Dixon J).

23. *George v Paul George Pty Ltd* (NSW, Supreme Court, 2575/1993, Santow J, 29 February 1996, unreported) at 30-32.

24. J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) at para 1405; A J Duggan, "Undue Influence" in P Parkinson (ed), *The Principles of Equity* (LBC Information Services, Sydney, 1996) at para 1120.

25. See *Alderton v Prudential Assurance Company Ltd* (1993) 41 FCR 435 at 444-447 and the cases cited there.

26. For example, *Bank of New South Wales Ltd v Rogers* (1941) 65 CLR 42.

27. *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 464 (Mason J, commenting on the statement of claim in the case).

28. (1939) 63 CLR 649, reaffirmed by the High Court in *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395.

29. *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395 at 408-411 (Gaudron, McHugh, Gummow and Hayne JJ).

30. *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395 at 411-412 (Gaudron, McHugh, Gummow and Hayne JJ).

- if she failed to understand the effect or significance of the guarantee, unless the lender took steps to inform her of these matters.<sup>31</sup>

The first limb goes beyond the traditional law of undue influence because the lender's liability is attracted by notice of the relationship. Likewise, the second limb goes further than the law of unconscionability expounded in *Amadio*, since the lender's liability is not dependent on notice of some unconscionable dealing between the husband as borrower and the wife as guarantor at the time that the guarantee is taken out.

2.13 *Garcia v National Australia Bank*<sup>32</sup> illustrates the operation of this principle. Mrs Garcia, whom the trial judge described as a "capable professional", and her husband executed a mortgage over the family home in favour of the bank to secure a loan made to both of them. The mortgage secured all moneys they might owe including moneys secured by future guarantees. The loans were repaid but the mortgage was never discharged. Mrs Garcia subsequently executed several guarantees relating to loans made to a company of her husband's that was in the business of buying and selling gold. She signed the guarantees following requests by her husband to do so. Her husband told her there was no danger in signing the guarantees because "if the money isn't there the gold is there". She was a director and shareholder of the company but she was not involved in its operations. Following the parties' divorce (which resulted in the family home being transferred to her subject to the mortgage), Mrs Garcia sought a declaration that the guarantees were void, the bank cross claiming to obtain possession of the mortgaged property under one of the guarantees. When she had executed that guarantee in the presence of an officer of the bank, Mrs Garcia had believed that it was a guarantee of the business's overdraft; she did not understand that it was secured by the all-moneys mortgage over the family home. The bank had not informed her of the true nature of the transaction. Although her husband had not unduly influenced her, she had agreed to the guarantee relying on his representations that it was risk proof. The High Court, applying *Yerkey v Jones*, sustained Mrs Garcia's claim.

2.14 The "special equity"<sup>33</sup> in favour of wives said to be the basis of *Yerkey v Jones* and applied in *Garcia* has attracted much debate and criticism. Some regard it as perpetuating undesirable gender stereotypes, presupposing an inferior position of women in society that is incompatible with contemporary Australian social conditions.<sup>34</sup> Others argue that stereotyping that promotes the protection of a vulnerable group in society, rather than the perpetuation of discriminatory values, is not necessarily objectionable.<sup>35</sup> More radical critiques would regard either of these approaches as inadequate. By locating the debate as a choice between the

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31. See *Yerkey v Jones* (1939) 63 CLR 649 at 683-684 (Dixon J). For the view that both limbs of the case are explicable by reference to the doctrine of unjust enrichment, see J Edelman and E Bant, "Setting Aside Contracts of Suretyship: The Theory and Practice of Both Limbs of *Yerkey v Jones*" (2004) 15 *Journal of Banking and Finance Law and Practice* 5.

32. (1998) 194 CLR 395.

33. See for example, *Barclays Bank plc v O'Brien* [1994] 1 AC 180 at 194 (Lord Browne-Wilkinson).

34. See *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395 at 421-429 (Kirby J dissenting). See also Su-King Hii, "From *Yerkey* to *Garcia*: 60 Years on and Still as Confused as Ever!" (1999) 7 *Australian Property Law Journal* 47 at 56-57.

35. See R Haigh and S Hepburn, "The Bank Manager Always Rings Twice: Stereotyping in Equity After *Garcia*" (2000) 26 *Monash University Law Review* 275.

desirability of formulating gender-neutral or gender-specific principles, these approaches simply reinforce fundamental assumptions about gender.<sup>36</sup> For example, by accepting that sexually transmitted debt is a problem that affects married women, all the judgments in *Garcia* focus on women's difference, and it matters not whether the assumption is made because married women in practice leave business decisions to their husbands,<sup>37</sup> generally prefer to do so<sup>38</sup> or are dependent on their husbands.<sup>39</sup> In doing so, these approaches simply miss the point that the problem is caused by structural gendered inequality in marriage – particularly economic inequality – that results from male dominance and that is not necessarily remedied by the provision of information or independent advice.<sup>40</sup>

2.15 Whatever the force of these various points of view, their emphasis on *Garcia*'s reformulation of *Yerkey v Jones* as a principle applicable only to married women is probably misplaced. *Garcia* makes it clear that the basis of *Yerkey v Jones* is that it is unconscionable for a lender to have the benefit of a guarantee when the lender is taken to know that the guarantor reposes trust and confidence in the borrower (as a result of which there may not have been an adequate explanation of the effect of the guarantee), and fails to explain the transaction to the guarantor, who receives no benefit from the transaction and was mistaken about its purport and effect.<sup>41</sup> *Garcia* establishes that a lender is taken to know of the trust and confidence that a wife reposes in her husband in business affairs. It expressly leaves open when (if ever) this can be said about other relationships – for example, “long term and publicly declared relationships short of marriage between members of the same or of the opposite sex”.<sup>42</sup> Case law since *Garcia*, including decisions of the Queensland<sup>43</sup> and Victorian<sup>44</sup> Courts of Appeal, shows some willingness to apply the principle in *Yerkey v Jones* to other relationships of trust and confidence, both intimate<sup>45</sup> and non-intimate,<sup>46</sup> of which the lender has notice.

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36. See K Dunn, “‘Yakking Giants’: Equality Discourse in the High Court” (2000) 24 *Melbourne University Law Review* 427, 437-47.
37. *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395 at 404 (Gaudron, McHugh, Gummow and Hayne JJ).
38. *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395 at 433-434 (Kirby J dissenting).
39. *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395 at 443 (Callinan J).
40. See D Otto, “A Barren Future? Equity's Conscience and Women's Inequality” (1992) 18 *Melbourne University Law Review* 808; K Dunn, “‘Yakking Giants’: Equality Discourse in the High Court” (2000) 24 *Melbourne University Law Review* 427 at 447-60.
41. *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395 at 408-409 (Gaudron, McHugh, Gummow and Hayne JJ).
42. *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395 at 404 (Gaudron, McHugh, Gummow and Hayne JJ).
43. *ANZ Banking Group Ltd v Alirezai* [2004] QCA 6.
44. *Kranz v National Australia Bank* (2003) 8 VR 310 (CA).
45. *Liu v Adamson* [2003] NSWSC 74. Compare *State Bank of New South Wales v Hibbert* [2000] NSWSC 628 (de facto relationships).
46. *Kranz v National Australia Bank* (2003) 8 VR 310 (CA); *ANZ Banking Group Ltd v Alirezai* [2004] QCA 6. Compare *Watt v State Bank of New South Wales* [2003] ACTCA 7.

## Other doctrines

2.16 The facts surrounding the execution of a guarantee may allow a guarantor to resist the lender's enforcement of a guarantee by relying on other general law doctrines, namely:<sup>47</sup>

- **Duress:**<sup>48</sup> where the guarantor can establish that his or her consent to the guarantee resulted from illegitimate pressure (ranging from threats to person, property or economic interests)<sup>49</sup> either by the lender,<sup>50</sup> or by the borrower where the lender had knowledge of the borrower's duress or the borrower was the agent of the lender.<sup>51</sup>
- **Mistake:**<sup>52</sup> where the guarantor establishes that, at the time of executing the guarantee, he or she was under a fundamental mistake as to its nature, effect or subject-matter; that the lender knew about this and either deliberately set out to ensure that the guarantor did not become aware of the mistake,<sup>53</sup> or (perhaps), simply failed to correct it.<sup>54</sup>
- **Non est factum** ("it is not my contract"):<sup>55</sup> a species of mistake where the guarantor establishes that, without any carelessness on his or her part (for example, not bothering to read the document), he or she signed a document believing it was radically different from what it was in fact.<sup>56</sup>
- **Misrepresentation:**<sup>57</sup> where the guarantor establishes that he or she was induced to enter the contract by a material misstatement of fact either by the lender,<sup>58</sup> or by the

47. See NSW Law Reform Commission, *Guaranteeing Someone Else's Debts* (Issues Paper 17, 2000) at para 2.11-2.51.

48. See generally J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) ch 13.

49. See J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) para 1307-1313. See also *Crescendo Management Pty Ltd v Westpac Banking Corporation* (1988) 19 NSWLR 40 at 45-46 (McHugh JA).

50. For example, *Mutual Finance Co v Wetton* [1937] 2 KB 389.

51. See J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) para 1324.

52. See generally J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) at para 1252-1254.

53. See *Taylor v Johnson* (1983) 151 CLR 422 at 432 (Mason ACJ, Murphy and Deane JJ).

54. See J O'Donovan and J Phillips, *The Modern Contract of Guarantee* (3rd edition, LBC Information Services, 1996) at 142; G Andrews and R Millett, *Law of Guarantees* (4th edition, Sweet & Maxwell, 2005) at 125.

55. See J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) at para 1267-1275.

56. *Petelin v Cullen* (1975) 132 CLR 355 at 359-360, which stresses that the plea is difficult to establish and that there is a "heavy onus" on a person who pleads *non est factum*. See also *Child v Commonwealth Development Bank of Australia Ltd* [2000] NSWCA 256.

57. See generally J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) Ch 10.

58. For example, *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 454-458 where Gibbs CJ held that the bank's failure to disclose to the elderly parent guarantors unusual features of their son's overdrawn account amounted, in the circumstances, to a misrepresentation (material non-disclosure), having the effect that the guarantee was not binding on the parents.

borrower where the lender was a party to the misrepresentation or had knowledge of it at the time the guarantor entered the contract.<sup>59</sup>

## STATUTORY REGULATION

2.17 Just as guarantors may resist the enforcement of a guarantee by appealing to one or more of the general law doctrines that have been described above, so they may also rely on a number of statutory doctrines that are related, more or less, to those at common law or in equity. Unlike the general law, the scope of statutory regulation does not necessarily extend to all guarantees. In particular, it does not always extend to guarantees that support business loans.<sup>60</sup>

2.18 The following statutes contain principles that can be useful to guarantors:

- *Contracts Review Act 1980* (NSW) (“*Contracts Review Act*”),
- *Fair Trading Act 1987* (NSW) (“*Fair Trading Act*”),
- *Consumer Credit (New South Wales) Code* (“*Consumer Credit Code*”),<sup>61</sup> and
- *Australian Securities and Investment Commission Act 2001* (Cth) (“*ASIC Act*”).<sup>62</sup>

Their broad aim is to regulate unfair contracts or conduct, in particular:<sup>63</sup>

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59. See G Andrews and R Millett, *Law of Guarantees* (4th edition, Sweet & Maxwell, London, 2005) at 135-138. See also *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 458-459 (Gibbs CJ).

60. See specially para 2.34.

61. *Consumer Credit (New South Wales) Code* is the title adopted for the Consumer Credit Code as it applies in New South Wales. It is a generic description of the national uniform credit legislation which was first passed by Queensland in 1994 (*Consumer Credit (Queensland) Act 1994* (Qld)) and has either been adopted by the other States (*Consumer Credit Act 1995* (ACT); *Consumer Credit (Northern Territory) Act 1995* (NT); *Consumer Credit (South Australia) Act 1995* (SA); *Consumer Credit (Victoria) Act 1995* (Vic); and *Consumer Credit (Tasmania) Act 1996* (Tas)), or been the subject of consistent legislation (*Consumer Credit (Western Australia) Act 1996* (WA)). See, generally, A J Duggan and E V Lanyon, *Consumer Credit Law* (Butterworths, Sydney, 1999).

62. The relevant provisions of the *Australian Securities and Investments Commission Act 2001* (Cth) replace, in their application to guarantees, the equivalent provisions contained in the *Trade Practices Act 1974* (Cth) s 51AA-51AC, 52, 60 (contravening conduct); and s 80, 82, 87 (enforcement and remedies). The application of the *ASIC Act* to guarantees depends on the definition of “credit facility” in s 12BAA(7)(k), on which see *Australian Securities and Investments Commission Regulations 2001* (Cth) (“*ASIC Regulations*”) reg 2B(1). This is despite a contrary view in *Manso v David* [2003] NSWSC 905 at para 62 (O’Keefe J). See also *Cole v Challenge Bank Ltd* [2001] FCA 1425 at para 32, which, however, was handed down before the *ASIC Regulations* came into effect on 11 March 2002. It is not clear what effect the omission from *Trade Practices Act 1974* (Cth) s 51AAB(2) of s 51AC has on the operation of *Australian Securities and Investments Commission Act 2001* (Cth) s 12CC. The point may be academic, however, given that the terms of each provision are essentially identical.

- unjust contracts or transactions<sup>64</sup> and unconscionable conduct;<sup>65</sup> and
- misleading or deceptive conduct.<sup>66</sup>

## Unjust contracts and unconscionable conduct

2.19 The regimes established under the *Contracts Review Act*, Consumer Credit Code, *ASIC Act*<sup>67</sup> and *Fair Trading Act* cover unjust contracts, unjust transactions or unconscionable conduct:

- The *Contracts Review Act* allows a court to grant relief in relation to a contract or part of a contract that is “unjust in the circumstances relating to the contract at the time it was made”.<sup>68</sup> The term “unjust” is not restricted and its definition includes “unconscionable, harsh or oppressive”.<sup>69</sup>
- Under the Consumer Credit Code, a court may decide that a guarantee was “at the time it was entered into or changed ... unjust”.<sup>70</sup> “Unjust” includes “unconscionable, harsh or oppressive”.<sup>71</sup>
- The *ASIC Act* and the *Fair Trading Act* prohibit “persons” or “suppliers” respectively from engaging, in trade or commerce, in “conduct that is, in all the circumstances, unconscionable”.<sup>72</sup>
- The *ASIC Act* also prohibits a person, in trade or commerce, from engaging in unconscionable conduct within the meaning of “the unwritten law, from time to time, of the States and Territories”.<sup>73</sup>

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63. Also conceivably relevant are the statutory provisions aimed at controlling undue harassment and coercion: see *Australian Securities and Investments Commission Act 2001* (Cth) s 12DJ; *Fair Trading Act 1987* (NSW) s 55. See further *Campbell v Metway Leasing Ltd* (1998) ATPR 41-630; *Australian Competition and Consumer Commission v McCaskey* (2000) 104 FCR 8; *Australian Competition and Consumer Commission v Maritime Union of Australia* (2001) 114 FCR 472.

64. *Contracts Review Act 1980* (NSW) s 7; *Consumer Credit (New South Wales) Code* s 70.

65. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CA, 12CB, 12CC; *Fair Trading Act 1987* (NSW) s 43.

66. *Australian Securities and Investments Commission Act 2001* (Cth) s12DA; *Fair Trading Act 1987* (NSW) s 42.

67. The provisions of the *Australian Securities and Investments Commission Act 2001* (Cth), in their application to guarantees, replaced equivalent provisions contained in the *Trade Practices Act 1974* (Cth) s 51AA-51AC.

68. *Contracts Review Act 1980* (NSW) s 7.

69. *Contracts Review Act 1980* (NSW) s 4(1).

70. *Consumer Credit (New South Wales) Code* s 70(1).

71. *Consumer Credit (New South Wales) Code* s 70(7).

72. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB, 12CC; *Fair Trading Act 1987* (NSW) s 43.

73. The High Court has accepted that this is a reference to the principles stated in the previous High Court decisions of *Blomley v Ryan* (1956) 99 CLR 362 and *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447; *Australian Competition and Consumer Commission v C G Berbatis Holdings Pty Ltd* (2003) 214 CLR 51 at para 38-40.



2.20 On their face, these statutory provisions reveal a clear overlap with the common law of unconscionability. And so far as they focus on the conduct of one of the parties to the guarantee, they are obviously also capable of encompassing the same ground as the other common law doctrines discussed in para 2.5-2.16. There are, however, a number of important differences between the statutory regimes and the common law.

2.21 First, liability under the statutory regimes is wider than at general law. On the face of the relevant legislation, an “unjust” contract or transaction is not restricted to one that is unconscionable; and, except to the extent to which the statute requires otherwise,<sup>74</sup> “unconscionable conduct” is not necessarily limited to any particular meaning at general law.<sup>75</sup> A general reason for this is that application of the unconscionability doctrine at general law is dependent on the special disability of the one party being “sufficiently evident” to the other party (who then takes advantage of it).<sup>76</sup> Under the legislative schemes, this is not necessarily an element of liability, though it may be relevant to the exercise of a court’s discretion whether or not to grant relief in the circumstances of the case.<sup>77</sup> Thus, Justice Kirby has remarked that a person may be liable under the *Contracts Review Act* even though they were ignorant of the circumstances of the other party or their conduct was “honourable” or “lawful”.<sup>78</sup> So also, the fact that a lender was not aware of the conduct of a borrower or agent in relation to a guarantor is not conclusive of whether or not the contract is unjust.<sup>79</sup> This means that liability under the statutory schemes may even be wider than liability under the principle of *Yerkey v Jones*.<sup>80</sup>

2.22 Secondly, unlike the general law, the legislative regimes all provide non-exhaustive “shopping lists” of matters to be taken into account in determining whether the situation is unjust or unconscionable in all the circumstances of the case.<sup>81</sup> They focus the court’s

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74. Consider *Australian Competition and Consumer Commission v C G Berbatis Holdings Pty Ltd* (2003) 214 CLR 51 (interpreting *Trade Practices Act 1974* (Cth) s 51AA as including a reference to the unwritten law expounded in *Blomley v Ryan* and *Amadio*, but leaving open the scope of what else (if anything) was intended to be included: see para 42-46 (Gummow and Hayne JJ)).

75. J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) para 1527-1528.

76. See para 2.7.

77. See T Carlin, “The *Contracts Review Act 1980* (NSW) – 20 Years On” (2001) 23 *Sydney Law Review* 125 at 139-41; B Zipser, “Unjust Contracts and the *Contracts Review Act 1980* (NSW)” (2001) 17 *Journal of Contract Law* 76 at 86. See also J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) para 1522 (arguing that the element of “moral blameworthiness” in the general law is absent under the Act).

78. *Baltic Shipping Co v Dillon (The Mikhail Lermantov)* (1991) 22 NSWLR 1 at 20 (reversed on other grounds (1993) 176 CLR 344).

79. See *CIT Credit Pty Ltd v Keable* [2006] NSWCA 130 at para 68-69 (Spigelman CJ); B Zipser, “Unjust Contracts and the *Contracts Review Act 1980* (NSW)” (2001) 17 *Journal of Contract Law* 76 at 86-87.

80. See J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* (NSW Law Reform Commission and University of Sydney, Research Report 11, 2003) (“Lovric and Millbank”).

81. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2), 12CC(2), 12CC(3); *Contracts Review Act 1980* (NSW) s 9; *Consumer Credit (New South Wales) Code* s 70(2); *Fair Trading Act 1987* (NSW) s 43(2).

attention on matters that are relevant to the inquiry within the overall objectives of the statute in question. Unsurprisingly, the lists are not identical. Both the *Contracts Review Act* and the Consumer Credit Code require the courts to have regard to the public interest and to "all the circumstances of the case".<sup>82</sup> In broad terms, the matters listed focus on the characteristics and circumstances of the parties and the nature of the relationship between them, the nature and characteristics of the contract, and the circumstances surrounding its negotiation and formation, as well as the commercial context of the transaction. Generally speaking, they include the following considerations:

- inequality of bargaining power;<sup>83</sup>
- difficult or harsh terms;<sup>84</sup>
- intelligibility of the contractual documents;<sup>85</sup>
- unfair tactics or undue influence or pressure exerted by another person;<sup>86</sup>
- comparable conduct in similar contracts or transactions;<sup>87</sup>
- standard form contracts, or whether the parties negotiated the provisions of the contract<sup>88</sup> or were willing to do so;<sup>89</sup>
- acting in good faith;<sup>90</sup>
- the ability of the guarantor to protect his or her own interests;<sup>91</sup>
- relative financial circumstances, educational background, literacy;<sup>92</sup>

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82. *Contracts Review Act 1980* (NSW) s 9(1); *Consumer Credit (New South Wales) Code* s 70(2).

83. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(a), 12CC(2)(a), 12CC(3)(a); *Contracts Review Act 1980* (NSW) s 9(2)(a); *Consumer Credit (New South Wales) Code* s 70(2)(b); *Fair Trading Act 1987* (NSW) s 43(2)(a).

84. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(b), 12CC(2)(b), 12CC(3)(b); *Contracts Review Act 1980* (NSW) s 9(2)(d); *Consumer Credit (New South Wales) Code* s 70(2)(e); *Fair Trading Act 1987* (NSW) s 43(2)(b).

85. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(c), 12CC(2)(c), 12CC(3)(c); *Contracts Review Act 1980* (NSW) s 9(2)(g); *Consumer Credit (New South Wales) Code* s 70(2)(g); *Fair Trading Act 1987* (NSW) s 43(2)(c).

86. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(d), 12CC(2)(d), 12CC(3)(d); *Contracts Review Act 1980* (NSW) s 9(2)(j); *Consumer Credit (New South Wales) Code* s 70(2)(j); *Fair Trading Act 1987* (NSW) s 43(2)(d).

87. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CC(2)(f), 12CC(3)(f); *Contracts Review Act 1980* (NSW) s 9(2)(k).

88. *Contracts Review Act 1980* (NSW) s 9(2)(b), 9(2)(c); *Consumer Credit (New South Wales) Code* s 70(2)(c), 70(2)(d).

89. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CC(2)(j), 12CC(3)(j).

90. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CC(2)(k), 12CC(3)(k).

91. *Contracts Review Act 1980* (NSW) s 9(2)(e); *Consumer Credit (New South Wales) Code* s 70(2)(f). Although no specific provisions exist in trade practices legislation, this may be subsumed under the concept of relative strength of bargaining power: *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(a), 12CC(2)(a), 12CC(3)(a); *Fair Trading Act 1987* (NSW) s 43(2)(a).

- whether or not independent legal advice or other expert advice was obtained;<sup>93</sup>
- accurate explanation of the legal and practical effect of the contract;<sup>94</sup>
- whether the provisions of the transaction were understood;<sup>95</sup>
- terms of comparable transactions, including rates of interest or charges.<sup>96</sup>

2.23 Thirdly, liability under one of the legislative schemes gives rise to a “smorgasbord” of relief not available at common law.<sup>97</sup> This is considered in para 2.25-2.29.

## Misleading or deceptive conduct

2.24 Both the Commonwealth and New South Wales relevantly proscribe, in trade or commerce, conduct that is misleading or deceptive, or is likely to mislead or deceive.<sup>98</sup> These sections may extend to conduct that would not be reached at common law. Thus, silence may constitute misleading or deceptive conduct, while at common law it would not ground liability in misrepresentation in the absence of a duty to disclose.<sup>99</sup> Moreover, liability for misleading and deceptive conduct is strict. A person can mislead or deceive another without necessarily intending to do so.<sup>100</sup> While the general law can also, exceptionally, be strict (for example,

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92. *Contracts Review Act 1980* (NSW) s 9(2)(f). Although no specific provisions exist in trade practices legislation, this may be subsumed under the concept of relative strength of bargaining power: *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(a), 12CC(2)(a), 12CC(3)(a); *Fair Trading Act 1987* (NSW) s 43(2)(a).
93. *Contracts Review Act 1980* (NSW) s 9(2)(h); *Consumer Credit (New South Wales) Code* s 70(2)(h), but there is *no direct requirement* for the provision of independent legal or other expert advice. Although no specific provisions exist in trade practices legislation, this may be subsumed under the concept of generally understanding the documents: *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(c), 12CC(2)(c), 12CC(3)(c); *Fair Trading Act 1987* (NSW) s 43(2)(c).
94. *Contracts Review Act 1980* (NSW) s 9(2)(i); and *Consumer Credit (New South Wales) Code* s 70(2)(i). Although no specific provisions exist in trade practices legislation, this may be subsumed under the concept of generally understanding the documents: *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(c), 12CC(2)(c), 12CC(3)(c); *Fair Trading Act 1987* (NSW) s 43(2)(c).
95. *Contracts Review Act 1980* (NSW) s 9(2)(i); *Consumer Credit (New South Wales) Code* s 70(2)(i), 70(2)(k). Although no specific provisions exist in trade practices legislation, this may be subsumed under the concept of generally understanding the documents: *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(c), 12CC(2)(c), 12CC(3)(c); *Fair Trading Act 1987* (NSW) s 43(2)(c).
96. *Consumer Credit (New South Wales) Code* s 70(2)(n); *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(e), 12CC(2)(e), 12CC(3)(e); *Fair Trading Act 1987* (NSW) s 43(2)(e).
97. See *Akron Securities v Iliffe* (1997) 41 NSWLR 353 at 364-366 (Mason P, dealing with remedies under *Trade Practices Act 1974* (Cth) s 87).
98. *Australian Securities and Investments Commission Act 2001* (Cth) s 12DA (“in relation to financial services”); *Fair Trading Act 1987* (NSW) s 42.
99. See J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) para 1110.
100. See, eg, *Hornsby Building Information Centre Pty Ltd v Sydney Building Information Centre* (1978) 140 CLR 216 at 228 (Barwick CJ); *Parkdale Custom Built Furniture Pty*

where liability exists for innocent misrepresentation),<sup>101</sup> the remedies available under the legislation are much broader than those available at general law.<sup>102</sup> On the other hand, in the absence of agency or knowing involvement in a contravention of the legislation, it may be more difficult to impose liability on a lender for the conduct of a borrower than at general law.<sup>103</sup>

## Relief available

2.25 A guarantor who bases a claim against the lender under one of the statutory regimes covered in this section has access to a much wider range of remedies than at common law, where the normal remedy is the sometimes fragile one of rescinding the contract.<sup>104</sup>

### *Contracts Review Act*

2.26 Under the *Contracts Review Act*, if a court finds a contract or a provision in a contract unjust, it may refuse to enforce any or all of the provisions of the contract; or declare the contract void in whole or in part; or vary any provision of the contract. Further, the court may make any of the ancillary orders listed in Schedule 1 of the Act, including such orders "as may be just in the circumstances".<sup>105</sup>

2.27 The flexibility of the remedies under the *Contracts Review Act* is illustrated in a number of cases where parents mortgaged their family home by way of security for a guarantee given in support of a loan to a business of their children or other close relatives. In these cases, the courts have sometimes given more limited relief than simply setting aside the contract. They have, for example, prevented the exercise of the mortgagee's power of sale during the mortgagor's lifetime or released or postponed the mortgagor's personal liability.<sup>106</sup> This has led one commentator to observe that:

*the ability to choose something other than the more traditional all-or-nothing solution may well result in judges giving at least some measure of relief in circumstances where they would otherwise have felt compelled to refuse relief on the basis that the injustice that would otherwise be caused to the defendant*

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*Ltd v Puxu Pty Ltd* (1982) 149 CLR 191 at 197 (Gibbs CJ); *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452 at 467 (Black CJ, von Doussa and Cooper JJ).

101. See J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) para 1037-1038.

102. See para 2.29.

103. See *Australian Securities and Investments Commission Act 2001* (Cth) especially s 12GD(1)(e), 12GH(4), 12GM; *Fair Trading Act 1987* (NSW) s 61(c), 65(1)(e), 70(4). Compare *Trade Practices Act 1974* (Cth) s 75B. See also *Cassidy v NRMA Health Pty Ltd* (2002) ATPR 41-891 at para 71-73 (affirmed *Cassidy v Saatchi and Saatchi Australia Pty Ltd* (2004) ATPR 41-980).

104. J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) para 1120, 1526.

105. *Contracts Review Act 1980* (NSW) s 7, 8.

106. *Melverton v Commonwealth Development Bank of Australia* (1989) ASC ¶155-921; *Bridge Wholesale Acceptance (Australia) Ltd v GVS Associates Pty Ltd* (1991) ¶ASC 56-105; *National Australia Bank Ltd v Hall* (1993) ASC ¶156-234; *Burke v State Bank of NSW Ltd* (1994) 37 NSWLR 53; *Hayward v Nichols* (1996) NSW Conv R 55-763.

by setting aside the contract would outweigh the injustice caused to the plaintiff by its enforcement.<sup>107</sup>

#### *Consumer Credit Code*

2.28 When the court reopens an unjust transaction under the Consumer Credit Code, it may make a number of orders including:

- relieving the guarantor from payment of any amount the court considers to be in excess of what is reasonably payable;
- setting aside either wholly or in part or revising or altering any agreement made in connection with the transaction;
- ordering the mortgagee to take the steps necessary to discharge the mortgage;
- ordering a party be paid an amount that is justly due under the agreement, having regard to such relief as the court thinks fit to grant; and
- making ancillary or consequential orders.<sup>108</sup>

#### *Australian Securities and Investments Commission Act and Fair Trading Act*

2.29 Relevant parts of the financial services and fair trading legislation provide for the following relief:

- **Injunctions.** The court may grant injunctions<sup>109</sup> against those involved in contravening conduct.<sup>110</sup> Any person may apply for an injunction, not only those directly affected by the conduct. The injunction may be “in such terms as the Court determines to be appropriate”.<sup>111</sup> An injunction could, for example, restrain a lender from seeking to enforce or retain the benefit of a mortgage used to secure a loan.<sup>112</sup>
- **Damages.** A person who suffers loss or damage as a result of contravening conduct may generally recover the “amount of the loss or damage” from the person in breach,<sup>113</sup> although damages are not available for unconscionable conduct under the *Fair Trading Act 1987* (NSW).<sup>114</sup> However, a court may also order compensation for unconscionable conduct in its discretion under the “other orders” provisions.<sup>115</sup>

107. D Harland, “Unconscionable and Unfair Contracts: An Australian Perspective” in R Brownsword, N Hird and G Howells, *Good Faith in Contract: Concept and Context* (Ashgate Publishing Limited, Aldershot, 1999) at 262.

108. *Consumer Credit (New South Wales) Code* s 71.

109. Under *Australian Securities and Investments Commission Act 2001* (Cth) s 12GD; *Fair Trading Act 1987* (NSW) s 65.

110. Under *Australian Securities and Investments Commission Act 2001* (Cth) s 12CA-12CC; *Fair Trading Act 1987* (NSW) s 42, 43, 55.

111. *Australian Securities and Investments Commission Act 2001* (Cth) s 12GD(1); *Fair Trading Act 1987* (NSW) s 65(1).

112. See, for example, *Gregg v Tasmanian Trustees Ltd* (1997) 73 FCR 91 at 127-128 (Merkel J).

113. *Australian Securities and Investments Commission Act 2001* (Cth) s 12GF; *Fair Trading Act 1987* (NSW) s 68.

114. *Fair Trading Act 1987* (NSW) s 68(1).

115. *Australian Securities and Investments Commission Act 2001* (Cth) s 12GM(7)(e); *Fair Trading Act 1987* (NSW) s 72(5)(e). See *Trade Practices Act 1974* (Cth) s 87(2)(d). The

- **Other orders.** The court may also make “such order or orders as it thinks appropriate” to compensate a person who suffers, or who is likely to suffer, loss or damage by a person engaging in contravening conduct.<sup>116</sup> For example, a court may: declare part or all of a contract void from the beginning; vary a contract; refuse to enforce all or part of a contract; direct the refund of money or the return of property; or direct the payment of the amount of the loss or damage suffered.<sup>117</sup> These provisions in no way limit the scope of an injunction otherwise granted by the court.<sup>118</sup>

## Limitations on the reach of statutory regulatory regimes

2.30 There are limitations on the scope of application of the statutory provisions considered above. Those relevant to this Report are as follows:

### *Contracts Review Act*

2.31 Relief under the *Contracts Review Act* is not available to corporations.<sup>119</sup> Nor is it available to a person in respect of a contract entered into “in the course of or for the purpose of a trade, business or profession carried on by the person or proposed to be carried on by the person other than a farming undertaking”.<sup>120</sup> This restriction does not, on its face, apply when an individual guarantees a loan that was taken out for the borrower’s business purposes, since the business in question will not be “carried on by” the guarantor. Such guarantees are, therefore, subject to the Act,<sup>121</sup> even where the guarantor has a stake (for example, as a shareholder) in the borrower’s business.<sup>122</sup> Most of the guarantees considered in this Report will, therefore, be subject to the *Contracts Review Act*. But guarantors of, for example, small business loans will lose the protection of the Act if their giving of guarantees reveals a pattern of sustained activity and transactions aimed at their own business profitability.<sup>123</sup>

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relationship between *Trade Practices Act 1974* (Cth) s 82 and 87 has been the subject of a recent High Court decision: *I & L Securities Pty Ltd v HTW Valuers (Brisbane) Pty Ltd* (2002) 210 CLR 109. See also P Mendelow, “Trade Practices Act: Recent developments in assessment of damages” (2003) 77 *Australian Law Journal* 534.

116. Under *Australian Securities and Investments Commission Act 2001* (Cth) s 12GM; *Fair Trading Act 1987* (NSW) s 72.
117. *Australian Securities and Investments Commission Act 2001* (Cth) s 12GM(7).
118. Under *Australian Securities and Investments Commission Act 2001* (Cth) s 12GD: *Australian Securities and Investments Commission Act 2001* (Cth) s 12GM(1) and 12GM(2).
119. *Contracts Review Act 1980* (NSW) s 6(1).
120. *Contracts Review Act 1980* (NSW) s 6(2).
121. For example, *St George Bank Ltd v Trimarchi* [2004] NSWCA 120; *Elkofairi v Permanent Trustee Co Ltd* [2002] NSWCA 413; *Esanda Finance Corp Ltd v Tong* (1997) 41 NSWLR 482. See further B Zipser, “Unjust Contracts and the Contracts Review Act 1980 (NSW)” (2001) 17 *Journal of Contract Law* 76 at 76-78 (pointing out that s 6(2) of the *Contracts Review Act* has been narrowly interpreted).
122. *Toscano v Holland Securities Pty Ltd* (1985) 1 NSWLR 145; *Australian Bank Ltd v Stokes* (1985) 3 NSWLR 174. See also *Ring Tread Systems Australasia Pty Ltd v Tubb* (NSW, Court of Appeal, 40830/1996, 30 October 1998, unreported) at 7-8 (Mason P).
123. *Multi-Span v Portland* [2001] NSWSC 696 at para 117.

*Financial services and fair trading legislation*

2.32 The provisions of *Australian Securities and Investment Commission Act 2001* (Cth) that deal with unconscionable conduct apply only to conduct, in trade and commerce, in connection with:

- consumer transactions, that is, the supply of financial services “of a kind ordinarily acquired for personal, domestic or household use”,<sup>124</sup> or
- certain business transactions, that is, “for the purpose of trade or commerce” up to a value of \$3,000,000.<sup>125</sup>

2.33 The provisions of *Fair Trading Act* which deal with unconscionable conduct originally applied only to consumer transactions.<sup>126</sup> However, amendments passed in 2003<sup>127</sup> have removed this restriction, thereby extending coverage to all transactions, including business transactions.<sup>128</sup>

*Consumer Credit Code*

2.34 The Consumer Credit Code and its regulations<sup>129</sup> apply to guarantors who are individuals or strata corporations<sup>130</sup> where the guarantee supports a credit contract that is “wholly or predominantly for personal, domestic or household purposes”.<sup>131</sup> They, therefore, apply only to consumers, and do not protect individuals who guarantee business loans, even when they have no direct interest in the business.

## REGULATION OF GUARANTEES UNDER THE CONSUMER CREDIT CODE

2.35 In addition to the power of a court to determine that a guarantee or other credit contract is “unjust”,<sup>132</sup> the Consumer Credit Code contains a number of provisions that either deal specifically with guarantees or are capable of application to such contracts. These provide a number of significant safeguards for guarantors, but do not extend to guarantees that support business loans.<sup>133</sup> For example, the Consumer Credit Code:

- requires lenders to give prospective guarantors, prior to the signing of the guarantee, not only a copy of the contract but also: (a) a copy of the loan contract to which the

124. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(5).

125. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CC(6)-(9).

126. *Fair Trading Act 1987* (NSW) s 43.

127. *Fair Trading Amendment Act 2003* (NSW) Sch 1[18]-[20].

128. All business transactions would appear to be covered despite the intention, expressed in the second reading speech, that the amendments cover small business transactions: NSW, *Parliamentary Debates (Hansard)* Legislative Assembly, 21 May 2003 at 933.

129. *Consumer Credit (New South Wales) Regulations*, applying the regulations enacted under *Consumer Credit (Queensland) Act 1994* (Qld) Part 4.

130. *Consumer Credit (New South Wales) Code* s 9(1).

131. *Consumer Credit (New South Wales) Code* s 6(1)(b). On the definition of “personal, domestic or household”, see *Jonsson v Arkway Pty Ltd* (2003) ASC 155-060 at para 17-34.

132. *Consumer Credit (New South Wales) Code* s 70. See further Chapter 11.

133. See para 2.34.

proposed guarantee relates; and (b) a document explaining the rights and obligations of guarantors.<sup>134</sup> This addresses, to a limited extent, the information disparity between guarantors and financial institutions. By giving guarantors access to the loan document, this provision puts them in a position to examine or get advice on their potential liability.

- requires every guarantee to contain a warning, called "Form 4", which informs the guarantor that he or she may be personally liable for the debt, and that this could jeopardise the guarantor's assets, including his or her home. It also advises the guarantor that it may be possible to withdraw from the guarantee or to limit his or her liability under the guarantee. It further outlines the guarantor's rights in relation to an extension of credit. It recommends that the guarantor get independent legal and financial advice, and make his or her own inquiries about the borrower's financial position and credit risk.<sup>135</sup>
- directs guarantees to be in legible form and to use plain language.<sup>136</sup> This is intended to make it easier for guarantors to understand the contract.
- grants guarantors a cooling off period. More specifically, it allows guarantors to withdraw from the contract at any time before credit is first provided to the borrower.<sup>137</sup> This gives them time to consider the transaction further, even though they have already signed the contract.
- obliges lenders to supply the guarantor with ongoing information about the loan, including the current balance of the borrower's account and any amounts that are overdue.<sup>138</sup> The Consumer Credit Code, therefore, imposes continuing obligations on credit providers. This provision enables a guarantor to monitor instances when his or her liability might arise as a result of the borrower's default.

## OTHER PARTICULAR STATUTORY REGULATION

### Anti-Discrimination Act

2.36 Some, as yet untested, provisions of the *Anti-Discrimination Act 1977* (NSW) are capable of extending to guarantors.<sup>139</sup> The Act makes it unlawful for a service provider to discriminate against a person on the ground of marital status (a) by refusing to provide the person with those services, or (b) in the terms on which he or she provides the person with those services.<sup>140</sup> Discrimination on the ground of marital status occurs where the "perpetrator" treats "the aggrieved person less favourably than in the same circumstances, or in circumstances which are not materially different, the perpetrator treats or would treat a person of a different marital status".<sup>141</sup> The effect of these provisions would appear to be that,

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134. *Consumer Credit (New South Wales) Code* s 51(2).

135. *Consumer Credit (New South Wales) Code* s 50; *Consumer Credit (New South Wales) Regulations* s 20.

136. *Consumer Credit (New South Wales) Code* s 162(1)(a) and (c).

137. *Consumer Credit (New South Wales) Code* s 53(1)(a).

138. *Consumer Credit (New South Wales) Code* s 34.

139. See L Katz, "An Unused Potential Statutory Remedy for Spousal Guarantors" [2004/2005] *Bar News* (Summer ) 32.

140. *Anti-Discrimination Act 1977* (NSW) s 47.

141. *Anti-Discrimination Act 1977* (NSW) s 39.



although a lender may require, as a condition of providing credit to a married borrower, that the borrower find a guarantor, the lender cannot require that the borrower's spouse become that guarantor.<sup>142</sup>

2.37 An alleged contravention of the Act can only be pursued by way of complaint to the President of the Anti-Discrimination Board and, ultimately, reference to the Administrative Decisions Tribunal.<sup>143</sup> If a complaint is substantiated, the Tribunal can do one or more of the following:

- order the lender to pay the guarantor up to \$40,000 by way of compensation for any loss or damage;
- order the lender to stop the unlawful conduct;
- order the lender to do something to redress any loss suffered by the guarantor; or
- declare void in whole or in part any guarantee made in contravention of the Act.<sup>144</sup>

## Farm Debt Mediation Act

2.38 The *Farm Debt Mediation Act 1994* (NSW) applies in situations where a farmer, as either a borrower or a guarantor, owes money to a lender under a "farm mortgage"<sup>145</sup> and the lender seeks to enforce the loan. When the farmer is a guarantor, the Act only applies where the guarantee is secured by farm property. It provides for delay in enforcement by requiring that 21 days' notice be given to the guarantor.<sup>146</sup> During the notice period, the farmer guarantor may request mediation<sup>147</sup> and enforcement cannot continue until the Rural Assistance Authority has issued a certificate that it is satisfied that certain processes have been carried out.<sup>148</sup>

2.39 The Act is simply a means of delaying enforcement actions against farmers in the hope that a better solution can be found through mediation. A guarantee cannot be overturned unless the parties agree. The Act does not affect any rights to have the guarantee reviewed under other relevant legislation such as the *Contracts Review Act 1980* (NSW) or "any other Act or law that deals with the granting of relief in respect of harsh, oppressive, unconscionable or unjust contracts or on the grounds of hardship".<sup>149</sup>

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142. This places the spouse of a borrower in a position similar to that in which the spouses of borrowers are placed by the *Equal Credit Opportunity Act* (US) (15 USC § 1691-1691f) and the regulation made under that Act (12 CFR Pt 202): see para 3.14-3.27.

143. See generally *Anti-Discrimination Act 1977* (NSW) s 89-113. This is different from the American regime where the spousal guarantor is able to rely at any time on a contravention of the spousal guarantee provisions as a defence in recoupment to an action brought on the guarantee by the lender: see para 3.22-3.27.

144. *Anti-Discrimination Act 1977* (NSW) s 108(2).

145. Defined in *Farm Debt Mediation Act 1994* (NSW) s 4(1).

146. *Farm Debt Mediation Act 1994* (NSW) s 8(1).

147. *Farm Debt Mediation Act 1994* (NSW) s 9(1).

148. *Farm Debt Mediation Act 1994* (NSW) s 11(1).

149. *Farm Debt Mediation Act 1994* (NSW) s 7(1).

## Controlling contractual terms

2.40 Injunctive relief under financial services and fair trading legislation could extend to the making of an order against a financial service provider prohibiting it from engaging in conduct that constitutes a contravention of a relevant provision of the legislation, such as entering into a contract that contains terms that would breach a section of the Act.<sup>150</sup> "Any person", including a consumer organisation, has standing to apply for such an injunction.<sup>151</sup> Further, the Attorney General or Minister may apply for an order, under s 10 of the *Contracts Review Act*, prescribing or restricting the terms on which any person may enter into contracts of a specified class in order to prevent that person from engaging in a course of conduct leading to the formation of unjust contracts. Thus, in *Minister of Consumer Affairs v W W Vallack Real Estate Pty Ltd*,<sup>152</sup> the Minister obtained an order against defendant real estate agents prohibiting their use of an unjust term in their standard form contracts with vendor clients that gave them an interest in the property being sold as security for any unpaid commission.

2.41 These provisions obviously have the potential to be used in guarantee contracts against lenders, such as banks, and could prohibit, for example, all moneys clauses in such contracts, that is, clauses providing that the guarantee is a continuing security and covers all moneys currently owing or remaining unpaid or which may from time to time be owing or remain unpaid.<sup>153</sup>

## INDUSTRY PRACTICE

2.42 The Australian Bankers Association released a Code of Banking Practice ("Banking Code") in November 1993 and revised it, after a substantial review in 2003.<sup>154</sup> The latest version was issued in May 2004. The Banking Code is not law, but rather a self-regulatory code setting "standards of good banking practice"<sup>155</sup> for the Association's members. A bank can, of course, decide whether or not to adopt the Banking Code. Once it has done so, it is contractually bound to observe its provisions.

2.43 The provisions of the Banking Code deal generally with the relationship between banks and their customers, and contain provisions specifically dealing with guarantees.<sup>156</sup> The 2003 version of the Banking Code was the first to extend its provisions substantially to loans taken out by small business customers.<sup>157</sup> Small business customers are defined as

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150. See para 2.29.

151. Especially *Truth About Motorways Pty Ltd v Macquarie Infrastructure Investment Management Ltd* (2000) 200 CLR 591.

152. (1986) ASC ¶155-478.

153. See generally J W Carter and D J Harland, *Contract Law in Australia* (4th ed, Butterworths, Chatswood NSW, 2002) at para 1529-30.

154. See *Review of the Code of Banking Practice: Final Report* (RTV Consulting Pty Ltd, October 2001) ("Viney Report"). For an evaluation of the review process and of aspects of the Code, see C Godfrey, "The Revised Code of Banking Practice: Is It Made of Straw, or Does It Have Enough Bricks to Provide Effective Consumer Protection?" (2006) 14 *Competition and Consumer Law Journal* 146

155. Code of Banking Practice (2004) cl 1.1.

156. Code of Banking Practice (2004) cl 28.

157. But see the exception in Code of Banking Practice (2004) cl 28.14.

having “less than 20 full time (or equivalent) people” unless the business involves the “manufacture of goods” in which case they must have “less than 100 full time (or equivalent) people”.<sup>158</sup>

2.44 Some of the provisions in the Banking Code that benefit guarantors are patterned after the Consumer Credit Code, except that the former extends some (but not all) of them to small business guarantees.<sup>159</sup> For example, the Banking Code requires guarantees to include the Form 4 warning of the Consumer Credit Code.<sup>160</sup> It also gives guarantors a cooling off period, which is similar in terms to the one found in the Consumer Credit Code.<sup>161</sup> In comparison to the Consumer Credit Code, however, the Banking Code substantially increases the obligation on lenders in respect of pre-contract disclosure of information. Both Codes require lenders to give a prospective guarantor a copy of the loan document, in addition to the guarantee. However, the Banking Code requires the disclosure of, among other things, any relevant credit report obtained by the bank about the borrower; financial accounts or statements of financial position given by the borrower to the bank for purposes of obtaining the credit facility; the latest statement of account relating to the credit facility; and any unsatisfied notice of demand made in relation to the credit facility in the previous two years.<sup>162</sup> These pieces of information, which essentially relate to the borrower’s credit history, are intended to give better information to the prospective guarantor about the risks of entering into the guarantee.

2.45 Not all banks have adopted the latest version of the Banking Code. Some are still governed by the 1993 Banking Code while others are governed by the original 2003 revision<sup>163</sup> - a matter that may not be readily apparent to any intending borrower or guarantor.

2.46 The 1993 Banking Code was followed in 1994 by similar industry codes of practice for building societies and credit unions,<sup>164</sup> which contractually bound member institutions once they agreed to be bound.<sup>165</sup> The Credit Union Code of Practice is still in force, but the Building Society Code of Practice ceased in 2003. Neither finance companies nor mortgage brokers have industry codes of practice.

2.47 The Credit Union Code applies to guarantees signed by individuals (not companies) and is still limited to loans that support consumer transactions.<sup>166</sup> The borrower cannot be a (public) corporation, or a corporation where the guarantor is a director or secretary, or a trustee of a trust (including a discretionary trust) where the guarantor is a beneficiary.<sup>167</sup> Nor will the code apply where the borrower is a co-owner, agent, consultant or associate of the

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158. Code of Banking Practice (2004) cl 40.

159. See Code of Banking Code (2004) cl 28.14 for an example of a provision that has not been extended to small business guarantees.

160. Code of Banking Practice (2004) cl 28.8.

161. Code of Banking Practice (2004) cl 28.11.

162. Code of Banking Practice (2004) cl 28.4(d).

163. See the website of the Australian Bankers’ Association at <http://www.bankers.asn.au/>.

164. The Building Society Code of Practice (released in October 1994) and the Credit Union Code of Practice (released in July 1994).

165. Building Society Code of Practice (1994) cl 1.3; and Credit Union Code of Practice (1994) cl 1.3.

166. Credit Union Code of Practice (1994) s 17.1 in relation to s 1.1 (definition of “credit union product or service”).

167. Credit Union Code of Practice (1994) s 17.1.

guarantor.<sup>168</sup> Thus, the Credit Union Code does not generally apply to the very common situations in family businesses, where the wife is both guarantor and director of the borrowing family company, or is both guarantor and a beneficiary of the discretionary family trust for which a loan is made.<sup>169</sup>

2.48 Where there is a conflict between the Consumer Credit Code and the codes of practice, the Consumer Credit Code, being legislation, prevails.<sup>170</sup>

## AN OVERVIEW

2.49 The following general observations can be made about the current legal regulatory regime of third party guarantees in New South Wales:

- a multitude of overlapping sources regulate guarantees in New South Wales;
- generally, regulation is reactive rather than preventive: it addresses problems after they have arisen rather than attempting to prescribe standards or conduct that prevent problems arising in the first place;
- the protection afforded guarantors is traditionally very much focused on the circumstances of the particular case;
- the only comprehensive preventive legal regime is found in the Consumer Credit Code, but this extends only to consumer loans; in particular, it does not apply to loans for small business purposes;
- regulation in specific contexts (such as under the *Anti-Discrimination Act 1977* (NSW)) yields very limited relief; and
- industry regulation of guarantees is, sometimes, in advance of legal regulation.

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168. Credit Union Code of Practice (1994) s 17.1(iv).

169. This is the situation in a number of the cases: see, eg, the facts of *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395. See also Lovric and Millbank at para 2.7-2.18.

170. Code of Banking Practice (May 2004) cl 3 and 4; and Credit Union Code of Practice (1994) s 1.2.

### 3. Guarantees in historical and comparative perspective

- Ban on women as sureties
- Human rights and equal opportunity
- Limiting the use of particular property as security
- Regulating transactions

3.1 This chapter outlines some of the diverse approaches that various legal systems have taken to the problems presented by guarantees. These approaches range from placing a ban on vulnerable people entering guarantees and placing particular assets beyond the reach of lenders who seek to enforce a guarantee; to more holistic attempts at ensuring equality of bargaining power or fair dealing on the part of lenders.

## BAN ON WOMEN AS SURETIES

3.2 Roman and some later civilian systems of law have dealt with the problem of guarantees by preventing women from entering them at all.

### Roman law

3.3 The Roman Senate enacted the *Senatus Consultum Velleianum* ("SCV") in the period 41CE-65CE. The SCV provided that women could not guarantee anyone's debts or undertake a primary obligation for the benefit of another. This decree went further than earlier imperial edicts from the time of the emperors Augustus (27 BCE-14 CE) and Claudius (41CE-54CE) which simply prohibited women from acting as guarantors for their husbands' debts. The policy underlying the SCV is controversial.<sup>1</sup> Near contemporary reasons given for it include:

- imposing legal incapacity on women, while customary in many spheres of Roman life, was particularly necessary in situations where a woman could risk her entire private property;
- it was considered unjust for women to be liable for performing what were considered to the "duties of men";
- women were seen as subject to weakness and infirmity and, therefore, deserved the protection of the edict; and
- women incur obligations (such as guarantees) more readily than they would if they were simply giving their property away (which they were still permitted to do in certain circumstances under Roman law).<sup>2</sup>

3.4 Some commentators have suggested that the protections were necessary because of the recklessness displayed by some women as guarantors following the abolition of agnatic guardianship in the first half of the first century.<sup>3</sup> Women who had been subject to agnatic guardianship were previously unable to deal with property without the assent of their agnatic (male) guardian, in practice usually a brother or uncle.<sup>4</sup>

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1. R Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (Juta and Co, Cape Town, 1990) at 146-148.
  2. *Digest* 16.1 (*Ad senatus consultum velleianum*).
  3. This could be seen as equivalent, in some respects, to the extension of contractual capacity to married women at the end of the 19th century.
  4. See J A Crook, "Feminine inadequacy and the *senatusconsultum Velleianum*" in B Rawson (ed), *The Family in Ancient Rome: New Perspectives* (Routledge, London, 1986) at 58-92; J B Moyle, *Imperatoris Iustiniani Institutionum Libri Quattor* (5th edition, Clarendon Press, Oxford, 1912) at 429.

3.5 Some contemporary records have suggested that preventing women from guaranteeing debts effectively excluded them from the social networking that was part and parcel of participation in business activities among Roman men.<sup>5</sup>

3.6 The developing emancipation and business experience of women made the SCV increasingly impractical and a teleological interpretation was devised to get around its terms.<sup>6</sup> Buckland has summarised the exceptions that were developed by the jurists:

*It did not apply if the creditor was a minor and the principal debtor was insolvent, or if it was to save the father from execution of a judgment, or if, though she appeared as surety, it was really the woman's own affair, or if it was to provide a dos for her daughter, or by a rescript of Pius, if she had deceived the creditor.<sup>7</sup>*

3.7 The Emperor Justinian decreed that a guarantee was binding if, after two years, the woman confirmed it, or was paid for undertaking it. However, it became sufficient for the woman merely to acknowledge payment in the instrument itself, albeit before three witnesses.<sup>8</sup> However, Justinian confirmed an absolute ban on a woman acting as guarantor for her husband except where the money received from the transaction was spent for her benefit.<sup>9</sup> At around this time, it was also possible for a woman to renounce the benefits of the SCV, at least in cases where she was acting as tutor to her children or grandchildren, following the death of her husband.<sup>10</sup>

## Later development

3.8 The *Senatus Consultum Velleianum* had largely disappeared from civil law and mixed law jurisdictions by the beginning of the 20th century.<sup>11</sup> However, it survived in South Africa until it was abolished in 1971.<sup>12</sup> This led to the following from a South African judge in 1942:

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5. J F Gardner, "Women in business life: some evidence from Puteoli" in P Setala and L Savunen (ed) *Female Networks and the Public Sphere in Roman Society* (Acta Instituti Romani Finlandiae, 22, Rome, 1999) at 11-27.
  6. R Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (Juta and Co, Cape Town, 1990) at 148-151.
  7. W W Buckland, *A Text-book of Roman Law from Augustus to Justinian* (3rd edition, Cambridge University Press, Cambridge, 1966) at 448. See also J B Moyle, *Imperatoris Iustiniani Institutionum Libri Quattuor* (5th edition, Clarendon Press, Oxford, 1912) at 430.
  8. See W W Buckland, *A Text-book of Roman Law from Augustus to Justinian* (3rd edition, Cambridge University Press, 1966) at 449.
  9. J A C Thomas, *Textbook of Roman Law* (Kluwer Law and Taxation Publishers, Deventer [Netherlands], 1976) at 243.
  10. J B Moyle, *Imperatoris Iustiniani Institutionum Libri Quattuor* (5th edition, Clarendon Press, Oxford, 1912) at 147.
  11. R Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (Juta and Co, Cape Town, 1990) at 152.
  12. *Suretyship Amendment Act 1971* (South Africa).

*One of the incongruities of this inconsequent age is the fact that women, while enjoying full rights of citizenship, including that of making or marring policies of the State as effectively as any male, are able in their private affairs to invoke a defence based on their innate fecklessness and incapacity and so avoid liability in respect of obligations which they have deliberately assumed. We have to administer the law as we find it. On the other hand our law in this respect is a recognised anomaly, a fossil left over from a dispensation in which it was deemed reprehensible in a woman to engage in anything so masculine as the undertaking of suretyship. We should not be astute, therefore, to extend the scope of the legal benefits by analogy or to restrict the operation of statutes designed to curtail them.<sup>13</sup>*

## HUMAN RIGHTS AND EQUAL OPPORTUNITY

3.9 Some legal systems have dealt with the problem of guarantees by interpreting provisions of their law in light of overriding principles of fairness and human rights. Such approaches are illustrated by:

- the interpretation, in Germany, of the civil law in light of the Basic Law<sup>14</sup> which guarantees autonomy of private individuals; and
- the use of the Equal Credit Opportunity Act in the United States.

### Effect of the German Basic Law

3.10 Traditionally, under the German civil law, the courts would not interfere in a guarantee even where it was burdensome and there was an inequality of bargaining power between the parties. The law relating to guarantees is set out in the Civil Code<sup>15</sup> and derives from Roman law antecedents. The Civil Code also contains a general provision, §138, which invalidates contracts that are “against good morals”:<sup>16</sup>

*(1) A legal transaction which violates good morals is void.*

*(2) In particular, a legal transaction is void by which someone through exploitation of the predicament, inexperience, lack of judgment or significant weakness of will of another person, causes to be promised or granted to himself or a third party in return for a performance economic advantages which are conspicuously disproportionate to the performance.*

3.11 In Germany, laws are subject to the Federal Constitutional Court’s interpretation of the Basic Law, which includes a Bill of Rights. This Bill of Rights constitutes “a system of

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13. *Van Rensburg v Minnie* 1942 OPD 257 at 259, 262 (van den Heever J) quoted in R Megarry, *A Second Miscellany-at-Law: A Further Diversion for Lawyers and Others* (Stevens and Sons Ltd, London, 1973) at 245.

14. *Grundgesetz*.

15. *Bürgerliches Gesetzbuch* (BGB) §765-778.

16. See B Markesinis, H Unberath and A Johnston, *The German Law of Contract: A Comparative Treatise* (2nd edition, Hart Publishing, Oxford, 2006) at 870.



basic values permeating the [German] legal system as a whole". This means that "the entire body of private law must be interpreted in the spirit of fundamental rights". The courts initially did not invoke § 138 because they considered that a guarantee imposed obligations only on the guarantor and was, therefore, not subject to "control in terms of overriding standards of justice and fairness". In 1993, the Federal Constitutional Court relieved a guarantor from full liability, holding that the courts, when applying § 138, should have regard to the "basic right guarantee of private autonomy" enshrined in the Basic Law. It also stated that courts were bound to control the content of contracts which disclosed a "structural inferiority of one of the contracting parties" and where "the consequences of the contract are unusually burdensome for the inferior contracting party".<sup>17</sup>

3.12 The Federal Supreme Court now reviews guarantees entered into by close family members of borrowers under § 138. Despite this, close relatives of borrowers may still guarantee risky loans. Guarantees are not regarded as void merely because guarantors have accepted what is, in their case, a considerable burden.<sup>18</sup> Close relatives are protected if, in addition to being responsible for a large debt, they are also subject to additional burdens which lead to an "intolerable imbalance" between the parties to the contract. Such burdens can be the result of a lender exploiting a guarantor's inexperience in business or exploiting the borrower's influence over the guarantor<sup>19</sup> - that is, their obligations "cannot be said to be the result of an act of free self-determination".<sup>20</sup>

3.13 There are a number of categories of close relative which may give rise to a "presumption of an intolerable imbalance between creditor and surety" which could lead a court to declare a guarantee void under § 138. The presumption can arise with respect to a child or spouse of the borrower in circumstances where:<sup>21</sup>

- he or she does not have an "adequate degree of business experience";
- the borrower has induced him or her to undertake the "ruinous obligation"; or
- the lender has influenced the guarantor's will by, for example, playing down the significance or risks of the guarantee.<sup>22</sup>

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17. (BVG) NJW 1994, 36 (19 October 1993), reproduced in English in B Markesinis, H Unberath and A Johnston, *The German Law of Contract: A Comparative Treatise* (2nd edition, Hart Publishing, Oxford, 2006) at 744-751. See also M Habersack and R Zimmermann, "Legal Change in a Codified System: Recent Developments in Germany Suretyship Law" (1999) 3 *Edinburgh Law Review* 272 at 274-277.
18. (BGH), NJW 47, 1341 (24 February 1994); M Habersack and R Zimmermann, "Legal Change in a Codified System: Recent Developments in Germany Suretyship Law" (1999) 3 *Edinburgh Law Review* 272 at 281.
19. (BGH) NJW 47, 1341 (24 February 1994).
20. M Habersack and R Zimmermann, "Legal Change in a Codified System: Recent Developments in Germany Suretyship Law" (1999) 3 *Edinburgh Law Review* 272 at 281.
21. M Habersack and R Zimmermann, "Legal Change in a Codified System: Recent Developments in Germany Suretyship Law" (1999) 3 *Edinburgh Law Review* 272 at 283-284.
22. See especially (BGH) NJW 47, 1341 at II.6 (24 February 1994). See also (BGH) NJW 2002, 2228 at II.1 (14 May 2002).

For example, a lender's claim could be impaired by a borrower inducing a close family member to undertake a guarantee. That is, if the lender "knew both of the child's financial dependence on [his or her] parent and of the ruinous character of the contract of suretyship" or "if these circumstances would have become apparent as a result of a proper examination of the surety's financial standing".<sup>23</sup> However, in the case of spouses, the courts may find that a spouse has an economic interest even if the credit supplied to the other spouse only indirectly contributes to the maintenance of the family.<sup>24</sup> This, therefore, will not affect a spouse's guarantee even if enforcing it would prove ruinous for the spouse.

## United States Equal Credit Opportunity Act

3.14 In the United States, the *Equal Credit Opportunity Act* ("ECOA") has some relevance where spouses act as guarantors.

3.15 The US Congress passed the ECOA<sup>25</sup> in 1974. Among other things, it makes it unlawful for any lender to discriminate in the provision of credit on the basis of sex or marital status.<sup>26</sup> Initially, it aimed to protect married women from discriminatory credit practices.<sup>27</sup> Requiring an otherwise creditworthy individual to get her husband's signature was seen as discriminatory because an unmarried applicant who was creditworthy would not be required to provide a spouse's signature.<sup>28</sup> The Act, therefore, intended that all applicants for loans should be able to establish an individual credit rating. To this end it also expressly prevented lenders from asking questions aimed at discovering an applicant's marital status.

3.16 The provisions apply to all contexts in which guarantees may be sought, whether or not they are primarily for personal, family or household purposes, business or commercial loans and whether or not they are made available by financial institutions or otherwise.<sup>29</sup> It has been suggested that the potential for lenders to violate the ECOA in the

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23. M Habersack and R Zimmermann, "Legal Change in a Codified System: Recent Developments in Germany Suretyship Law" (1999) 3 *Edinburgh Law Review* 272 at 284.

24. M Habersack and R Zimmermann, "Legal Change in a Codified System: Recent Developments in Germany Suretyship Law" (1999) 3 *Edinburgh Law Review* 272 at 284-285. See also B Markesinis, H Unberath and A Johnston, *The German Law of Contract: A Comparative Treatise* (Hart Publishing, Oxford, 2006) at 257.

25. "*Equal Credit Opportunity Act*" is the title applied to 15 *United States Code* §1691-1691f.

26. 15 *United States Code* § 1691.

27. A M Farley, "The Spousal Defence - A Ploy to Escape Payment or Simple Application of the Equal Credit Opportunity Act?" (1996) 49 *Vanderbilt Law Review* 1287 at 1291. See also the discussion of the court in *CMF Virginia Land LP v Brinson* 806 F Supp 90 (1992) at 96.

28. A M Farley, "The Spousal Defence - A Ploy to Escape Payment or Simple Application of the Equal Credit Opportunity Act?" (1996) 49 *Vanderbilt Law Review* 1287 at 1293.

29. See 15 USC § 1691b(a)(2), 1691b(a)(4), 1691b(a)(5).

context of commercial lending is “significant”.<sup>30</sup> However, the Act also states that certain activities do not constitute discrimination for the purposes of the ECOA. For example, it is not discrimination for a lender to:

- ask about marital status in order to ascertain the lender’s rights and remedies against the borrower and not to discriminate in determining whether he or she is creditworthy;<sup>31</sup> or
- request the signature of both parties to a marriage for the purpose of creating a valid lien, passing clear title, waiving inchoate rights to property or assigning earnings, provided marital status is not taken into account in evaluating creditworthiness.<sup>32</sup>

#### *Regulation B*

3.17 The Board of Governors of the Federal Reserve System may make regulations to carry out the ECOA’s purposes.<sup>33</sup> Regulation B provides particular protection for spousal guarantors. It provides:

*a creditor shall not require the signature of an applicant’s spouse or other person, other than a joint applicant, on any credit instrument if the applicant qualifies under the creditor’s standards of creditworthiness for the amount and terms of the credit requested.*<sup>34</sup>

An “applicant” is “any person who requests... an extension of credit from a creditor, and includes any person who is or may become contractually liable regarding an extension of credit” and includes “guarantors, sureties, endorsers, and similar parties”.<sup>35</sup>

3.18 The ECOA and Regulation B also offer protection when any changes are made to the original agreement between lender and borrower so that, when a credit agreement is renewed or extended, the lender must again evaluate the borrower’s individual creditworthiness and assess whether a guarantee is warranted.<sup>36</sup>

#### *Development*

3.19 The ECOA originally sought to prevent lenders from requiring that a husband be a co-signatory or guarantor to his wife’s loan where she was otherwise creditworthy.

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30. K A Palmer, “ECOA, Regulation B, and the Spousal Guaranty” (1993) 110 *The Banking Law Journal* 342 at 342.

31. 15 USC §1691(b)(1). See also 12 CFR § 202.5 and 202.6(b).

32. 15 USC § 1691d(a).

33. 15 USC § 1691b(a)(1).

34. 12 *Code of Federal Regulations* § 202.7(d)(1).

35. 12 *Code of Federal Regulations* § 202.2(e). This would appear to mean that a guarantor could sue under 15 USC § 1691e: see *Silverman v Eastrich Multiple Investor Fund LP* 51 F3d 28 (1995) at 30-31

36. 12 *Code of Federal Regulations* § 202.7(d)(5); 15 USC § 1691a(b). See also *Stern v Espirito Santo Bank of Florida* 791 F Supp 865 at 869 (1992).

However, now both husbands and wives are using a breach of the Act as a defence to the enforcement of guarantees.<sup>37</sup>

3.20 Common examples of breaches of the ECOA include:

- where a lender requires a husband to get his wife's signature even though the husband is individually creditworthy; and
- where there is a loan to a company and the lender requires not only the husband (as a director of the company) to guarantee the loan, but the wife as well.<sup>38</sup>

3.21 This unexpected application of the provisions of the ECOA has raised a number of questions, for example, as to whether:

- husbands can claim to have been discriminated against by lenders requiring that their wives act as guarantors; and
- wives can, therefore, seek to avoid their obligations as guarantors.<sup>39</sup>

The application of the ECOA in these circumstances is now an unsettled area of the law.

*Affirmative defence or counterclaim*

3.22 Much currently turns on the interpretation of the section of the ECOA which allows courts to "grant such equitable and declaratory relief as is necessary to enforce the requirement imposed under [the ECOA requirements]".<sup>40</sup> If used as an affirmative defence, the provisions can prevent a lender obtaining summary judgment on the guarantee. However, it has also been argued that these provisions can only be used by a guarantor to establish a "compulsory counterclaim". In the US legal system, this means that a guarantor's ECOA claim would have to be pursued separately to the lender's application for summary judgment.<sup>41</sup> This puts a guarantor at a significant strategic disadvantage in litigation if judgment is entered against him or her in the first proceeding.<sup>42</sup>

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37. A M Farley, "The Spousal Defence - A Ploy to Escape Payment or Simple Application of the Equal Credit Opportunity Act?" (1996) 49 *Vanderbilt Law Review* 1287 at 1288-1289, 1293-1295.

38. A M Farley, "The Spousal Defence - A Ploy to Escape Payment or Simple Application of the Equal Credit Opportunity Act?" (1996) 49 *Vanderbilt Law Review* 1287 at 1289.

39. A M Farley, "The Spousal Defence - A Ploy to Escape Payment or Simple Application of the Equal Credit Opportunity Act?" (1996) 49 *Vanderbilt Law Review* 1287 at 1289.

40. 15 USC § 1691e(c).

41. A L diLorenzo, "Regulation B: How Lenders can Fight Back Against the Affirmative Use of Regulation B" (2000) 8 *University of Miami Business Law Review* 215 at 217-218.

42. See A M Farley, "The Spousal Defence - A Ploy to Escape Payment or Simple Application of the Equal Credit Opportunity Act?" (1996) 49 *Vanderbilt Law Review* 1287 at 1296-1297.

The question, therefore, becomes whether the ECOA provides a defence to enforcement actions or whether a counterclaim is a spouse's only available form of relief.<sup>43</sup>

3.23 Some courts have used this section to relieve spouses from any obligation as guarantors,<sup>44</sup> while others have refused to offer such relief because the remedy has not been specifically provided for or is considered too drastic.<sup>45</sup>

3.24 One of the chief consequences of this provision, in view of the uncertainty in the law, is that prudent lenders, when deciding to grant credit or revise an existing arrangement, must assess the creditworthiness of the business standing alone. If the business is individually creditworthy, then the lender will not need a guarantee from a spouse. In any event, even if the lender determines that the borrower is not individually creditworthy under the ECOA, the lender cannot require that the spouse be guarantor.<sup>46</sup>

3.25 It has also been suggested that lenders should ensure that spouses who guarantee loans:

*sign written acknowledgments evidencing that the spousal guaranty was provided voluntarily, was not required by the lender, and that the guarantors were advised by the lender of the protections afforded them by the ECOA.*<sup>47</sup>

One commentator has suggested that:

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43. A M Farley, "The Spousal Defence - A Ploy to Escape Payment or Simple Application of the Equal Credit Opportunity Act?" (1996) 49 *Vanderbilt Law Review* 1287 at 1290.
44. *Silverman v Eastrich Multiple Investor Fund LP* 51 F 3d 28 (1995); *Integra Bank v Freeman* 839 F Supp 326 (993); *Federal Deposit Insurance Corporation v Medmark Inc* 897 F Supp 511 at 514 (1995); *Southwestern Pennsylvania Regional Council Inc v Gentile* 776 A 2d 276 at 282 (2001).
45. *CMF Virginia Land LP v Brinson* 806 F Supp 90 (1992) at 95-96; *Diamond v Union Bank and Trust of Bartlesville* 776 F Supp 542 (1991); *Federal Deposit Insurance Corporation v 32 Edwardsville Inc* 873 F Supp 1474 at 1480 (1995). But see A L diLorenzo, "Regulation B: How lenders can fight back against the affirmative use of Regulation B" (2000) 8 *University of Miami Business Law Review* 215 at 217-218; K A Palmer, "ECOA, Regulation B, and the Spousal Guaranty" (1993) 110 *The Banking Law Journal* 342 at 349; A M Farley, "The Spousal Defense - A Ploy to Escape Payment or Simple Application of the Equal Credit Opportunity Act?" (1996) 49 *Vanderbilt Law Review* 1287 at 1298-1304; *Silverman v Eastrich Multiple Investor Fund LP* 51 F 3d 28 at 33 (1995).
46. For examples of advice to lenders aimed at ensuring compliance with the ECOA see K A Palmer, "ECOA, Regulation B, and the Spousal Guaranty" (1993) 110 *The Banking Law Journal* 342 at 349-351; A L DiLorenzo, "Regulation B: How Lenders can Fight Back Against the Affirmative Use of Regulation B" (2000) 8 *University of Miami Business Law Review* 215 at 222-223. See also P H Schieber, "Attention Lenders: Reevaluate Spousal Signature Policies and Procedures" (1993) 5 *Loyola Consumer Law Reporter* 68.
47. K A Palmer, "ECOA, Regulation B, and the Spousal Guaranty" (1993) 110 *The Banking Law Journal* 342 at 350-351.

*Such evidence is cheap insurance against future claims in the event the guarantor is ever called on to perform.*<sup>48</sup>

3.26 In the United States, the credit industry has argued that the costs arising from compliance with the ECOA will be passed on to consumers in the form of higher interest rates, higher charges or more stringent credit standards.<sup>49</sup> The Law Reform Commission has received submissions to similar effect in response to a question whether all third party guarantees should be prohibited.<sup>50</sup>

3.27 There are a number of responses to such claims, including the observation that costs would only be placed completely on borrowers if supply were "perfectly elastic". A review of empirical evidence suggests that supply in the credit market is not perfectly elastic.<sup>51</sup> It has also been suggested that, in an already heavily regulated sector of the economy, the enforcement of a "singular regulatory act" is unlikely to have the negative effects predicted by some:

*Credit transactions occur within a competitive market. If a huge pool of credit-seeking applicants are left without the ability to obtain credit, the market will compensate for this deficiency either by introducing alternative means of obtaining credit, or by the incursion of less "established" financial institutions profiting from a readily available group of customers. In either case, the possibility of creditors raising the standards of creditworthiness to the point of pricing themselves out of the market is remote.*<sup>52</sup>

## LIMITING THE USE OF PARTICULAR PROPERTY AS SECURITY

3.28 In some overseas jurisdictions, there are laws known as "homestead" laws. These laws impose limits on the extent to which residential property can be used as security for debts, for example, by protecting all or part of its value. The laws vary from place to place and have been enacted for many different reasons. They generally offer limited, incidental protection to guarantors.<sup>53</sup>

3.29 Homestead laws had their origins in the mid 19th century in North America and were intended to prevent lenders using debtors' land to satisfy debts. The Republic of

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48. K A Palmer, "ECOA, Regulation B, and the Spousal Guaranty" (1993) 110 *The Banking Law Journal* 342 at 351.

49. A M Farley, "The Spousal Defense - A Ploy to Escape Payment or Simple Application of the Equal Credit Opportunity Act?" (1996) 49 *Vanderbilt Law Review* 1287 at 1307.

50. See para 4.32.

51. A M Farley, "The Spousal Defense - A Ploy to Escape Payment or Simple Application of the Equal Credit Opportunity Act?" (1996) 49 *Vanderbilt Law Review* 1287 at 1308.

52. A M Farley, "The Spousal Defense - A Ploy to Escape Payment or Simple Application of the Equal Credit Opportunity Act?" (1996) 49 *Vanderbilt Law Review* 1287 at 1309.

53. See B Fehlberg, *Sexually Transmitted Debt: Surety Experience and English Law* (Clarendon Press, Oxford, 1997) at 273-274.

Texas enacted the first homestead law in 1839 in an attempt to encourage debtors fleeing the United States to settle there.<sup>54</sup>

3.30 While some homestead laws still apply to all owners of “homestead” property, other schemes only apply where family members or spouses also live in the property. Where the “homestead” must also be occupied by a spouse to be eligible for protection, a distinction can be drawn between schemes that protect only spouses who have no other property interest in the homestead (“non-owning” spouses) and those that also protect spouses who have a real interest in the homestead, for example, as joint tenants or tenants-in-common. Some of these latter schemes are limited to situations where the security over the property has been entered without the consent of the other spouse.

3.31 Examples of the different types of homestead laws are found in the United States, Canada and New Zealand. There is also an example, of historical interest only, in New South Wales. Each of these examples would have limited, and only incidental, application to situations where family members or friends have guaranteed loans.

## United States homestead laws

3.32 Every State in the United States has laws that protect some of the assets of debtors from claims by lenders and the majority of them have laws that offer some protection to “homestead” properties.<sup>55</sup> The homestead exemptions are usually available for properties up to a certain value and the limits may vary depending on whether the debtor is part of a family, single, a veteran or elderly.<sup>56</sup> Most exemptions could conceivably apply to guarantors who have become responsible for the debts of another.

3.33 A law and economics analysis of the different regimes has suggested that homestead laws may, in fact, not be a response to a real problem, noting that they “restrict credit markets in the absence of a well-defined market failure to which they would be a suitable response”. This analysis concluded that the “best predictor of current levels of exemptions is historical levels of exemptions”.<sup>57</sup> The historical reasons for offering the protection have not been to protect the property interests of guarantors but have rather been to:

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54. A Milner, “A Homestead Act for England?” (1959) 22 *Modern Law Review* 458 at 462.

55. See R M Hynes, A Malani and E A Posner, “The Political Economy of Property Exemption Laws” (2004) 47 *Journal of Law and Economics* 19 at 19 and 25-26 (Table 1). See also G L Haskins, “Homestead Exemptions” (1950) 63 *Harvard Law Review* 1288 for an overview of the position in 1950.

56. See R M Hynes, A Malani and E A Posner, “The Political Economy of Property Exemption Laws” (2004) 47 *Journal of Law and Economics* 19 at 23.

57. R M Hynes, A Malani and E A Posner, “The Political Economy of Property Exemption Laws” (2004) 47 *Journal of Law and Economics* 19 at 20, 40-41.

- secure the family “which in turn benefits the community to the extent that such security prevents pauperism and provides the members of the family with some measure of stability and independence”,<sup>58</sup>
- encourage home ownership;<sup>59</sup>
- protect the elderly and disabled;<sup>60</sup> and
- attract settlers to “areas in which the home is accorded maximum protection”.<sup>61</sup>

*Kansas*

3.34 The State of Kansas protects the “homestead” against enforcement actions by lenders in a reasonably comprehensive manner. The relevant provisions state:

*A homestead ... occupied as a residence by the owner or by the family of the owner, or by both the owner and family thereof ... shall be exempted from forced sale under any process of law, and shall not be alienated without the joint consent of husband and wife, when that relation exists; but no property shall be exempt from sale for taxes, or for the payment of obligations contracted for the purchase of said premises, or for the erection of improvements thereon. The provisions of this section shall not apply to any process of law obtained by virtue of a lien given by the consent of both husband and wife, when that relation exists.*<sup>62</sup>

This provision will protect residential property owned by any person who guarantees another's debts. More specifically, property held jointly, for example, by a husband and wife, is also covered by the exemption.<sup>63</sup>

3.35 Kansas has had provisions of this sort since its foundation when the essential elements were included in its Constitution.<sup>64</sup> Commentators have observed that “with few exceptions, the courts have guarded its protections zealously”.<sup>65</sup> The Supreme Court of Kansas once stated:

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- 58. G L Haskins, “Homestead Exemptions” (1950) 63 *Harvard Law Review* 1288 at 1288.
  - 59. G L Haskins, “Homestead Exemptions” (1950) 63 *Harvard Law Review* 1288 at 1289.
  - 60. M W McCarthy, “The Massachusetts Homestead Act: Throw Out the Bathwater” (2000) 44 *Boston Bar Journal* 12 at 12.
  - 61. G L Haskins, “Homestead Exemptions” (1950) 63 *Harvard Law Review* 1288 at 1289.
  - 62. *Kansas Statutes* §60-2301. Most of the provisions in this section have the force of constitutional protection, having been lifted directly from the Kansas Constitution: *Constitution of the State of Kansas* §15-9.
  - 63. *Grant v Mossman* 384 F2d 496 (1967), a case relating to jointly held property inherited by two brothers.
  - 64. R L Theis and K R Swartz, “Kansas Homestead Law” (1996) 65 *Journal of the Kansas Bar Association* 20 at 20.
  - 65. R L Theis and K R Swartz, “Kansas Homestead Law” (1996) 65 *Journal of the Kansas Bar Association* 20 at 48.



*The preservation of the homestead is, under the policy of our law, considered more important than the payment of debts.*<sup>66</sup>

#### *Texas*

3.36 The State of Texas provides a similar level of protection to owners of a homestead against the claims of lenders. The provisions are also backed up by constitutional protections, which include some far-reaching and complex provisions regarding the extension of credit.<sup>67</sup> Amendments made in 1983 now protect the whole value of a homestead property,<sup>68</sup> subject to certain restrictions in land area, and apply whether the owner resides in the property alone or with a family.<sup>69</sup> A homestead property is automatically eligible for protection.

3.37 The courts of Texas have construed the homestead provisions liberally in favour of debtors. The United States Court of Appeals observed in 1992:

*Because homesteads are favourites of the law, we must give a liberal construction to the constitutional and statutory provisions that protect homestead exemptions. ... Indeed, we must uphold and enforce the Texas homestead laws even though in so doing we might unwittingly "assist a dishonest debtor in wrongfully defeating his creditor."*<sup>70</sup>

So, for example, while the initial burden to establish the homestead character of a property rests on the individual who seeks the protection, this burden is considered "a short hurdle" so that, in most cases, "mere evidence of 'overt acts of homestead usage'" is sufficient to discharge the burden.<sup>71</sup>

#### *Massachusetts*

3.38 Massachusetts provides an example of a homestead scheme that may also offer some protection to guarantors but to a more limited extent than that offered by Kansas.

3.39 The Massachusetts homestead provisions, subject to certain exceptions, protect a homestead estate against actions by lenders only to the extent of \$500,000. The owner must occupy the homestead as a principal residence either solely or as part of a family. The owner can be either a sole owner or a joint owner.<sup>72</sup> However, in order to qualify for the homestead estate protections, a property must be designated on the conveyance at purchase or, after purchase, duly declared and recorded in the registry of deeds.<sup>73</sup>

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66. *LaRue v Gilbert* 18 Kan 220 (1877) at 222.

67. *Texas Constitution* Art 16 §50 and 51.

68. *Texas Property Code* §41.001.

69. *Texas Property Code* §41.002.

70. *Bradley v Pacific Southwest Bank* 960 F2d 502 (1992) at 505-507.

71. *Bradley v Pacific Southwest Bank* 960 F2d 502 (1992) at 507.

72. *General Laws of Massachusetts* §188-1.

73. *General Laws of Massachusetts* §188-2. Separate provision is also made in relation to persons who are 62 years or older, "regardless of marital status" or who are disabled: *General Laws of Massachusetts* §188-1A.

3.40 There is little evidence of the use of the homestead protection in Massachusetts. Some commentators have suggested this is because most people were unaware of the notification requirements and had not taken advantage of them.<sup>74</sup> The provisions themselves have also been subject to considerable criticism for their poor drafting and conflicting provisions.<sup>75</sup>

## Canadian homestead laws

3.41 The Canadian homestead laws have a slightly different focus compared with their United States counterparts. The Canadian laws are more concerned with protecting the interests of the “non-owning” spouse in the residence when it is owned by the other spouse. So, for example, Saskatchewan and Alberta both offer a level of protection to a “non-owning spouse” when a property has been occupied by both spouses as their family home.<sup>76</sup> An “owning spouse” cannot deal with a homestead property without the consent of the non-owning spouse.<sup>77</sup>

3.42 The laws effectively exclude properties which both partners own, for example, as joint tenants or tenants-in-common, by deeming consent when both parties sign the relevant transaction documents.<sup>78</sup> The laws, therefore, do not apply to situations where one spouse guarantees the debts of the other.

3.43 The Alberta Law Reform Institute has observed that the requirement of consent from the non-owning spouse is necessary to Alberta's provisions for dower life estates whereby the non-owning spouse is entitled to a life interest in the homestead upon the death of the owning spouse:

*The promise of a dower life interest is less valuable if the home can be sold, leased or mortgaged by the owner without the consent of the other spouse.*<sup>79</sup>

## New Zealand homestead laws

3.44 The *Joint Family Home Act 1964* (NZ) allows for lawful spouses to register a home as a “joint family home”. Where one spouse originally owns the home, registration establishes a joint tenancy<sup>80</sup> so that the “non-owning” spouse gets a property interest where one did not exist previously.

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74. M W McCarthy, “The Massachusetts Homestead Act: Throw Out the Bathwater” (2000) 44 *Boston Bar Journal* 12 at 13.

75. M W McCarthy, “The Massachusetts Homestead Act: Throw Out the Bathwater” (2000) 44 *Boston Bar Journal* 12 at 12 and 27.

76. *Homesteads Act 1989*, SS 1989-90, c H-5.1.

77. *Homesteads Act 1989*, SS 1989-90, c H-5.1 s 5(1); *Dower Act RSA 2000* c D-15 s 4.

78. *Homesteads Act 1989*, SS 1989-90, c H-5.1 s 5(2); *Dower Act RSA 2000* c D-15 s 25(2).

79. Alberta Law Reform Institute, *The Matrimonial Home* (Report for Discussion 14, 1995) at 71.

80. *Joint Family Homes Act 1964* (NZ) s 9(1)(b).

3.45 Registration offers a definite protection against certain claims up to a specified sum, currently NZ\$103,000<sup>81</sup> and allows lenders to apply to the court to order a sale or mortgage to make the equity in the home above the specified sum available to lenders.<sup>82</sup>

3.46 However, the Act only offers limited protection in that it allows the property to be used as security so long as both parties enter into the agreement.<sup>83</sup> Registration, therefore, only protects the “joint family home” from unsecured claims up to the specified sum. It does not affect the rights of secured creditors.

3.47 The New Zealand Law Commission has observed that the practical effect of this arrangement is that the protection is largely confined to “consumer bankruptcies”.<sup>84</sup> This essentially renders the provisions useless from the point of view of the “guaranteeing” spouse. Fehlberg has observed:

*To offer effective protection, the Act would need to preclude creditor reliance on all charges given even with the consent of both spouses and would need to be extended to cover all owner-occupiers (not just spouses).<sup>85</sup>*

The New Zealand Law Commission also mooted, but ultimately rejected, the idea of replacing the current provisions in the *Joint Family Home Act 1964* (NZ) with a blanket protection of a bankrupt’s principal dwelling house.<sup>86</sup>

3.48 There is at least one instance of the protection operating where a spouse guaranteed a debt owed by a family company,<sup>87</sup> although the case did not raise any questions of unfairness in the circumstances.

## New South Wales homestead laws

3.49 Between 1895 and 1989, a scheme existed in New South Wales which offered homestead protection to certain occupiers of Crown land holdings. The final form of this scheme was contained in the *Crown Lands Consolidation Act 1913* (NSW).<sup>88</sup> The relevant

81. *Joint Family Homes Act 1964* (NZ) s 16(5).

82. See *Joint Family Homes Act 1964* (NZ) s 16(1)(b). The court’s discretion is unfettered and subject only to the requirements of justice in all the circumstances of the case: *Official Assignee v Lawford* [1984] 2 NZLR 257 at 264.

83. *Joint Family Homes Act 1964* (NZ) s 9(2)(d).

84. New Zealand, Law Commission, *The Future of the Joint Family Homes Act* (Report 77, 2001) at para 8.

85. B Fehlberg, *Sexually Transmitted Debt: Surety Experience and English Law* (Clarendon Press, Oxford, 1997) at 275.

86. New Zealand, Law Commission, *The Future of the Joint Family Homes Act* (Report 77, 2001) at para 16-21.

87. The court considered the circumstances would have been no different had it been the husband rather than the family company that was insolvent: *Official Assignee v Lawford* [1984] 2 NZLR 257.

88. The relevant provisions were originally enacted in *Crown Lands Act 1895* (NSW) s 23. The Act was repealed and the provisions replaced by *Crown Lands*

provisions allowed the owner of a homestead selection, homestead farm, suburban holding, Crown-lease or lease within an irrigation area<sup>89</sup> to obtain protection by registering an instrument in the "approved form". The protection ensured that the homestead would not be sold under any writ of execution, would not be taken into account on bankruptcy<sup>90</sup> and could "not in any other way be taken from the owner thereof for the satisfaction of any debt or liability under process or constraint of law".<sup>91</sup> The relevant section also preserved any liabilities entered into before registration of the holding as well as liability for any rates or taxes.

3.50 The provisions were originally part of a set of measures enacted in 1895 following a period of financial and natural difficulties in New South Wales which saw vast tracts of land end up unoccupied or in the hands of financial institutions. The measures were intended to encourage occupancy and cultivation of the land.<sup>92</sup>

3.51 The framework for this scheme was still in place in the 1980s when amendments were being made to fees chargeable in relation to the prescribed forms under the *Crown Lands Consolidation Act 1913* (NSW).<sup>93</sup> However, there would appear to be no reported cases dealing with these provisions. It is possible that the provisions were not widely known and that the registration requirements may have discouraged applicants.

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*Consolidation Act 1913* (NSW) s 271. The 1913 Act was repealed by the *Crown Lands Act 1989* (NSW) which did not replace the homestead provisions.

89. Homestead selection, homestead farm, suburban holding, Crown-lease, or lease within an irrigation area were all particular forms of land holdings available under the *Crown Lands Consolidation Act 1913* (NSW): see s 88-97, 118-123A, 124-129B; 130-136; 137-147N.
90. The provisions relating to bankruptcy may have been inoperative from 1928 following the coming into operation of the *Bankruptcy Act 1924* (Cth): See B A Helmore, *The Law of Real Property in New South Wales* (2nd edition, Law Book Co, Sydney, 1961) at 558. See also *Price v Parsons* (1936) 54 CLR 332 (in relation to *Bills of Sale Act 1898* (NSW) s 5); and *Broadcast Australia Pty Ltd v Minister Assisting the Minister for Natural Resources (Lands)* (2004) 204 ALR 46 at para 18 (in relation to a permissive occupancy under *Crown Lands Consolidation Act 1913* (NSW) s 136K(1)).
91. *Crown Lands Consolidation Act 1913* (NSW) s 271(1)(c).
92. S H Roberts, *History of Australian Land Settlement (1788-1920)* (Macmillan & Co, Melbourne, 1924) at 292-293.
93. See Regulation published in Government Gazette No 116 of 3 September 1982, cl 3, amending *Crown Lands Consolidation Regulations 1914* (NSW) reg 208. By 1982, in the case of Crown grants, an eligible person could lodge the prescribed form, together with a fee of \$30, with the Registrar-General, or with the Crown land agent in the district in the case of Crown leases, or Crown grants that had not yet been issued: *Crown Lands Regulations 1914* (NSW) reg 207-209 and Form 74. See also J Baalman and T Le M Wells, *The Practice of the Land Titles Office (New South Wales)* (3rd edition, Law Book Co, Sydney, 1952) at 104-105; and A G Lang, *Crown Land in New South Wales* (Butterworths, Sydney, 1973) at 415.

## REGULATING TRANSACTIONS

3.52 Another way in which legal systems have dealt with guarantees has been to regulate certain acts and practices in relation to contracts, including, in some cases, particular terms in contracts.<sup>94</sup> This approach can be seen in the European Community Directives of the European Union and the United States Trade Commission's Regulations. An incidental example can also be found in the homestead laws of some Canadian provinces.

### European Community Directives

3.53 There are a number of European Community Directives that can be identified as part of a general trend in the European Union towards "increased consumer protection".<sup>95</sup> The scope of some of these Directives arguably has some bearing on the validity of guarantees, although none of them deal with guarantees in direct terms.

3.54 The Directives provide a minimum standard on which the member States of the European Union must base their implementing legislation. Action may be taken against member States who do not implement the minimum standards contained in the Directives.

3.55 Three European Community Directives are considered in the following paragraphs:

- Directive on Unfair Terms in Consumer Contracts;<sup>96</sup>
- Directive on Consumer Credit;<sup>97</sup> and
- Directive for the Protection of consumers in respect of contracts negotiated away from business premises.<sup>98</sup>

Each directive only protects participants in consumer transactions.

#### *Unfair terms in consumer contracts*

3.56 The Directive on Unfair Terms in Consumer Contracts was promulgated in 1993. It aims to do two things:

- render particular unfair terms non-binding on consumers on a case by case basis;<sup>99</sup> and

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94. The Standing Committee on Law and Justice has recommended that the government establish a taskforce to develop amendments to the *Fair Trading Act 1987* (NSW) (modeled on the *Fair Trading Act 1999* (Vic) Pt 2B), that would result in the protection of consumers in relation to unfair terms in consumer contracts: see Parliament of New South Wales, Legislative Council, Standing Committee on Law and Justice, *Unfair Terms in Consumer Contracts* (Report 32, 2006).

95. M Habersack and R Zimmermann, "Legal Change in a Codified System: Recent Developments in Germany Suretyship Law" (1999) 3 *Edinburgh Law Review* 272 at 293.

96. Directive 93/13/EEC.

97. Directive 87/102/EEC.

98. Directive 85/577/EEC.

- prevent continued use of particular unfair terms in consumer contracts.<sup>100</sup>

3.57 The Directive applies to unfair terms in contracts concluded between sellers or suppliers and consumers.<sup>101</sup> Article 3(1) of the Directive provides:

*A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.*

3.58 The Directive identifies terms in standard contracts as being examples of terms that have not been individually negotiated.<sup>102</sup> The Directive also requires that, where a contract is in writing, the "terms must always be drafted in plain intelligible language".<sup>103</sup>

3.59 The courts, in determining whether a term is unfair, must have regard to "all the other terms of the contract or of another contract on which it is dependent"<sup>104</sup> and, where there is doubt as to the meaning of a term "the interpretation most favourable to the consumer shall prevail".<sup>105</sup>

3.60 The Directive has been implemented in member states of the European Union, including Germany and the United Kingdom.

3.61 Germany has implemented article 3 of the Directive as follows:

*Provisions in general conditions of business are ineffective if they unreasonably disadvantage the user's contracting partner in a manner contrary to the requirements of good faith.*<sup>106</sup>

3.62 The 9th Division of the Federal Supreme Court has applied this provision to all moneys clauses - referred to as "comprehensive suretyship agreements". Such clauses have been found to be contrary to the precepts of good faith.<sup>107</sup> This means that the Federal Supreme Court may now review all moneys clauses in guarantees.

3.63 The United Kingdom has implemented the Directive as follows:

*A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a*

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99. Directive 93/13/EEC art 6(1).

100. Directive 93/13/EEC art 7.

101. Directive 93/13/EEC art 1(1).

102. Directive 93/13/EEC art 3(2).

103. Directive 93/13/EEC art 5.

104. Directive 93/13/EEC art 4(1).

105. Directive 93/13/EEC art 5.

106. BGB §307(1), previously implemented by *Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen (AGBG)* § 9(1).

107. M Habersack and R Zimmermann, "Legal Change in a Codified System: Recent Developments in Germany Suretyship Law" (1999) 3 *Edinburgh Law Review* 272 at 287.

*significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.*<sup>108</sup>

3.64 The courts have not yet applied the Regulations to a case involving a guarantee. Some commentators have suggested that the Regulations may not, in fact, apply to guarantees because there must be a contract for the provision of goods and services by the supplier to the consumer.<sup>109</sup> This is a drafting issue which has not arisen, for example, in the case of the German implementation of the Directive which is not limited to situations where the supply is to the consumer.<sup>110</sup>

#### *Consumer credit*

3.65 The Directive on Consumer Credit, which applies to credit agreements, seeks to protect consumers. The relevant terms are defined in article 1(2):

*(a) 'consumer' means a natural person who, in transactions covered by this Directive, is acting for purposes which can be regarded as outside his trade or profession; ...*

*(c) 'credit agreement' means an agreement whereby a creditor grants or promises to grant to a consumer a credit in the form of a deferred payment, a loan or other similar financial accommodation.*

Article 2(1)(f) limits the Directive to credit agreements involving amounts between €200 and €20,000.

3.66 The Directive also allows member States to require that further terms be included in credit agreements, for example, a cooling off period.<sup>111</sup> So, in Germany, the Consumer Credit Law provides that the credit contract becomes effective only if the borrower does not cancel it within one week of receiving a notice from the lender informing the borrower of his or her right to withdraw from the contract and the procedure to be followed in doing so.<sup>112</sup>

3.67 There has been some dispute as to whether the Directive can in fact be applied to guarantees. These arguments were discussed in a case before the European Court of Justice. The case involved a guarantor who was not acting in the course of his trade or

108. *Unfair Terms in Consumer Contracts Regulations 1999* (UK) reg 5(1).

109. See, for example, *Unfair Terms in Consumer Contracts Regulations 1994* (UK) reg 5(1).

110. R Bradgate, "The Integration of Directive 93/13 into the National Legal Systems: Experience in the United Kingdom" paper delivered at the Conference *The Directive on "Unfair Terms": 5 Years on - Evaluation and Future Perspectives* (Brussels, Belgium, 1-3 July 1999) at 37, in relation to *Unfair Terms in Consumer Contracts Regulations 1994* (UK) reg 5(1)). The position does not appear to have altered in the 1999 regulations: *Unfair Terms in Consumer Contracts Regulation 1999* (UK) reg 8(1)). See also B Markesinis, H Unberath and A Johnston, *The German Law of Contract: A Comparative Treatise* (2nd edition, Hart Publishing, Oxford, 2006) at 47.

111. See Article 4(3), 15 and Annex I item 1(vii) to 87/102/EEC.

112. *Verbraucherkreditgesetz* (1990). This provision is subject to a maximum limit of one year from the conclusion of the credit agreement.

profession and who had not been informed of his alleged right of cancellation under the German Consumer Credit Law. The European Court of Justice found that the Directive did not apply to guarantees either expressly or by implication.<sup>113</sup> The Court noted, in particular, that the Directive seeks to protect borrowers by ensuring the provision of certain information and that there are no provisions for protecting guarantors whose primary concern is the solvency of the borrower.<sup>114</sup>

3.68 The Directive would, therefore, seem to be confined to credit agreements between lenders and borrowers. The European Commission has proposed extending some of the Directive's information provisions to guarantees.<sup>115</sup>

*Contracts negotiated away from business premises*

3.69 This Directive, sometimes referred to as the Directive on Consumer Protection in the Context of Doorstep Selling, aims to protect consumers who may not be able to appreciate all the implications of entering into the contract. This is because the contract is initiated by a person who is acting in a commercial or professional capacity,<sup>116</sup> and because the subject of the contract could be regarded as outside the consumer's trade or profession.<sup>117</sup>

3.70 The Directive is stated to:

*apply to contracts under which a trader supplies goods or services to a consumer and which are concluded:...*

*- during a visit by a trader*

*(i) to the consumer's home or to that of another consumer;*

*(ii) to the consumer's place of work;*

*where the visit does not take place at the express request of the consumer.*<sup>118</sup>

A "trader" includes "anyone acting in the name or on behalf of a trader".<sup>119</sup>

113. *Berliner Kindl Brauerei AG v Siepert* (European Court of Justice (5th Chamber), C-208/98, Judgment of the Court, 23 March 2000) at para 19-26. See also *Berliner Kindl Brauerei AG v Siepert* (European Court of Justice (5th Chamber), C-208/98, Opinion of Advocate General Léger, 28 October 1999) at para 43, 50, 62, 66.

114. *Berliner Kindl Brauerei AG v Siepert* (European Court of Justice (5th Chamber), C-208/98, Judgment of the Court, 23 March 2000) at para 25. See also *Berliner Kindl Brauerei AG v Siepert* (European Court of Justice (5th Chamber), C-208/98, Opinion of Advocate General Léger, 28 October 1999) at para 55-62.

115. Commission of the European Communities, *Report on the operation of Directive 87/102/EEC for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit* (COM (95) 117 final, 1995) at 88-89.

116. Directive 85/577/EEC art 1(1).

117. See Directive 85/577/EEC art 2.

118. Directive 85/577/EEC art 1(1).



3.71 The Directive provides that a contract becomes effective only if the consumer does not cancel it within at least seven days of receiving from the trader a notice informing the consumer of his or her right to cancel.<sup>120</sup>

3.72 The European Court of Justice has suggested that, unlike the Directive on Consumer Credit, this Directive can be applied to guarantees in certain circumstances.<sup>121</sup> In 1998, the Court, interpreting the then German version of the Directive,<sup>122</sup> held that a guarantee entered into by a person who is not acting in the course of that person's trade or profession, does not come within the scope of the Directive where the contract guarantees a debt undertaken by another person who is acting in the course of his or her trade or profession.<sup>123</sup> This means that the Directive could apply where both the guarantor and the borrower enter their agreements away from the business premises of the lender.<sup>124</sup> This is because nothing in the wording of the Directive requires that the person entering the contract under which goods or services are supplied must be the person to whom they are actually supplied.<sup>125</sup>

3.73 The United Kingdom has implemented the Directive, giving consumers a seven day cooling off period to cancel a contract entered into as a result of doorstep selling.<sup>126</sup>

## United States Trade Commission Regulations

3.74 In the United States, the *Federal Trade Commission Act* declares certain unfair or deceptive acts or practices in or affecting commerce to be unlawful.<sup>127</sup> Regulations have been framed under this Act<sup>128</sup> in relation to credit practices, including the taking of guarantees.<sup>129</sup> The particular provisions relating to guarantors (referred to as "cosigners") apply only to the extension of credit to a consumer,<sup>130</sup> that is, a person who "seeks or

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119. Directive 85/577/EEC art 2.

120. Directive 85/577/EEC art 4, 5.

121. *Berliner Kindl Brauerei AG v Siepert* (European Court of Justice (5th Chamber), C-208/98, Judgment of the Court, 23 March 2000) at para 24.

122. *Gesetz über den Widerruf von Haustürgeschäften und ähnlichen Geschäften* (16 January 1986), now contained in BGB §312

123. *Bayerische Hypotheken- und Wechselbank AG v Dietzinger* (European Court of Justice, C-45/96, Judgment of the Court (5th Chamber), 17 March 1998) at para 23.

124. *Bayerische Hypotheken- und Wechselbank AG v Dietzinger* (European Court of Justice, C-45/96, Judgment of the Court (5th Chamber), 17 March 1998) at para 22.

125. *Bayerische Hypotheken- und Wechselbank AG v Dietzinger* (European Court of Justice, C-45/96, Judgment of the Court (5th Chamber), 17 March 1998) at para 19. See also *Berliner Kindl Brauerei AG v Siepert* (European Court of Justice (5th Chamber), C-208/98, opinion of Advocate General Léger, 28 October 1999) at para 38-39.

126. *Consumer Protection (Contracts Concluded Away from Business Premises) Regulations 1987* (UK) reg 4.

127. See 15 USC § 45(a)(1).

128. See 15 USC § 57a(a)(1)(B).

129. See 16 CFR Pt 444.

130. 16 CFR § 444.3(a).

acquires goods, services, or money for personal, family, or household use<sup>131</sup> and only where that person "renders himself or herself liable for the obligation of another person without compensation".<sup>132</sup> The Regulations declare it to be a "deceptive act or practice... for a lender... directly or indirectly, to misrepresent the nature or extent of cosigner liability to any person".

3.75 The Regulations prescribe a notice that must be given to guarantors before they enter the obligation. The notice must consist of a separate document containing only the following statement:

*Notice to Cosigner*

*You are being asked to guarantee this debt. Think carefully before you do. If the borrower doesn't pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility.*

*You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increase this amount.*

*The creditor can collect this debt from you without first trying to collect from the borrower. The creditor can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become a part of your credit record.*

*This notice is not the contract that makes you liable for the debt.*<sup>133</sup>

The Regulations also allow State laws to continue to have effect provided they afford a level of protection to consumers that is "substantially equivalent to, or greater than", the protection afforded by the Regulations, and the State administers and enforces the law effectively.<sup>134</sup>

3.76 The Federal Trade Commission may take action in relation to the acts declared to be unlawful by the *Federal Trade Commission Act*.<sup>135</sup> However, it would appear that there is no private cause of action arising out of an alleged breach of these provisions.<sup>136</sup>

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131. 16 CFR § 444.1(d).

132. 16 CFR § 444.1(k).

133. 16 CFR § 444.3(c).

134. 16 CFR § 444.5(a).

135. 15 USC § 45(a)(1).

136. See *Holloway v Bristol-Myers Corp* 485 F2d 986 (1973); *Carlson v Coca-Cola Co* 483 F2d 279 (1973); *Fulton v Hecht* 580 F2d 1243 (1978); *Naylor v Case and McGrath Inc* 585 F2d 557 (1978); *Baum v Great Western Cities Inc* 703 F2d 1197 (1983); *RT Vanderbilt Co v OSHRC* 708 F2d 570 (1983); *Morrison v Back Yard Burgers Inc* 91 F3d 1184 (1996).

## Consent requirements in Canadian homestead laws

3.77 In Saskatchewan, where a person may not deal with a homestead property without the consent of the non-owning spouse, the non-owning spouse must indicate his or her consent to the property transaction in a prescribed form and must then acknowledge his or her consent before a judge, a justice of the peace, a solicitor or a notary public who does not have any interest in the transaction or in the preparation of the relevant documents. The non-owning spouse must make the declaration “separate and apart” from the owning spouse, and the person taking the acknowledgment must certify that they have examined the non-owning spouse, that the non-owning spouse understands his or her rights in the homestead, and that he or she has signed the consent freely and without compulsion from the owning spouse.<sup>137</sup>

3.78 The procedures for the examination of the non-owning spouse are similar to provisions in the *Fines and Recoveries Abolition Act of 1833* (Eng). This Act, which comes from the period before equality was extended to women in property dealings, effectively established a protective jurisdiction for married women who sought, for the purposes of the Act, to deal with property on their own account.<sup>138</sup>

3.79 Alberta also requires that the consent of the non-owning spouse must be separately acknowledged and certified apart from the other spouse.<sup>139</sup>

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137. *Homesteads Act 1989*, SS 1989-90, c H-5.1 s 7. See also A Milner, “A Homestead Act for England?” (1959) 22 *Modern Law Review* 458 at 467 for a discussion of an earlier version of the Saskatchewan statute.

138. See 3&4 William IV c 74 (Eng) s 80 which provides “that such Judge, Master in Chancery, or Commissioners as aforesaid, before he or they shall receive the Acknowledgment by any married Woman of any Deed by which any Disposition, Release, Surrender, or Extinguishment shall be made by her under this Act, shall examine her, apart from her Husband, touching her Knowledge of such Deed, and shall ascertain whether she freely and voluntarily consents to such Deed, and unless she freely and voluntarily consent to such Deed shall not permit her to acknowledge the same; and in such Case such Deed shall, so far as relates to the Execution thereof by such married Woman, be void”. See also the provisions requiring certification by the persons who have examined the married woman: 3&4 William IV c 74 (Eng) s 84.

139. *Dower Act* RSA 2000 c D-15 s 5.

## 4. Reforming the law

- Introduction
- Policy objectives
- Inadequacies of the present law
- Ruling out some reform options
- How to achieve reform

## INTRODUCTION

4.1 This chapter considers whether the law of New South Wales on third party guarantees is in need of reform and, if so, how this is achievable. It identifies:

- The policy objectives underlying this area of law;
- The extent to which the current law fails to achieve these objectives;
- Reform options that are incompatible with the realisation of these objectives; and
- The most effective means of achieving reform.

## POLICY OBJECTIVES

### Protecting third party guarantors from unfairness

4.2 An important goal of credit law is to provide a necessary measure of protection for consumers. Implicit in this goal is acceptance of the fact that the parties to the transaction may not be on an equal footing and able to bargain with each other from a position of comparable strength. Financial institutions, for example, are generally in a much stronger bargaining position than their customers (particularly individuals as distinguished from institutional clients) due to the superior information and resources they possess.

4.3 When financial institutions offer their products and services, there is usually very little or no effective bargaining with customers about terms and conditions. Instead, they provide these products (such as loan facilities including supporting transactions like guarantees) on the basis of standard, non-negotiable contracts. It is common for guarantee contracts to be drafted by the financial institution and given on a take-it-or-leave-it basis or with little opportunity for the guarantor to bargain or alter the provisions. There is, therefore, a real risk that the terms and conditions of these contracts will be materially biased towards the financial institution.

4.4 There is also an imbalance as regards information. While banks possess vital information about a proposed transaction, for example, the credit standing of the borrower and (if applicable) the viability of the business for which a loan is sought, a guarantor may not. Hence, a guarantor may not be in a position properly to assess the risks of the transaction.

4.5 The disadvantaged position of guarantors, in relation to lenders, may be aggravated by their personal characteristics, such as age, sex, literacy, level of income, and ethnic background.<sup>1</sup> The guarantor's relationship with the borrower and his or her motives for agreeing to the guarantee are also relevant.

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1. Some studies have identified women, older people and those who belong to minority groups as disadvantaged when negotiating transactions: see, for example, I Ayres, "Fair Driving: Gender and Race Discrimination in Retail Car Negotiations" (1991) 104 *Harvard Law Review* 817; I Ayres, "Further Evidence of Discrimination in New Car Negotiations and Estimates of its Cause" (1994) 94 *Michigan Law Review* 112; H

*Characteristics of guarantors in Australia*

4.6 The empirical research study undertaken by the Commission and the University of Sydney (“Lovric and Millbank”) has revealed some of the characteristics of guarantors in Australia, as well as their motives for entering into such transactions.<sup>2</sup>

4.7 **Family relationships.** Close family members sign the vast majority of guarantees or joint loans: mostly female spouses, followed by parents of borrowers. Many of them are elderly. A large number of them are also from non-English speaking backgrounds. While many had obtained good education and were confident about their literacy, a substantial number found it difficult to understand the guarantee documents they signed.

4.8 **Gender.** About two-thirds of guarantors are women, who mostly guarantee loans for borrowers with whom they are in a close personal relationship, usually their husband. Some of the women were likely to be influenced in their decision-making by their economic dependence on their husband, particularly where they perform unpaid housework or their spouse has more highly paid work. An overwhelming majority of guarantors said that one of the reasons they signed the guarantee was because they trusted the borrower. Women place a high value on trust in their relationships, with many believing that their relationship with the borrower obliges them to help him obtain credit. Many of the female guarantors said they did not feel they had a choice about signing the guarantee documents. The absence of choice sometimes arose from the women’s strong sense of obligation, and fear that their relationship with the borrower would be irreparably damaged if they refused. At other times, it meant that they experienced pressure or duress to sign. A few even received threats of violence from the borrower.<sup>3</sup>

4.9 **Age.** Older people were disproportionately represented in the study. Sixty-five per cent of respondents were over the age of 50. More than one third (37%) were 60 years old and over. This highlights the other relationship that is prevalent in guarantees – parent and child. The statistics on litigated guarantor cases pointed to a high proportion of parents guaranteeing loans for their children (29%). Many parents who assisted their children with loans did so out of a sense of moral obligation, that they would do anything for their children or that it was the right thing to do for the family. There is potential for pressure to be brought to bear on elderly parents, especially by someone they trust. Older people are particularly liable to be asked to guarantee adult children’s debts because they are more likely to have a valuable asset that can be used as security for a loan: an unencumbered residential home.<sup>4</sup>

4.10 **Language background.** A substantial number of guarantors were born overseas and/or did not speak English as their first language. Around 40% of those who participated in the guarantor survey were born outside Australia (this is around double the proportion

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Douglas, “Mixed-Gender Negotiation: Does Gender Need to Matter?” (1997) 8 *Australian Dispute Resolution Journal* 295; R Smith, “Fraud and Financial Abuse of Older Persons” (2000) 11 *Current Issues in Criminal Justice* 273; C Lowe, “Why it still cost more to be a woman...” (2001) 87 *Consuming Interest* 13.

2. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* (NSW Law Reform Commission, Research Report 11, 2003) ch 3.

3. Lovric and Millbank at para 3.6, 3.38, 3.42, 3.43, 3.51, 3.52.

4. Lovric and Millbank at para 3.9-3.12.

of overseas-born residents in the general Australian population) and, of those, 85% were from non-English speaking countries. Of those who indicated that English was their second language, the majority said their level of spoken and written English was weak or fair. The over-representation of people from non-English speaking backgrounds is reflected in litigated cases. Forty-two per cent of litigated guarantee cases involved guarantors from non-English speaking backgrounds.<sup>5</sup> For some people from non-English speaking backgrounds, the concept of credit transactions, particularly those attracting interest charges, is an alien one.

4.11 **Literacy.** Twenty-seven per cent of guarantors in the study reported that they could not read or did not understand the documents they had signed. This is despite the fact that most guarantors had secondary education and a technical or university qualification, and were confident about their literacy. A generally good level of education and confidence about their literacy did not translate into a high degree of comprehension of legal documents.<sup>6</sup>

4.12 The empirical evidence demonstrates that the vast majority of guarantors belong to categories of people who are traditionally considered vulnerable: the elderly, women, migrants, members of minority groups and those who find it difficult to understand legal documents and transactions. Because of their personal relationship with the borrower, guarantors generally enter guarantees for emotional rather than financial reasons. This hampers their ability to make an objective assessment. All these factors further weaken their already unequal position in relation to financial institutions. There is, therefore, a need for the law to give special protection to guarantors to make sure they are treated fairly.

## Promoting commercial certainty for lenders

4.13 The law must also consider the interests of lenders. Financial institutions are engaged in a commercial profit-based enterprise. When they offer credit facilities, they want to be certain the loan, including interest and other charges, will be repaid. The contract of guarantee is a device they use to minimise their risk by ensuring that, if the borrower is unable to pay the loan, someone else will. Any regulatory regime must take this into account. Moreover, the regime must give lenders confidence that, if they comply with it, the guarantee will be enforced and not be the subject of unnecessary and unpredictable litigation. It is only in these ways that finance for personal consumption and business purposes will remain reasonably accessible.

## Accommodating the interests of guarantors and lenders

4.14 In the Commission's view, it is obviously in the interests of guarantors, lenders and the efficiency of any regulatory regime, that such a regime is certain in its application; workable in practice; and does not unduly increase the cost of finance by transferring to borrowers unjustifiably high compliance costs. Further, striking the optimum balance between the need to protect guarantors from unfairness and the need to provide commercial certainty for lenders, requires a regime that is, in substance, aimed principally

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5. Lovric and Millbank at para 3.14-3.17.

6. Lovric and Millbank at para 3.21, 3.24.

at preventing disputes from arising, rather than simply reacting to their occurrence. Additionally, the regime should be as comprehensive as necessary: it should cover consumer and small business loans; and it should cover the entire span of the transaction – the formation stage of the contract, its operation, right up to the time of its enforcement or termination.

## INADEQUACIES OF THE PRESENT LAW

4.15 In the Commission’s view, the current law of New South Wales fails to achieve the policy objectives that we have identified. In particular:

- the numerous sources regulating contracts of guarantee create unnecessary complexity and inefficiency;
- the focus of regulation is reactive: it is not aimed at attempting to prescribe standards or conduct that will prevent problems from arising (a “preventive regime”);
- the primary focus of regulation on unjustness and unconscionability creates uncertainty in the law;
- the *Consumer Credit (New South Wales) Code* (“Consumer Credit Code”), the only preventive regime, does not apply to loans for small businesses; and
- the law fails to endorse industry standards that are certain and, presumably, cost effective.

## A regulatory mosaic

4.16 Legal regulation of guarantees occurs at common law, in equity and by statute.<sup>7</sup> The statutory regimes overlap with the general law.<sup>8</sup> The doctrines developed at common law and in equity overlap,<sup>9</sup> as do the equitable doctrines themselves.<sup>10</sup> In short, the legal categories are not mutually exclusive,<sup>11</sup> and may be constantly shifting.<sup>12</sup> Moreover, the

7. See Chapter 2.

8. See para 2.19-2.20. See also D Harland, “Unconscionable and Unfair Contracts: An Australian Perspective” in R Brownswood, N Hird and G Howells, *Good Faith in Contract: Concept and Content* (Ashgate Publishing, Aldershot UK 1999) 241 at 257-62.

9. For example, duress and undue influence (see NSW Law Reform Commission, *Guaranteeing Someone Else’s Debt* (Issues Paper 17, 2000) at para 2.37); unconscionability and misrepresentation (see *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447 (comparing the decision of Gibbs CJ with those of the other members of the court)); unconscionability and common law duress: consider *Australian Competition and Consumer Commission v C G Barbitis Holdings Pty Ltd* (2003) 214 CLR 51 at para 45.

10. For example, unconscionability and undue influence: see para 2.5-2.11.

11. *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 461 (equitable doctrines as species of unconscionable conduct).

12. See *Australian Competition and Consumer Commission v CG Barbitis Holdings Pty Ltd (No 2)* (2000) 96 FCR 491 at 501-502 (French J); on appeal *Australian*



exact content and boundaries of each doctrine are often unclear, since, as the Expert Group on Family Financial Vulnerability put it, the doctrines are highly technical and complex.<sup>13</sup> Thus, the law is often difficult to understand – not only for guarantors and financial institutions, but also for their lawyers.

4.17 Lovric and Millbank found that guarantors commonly plead from three to six different claims or defences.<sup>14</sup> This means that litigation is “often a complex maze of claims and cross claims”.<sup>15</sup> Obviously, this impacts adversely on the efficiency of litigation, suggesting the need for at least some consolidation of the sources dealing with the law of guarantees.

## Reactive regulation

4.18 Lovric and Millbank found that the most common defences or cross claims used by guarantors who dispute a guarantee are the statutory ground of unjustness under the *Contracts Review Act 1980* (NSW) and the equitable ground of unconscionability, including the “special wives’ equity” in *Garcia*.<sup>16</sup> These areas of law deal mainly with providing a remedy after the event. They do not prescribe standards that aim to prevent problems and disputes relating to guarantees from arising in the first place. The decision of the House of Lords in *Royal Bank of Scotland plc v Etridge (No 2)*<sup>17</sup> shows that it is possible for the general law to develop in this direction. However, it is unlikely that the common law of Australia will follow such a course.<sup>18</sup>

4.19 It is no doubt true that important court decisions, such as *Amadio*,<sup>19</sup> *Yerkey v Jones*,<sup>20</sup> and *Garcia*,<sup>21</sup> as well as the provisions of the *Contracts Review Act 1980* (NSW), have influenced legislation and industry practice to adopt measures which promote procedural fairness when financial institutions enter into contracts with guarantors, for example, by providing pre-contractual information that may assist the guarantor in

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*Competition and Consumer Commission v C G Berbatis Holdings Pty Ltd* (2003) 214 CLR 51 at para 44-45 (Gummow and Hayne JJ).

13. Report of the Expert Group on Family Financial Vulnerability, *Good Relations, High Risks: Financial Transactions Within Families and Between Friends* (1996) at 36-37. Consider also C Rickett, “Unconscionability and Commercial Law” (2005) 24 *The University of Queensland Law Journal* 73 (discussing the varying content of unconscionability).
14. Lovric and Millbank at para 7.10.
15. Lovric and Millbank at para 7.9.
16. Lovric and Millbank at para 7.10.
17. [2002] 2 AC 773 at para 50-80 (Lord Nicholls, indicating the steps that a bank must follow once it is put on inquiry).
18. See R P Meagher, J D Heydon and M J Leeming, *Meagher, Gummow and Lehane’s Equity Doctrine and Remedies* (4th ed, Butterworths, Chatswood, NSW, 2002) para 15-150 (describing the “judicial legislation” in the *Etridge* case as “deeply flawed”).
19. *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.
20. (1939) 63 CLR 649.
21. *Garcia v National Australia Bank* (1998) 194 CLR 395.

deciding whether or not to agree to the contract.<sup>22</sup> This effect is, however, indirect. The law on unfair or unconscionable contracts does not, and is not intended to, provide comprehensive regulation of guarantees. Moreover, its usefulness is limited to guarantors who have the resources to litigate.

## Uncertainty

4.20 The statutory ground of unjustness under the *Contracts Review Act 1980* (NSW) and the general law doctrines relevant to the protection of guarantors are, necessarily, very much concerned with the facts and circumstances of each individual case. Writing extra-curially of the list of factors that courts are directed to take into account when deciding whether or not a contract is unjust under the *Contracts Review Act*, Justice Michael McHugh has pointed out that:

*[t]he difficulties in applying such vague criteria mean that parties to contracts have difficulty in knowing what their rights are. Litigation is forced upon them. When courts have to apply vague standards, consistency of decision-making – which is one of the primary benefits of the rule of law – is difficult to achieve. Moreover, the decision of a court applying such vague criteria often seems arbitrary. Dissatisfaction with the decision maker in particular cases is often the result. In time, confidence in the judicial system is undermined.<sup>23</sup>*

4.21 In the Commission's view, these difficulties point, in this context, to the inadequacy of attempting to regulate guarantees *primarily* by reference to broad principles whose application in any case is very much dependent on the particular facts and circumstances of the case. Many third party guarantees take place within family relationships that put guarantors in a vulnerable position. It is quite impractical to require financial institutions to examine whether each and every guarantee transaction involves a family relationship and the potential impact of that relationship on the transaction. It is not feasible, for example, to make lenders determine a guarantor's personal (family-related) motives for agreeing to the guarantee, even if this has been shown to contribute to guarantors' vulnerability.<sup>24</sup> Hence, the regulatory rules on third party guarantees, while containing safeguards that ensure fairness to guarantors, should be capable of being applied by lenders universally, regardless of the vulnerability of the guarantor.

4.22 A comprehensive regulatory regime focusing on specific preventive strategies is required. This is not to say that the broad general law and statutory principles dealing with unjustness and unconscionability should be abandoned. Their proper place is, however, to deal with the circumstances of individual cases that may fall outside the comprehensive regulatory regime, but that nevertheless indicate unjustness or unconscionability in the circumstances. It is appropriate, therefore, that the broader doctrines of general and

22. See, for example, *Code of Banking Practice* (2004) cl 28.4(d), responding to the general law rule that the creditor has no general duty of disclosure to prospective guarantors: see para 2.44.

23. M McHugh, "The Growth of Legislation and Litigation" (1995) 69 *The Australian Law Journal* 37 at 43.

24. See para 4.8-4.9.

statutory law should remain in the background to apply, where necessary, in the circumstances of individual cases.

## Inapplicability of preventive regulation to business loans

4.23 The Consumer Credit Code provides a comprehensive regime to regulate the provision of credit wholly or predominately for personal, domestic or household purposes. It does not cover credit contracts and related guarantees that are undertaken for business purposes.<sup>25</sup> Yet Lovric and Millbank found that the vast majority of third party guarantees are undertaken to support small business borrowing, primarily by family businesses.<sup>26</sup> They found that 94% of litigated cases involving guarantees related to business loans. Ninety eight percent of solicitors and 70% of barristers who participated in the study reported that the last guarantee matter they handled had involved a business loan. About half of the guarantors who participated in the study said they guaranteed small business loans.<sup>27</sup> Hence, a very significant number of guarantees relate to small business loans, which fall outside the regulatory framework of the Consumer Credit Code.

4.24 The policy behind regulating transactions that relate to personal consumption more strictly than those involving business seems to be based on the premise that people engaged in business are in a better bargaining position when dealing with financial institutions than individual consumers. The empirical evidence does not support this assumption as far as guarantors are concerned.

4.25 Lovric and Millbank found that a vast majority of guarantors, regardless of whether they guaranteed personal or business loans, belong to vulnerable groups of people whose personal relationship with the borrower and their emotional motives for agreeing to the guarantee prevent them from making an objective assessment of the transaction. In particular, about half of those who guaranteed business loans described themselves as having no role in the business for which the loan was secured. A further 20% said they were "silent" directors, that is, they were nominal directors with no real power or involvement in the business. They were, therefore, unlikely to have possessed information about the business that would have been necessary to assess the risks properly. Even if they had such information, many would have found it difficult to refuse to sign the guarantee in light of their relationship with the borrower. Consequently, Lovric and Millbank concluded:

*The presumption that people entering into guarantees for businesses are more sophisticated, more empowered or on a more equal bargaining footing than those guaranteeing personal loans was not borne out in our research.<sup>28</sup>*

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25. *Consumer Credit (New South Wales) Code and Regulations 1995* (NSW) s 6, and note the presumptions in s 11. See *Permanent Mortgages Pty Ltd v Cook* [2006] NSWSC 1104.

26. Lovric and Millbank at xiii.

27. Lovric and Millbank at para 2.19.

28. Lovric and Millbank at para 2.17-2.18.

4.26 The implication is that many guarantors of small business loans do not get adequate protection.

## Failure to endorse industry standards

4.27 The Code of Banking Practice (“Banking Code”), which is partly based on the provisions of the Consumer Credit Code, regulates, in a preventive manner, various stages in the life of a guarantee. Since 2003, its provisions extend to small business loans.<sup>29</sup> The general law and statutes lag behind this industry standard in recognising the desirability of a preventive regulatory regime that extends to small business loans. From a banker’s point of view, the substance of the Banking Code obviously represents an acceptable accommodation of the interests of guarantors. From a guarantor’s point of view, the Commission has received no information that the application of the Banking Code has resulted in the prohibitive cost of finance.

4.28 Unfortunately, it is not only the general law and statutes that fail to live up to the standards prescribed in the Banking Code. So too does most of the finance industry. The Banking Code is of limited force: not all banks have subscribed to the 2003 or 2004 version, and there is no other Code of Practice that is so comprehensive in its coverage. Indeed, most of the finance industry operates without codes of practice. The proliferation of non-bank lenders in recent years, and particularly those involved in low document loan transactions, means that most lenders in the finance industry fall outside the protections that codes of practice can offer to guarantors.

## RULING OUT SOME REFORM OPTIONS

4.29 It is implicit in what we regard as the policy objectives underlying this area of the law that the Commission rejects a number of reform options, namely:

- the prohibition of third party guarantees;
- the imposition of restrictions on the use of the family home as security for loans; and
- leaving reform solely to industry self-regulation.

## Prohibiting third party guarantees

4.30 In the past, some legal systems have prohibited personal guarantees, at least in certain circumstances.<sup>30</sup> In the early 1990s, the National Consumer Affairs Advisory Council and the Australian Financial Counselling and Credit Reform Association recommended that all guarantees be prohibited.<sup>31</sup>

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29. See para 2.42-2.45.

30. See para 3.2-3.10.

31. See Australia, Trade Practices Commission, *Guarantors: Problems and Perspectives* (Discussion Paper, 1992) at 19-20; E Clark, *Young People and Consumer Credit: Summary* (National Clearinghouse for Youth Studies, Hobart, 1991) at 4. For a

4.31 The Commission raised this matter in Issues Paper 17 to test current community attitudes.<sup>32</sup>

*Views in submissions*

4.32 Most submissions oppose a ban on the use of guarantees.<sup>33</sup> These are the reasons that were given:

- It would prevent people from giving financial assistance to their family members.<sup>34</sup>
- Without third party guarantees, lenders might address the risk of borrowers' default by raising interest rates.<sup>35</sup> In other words, lenders may increase the cost of finance.<sup>36</sup>
- It would restrict borrowing<sup>37</sup> and, in particular, hinder the ability of small businesses to obtain finance.<sup>38</sup> This may create social harms. A tightening of financial opportunities may prevent social mobility for some people.<sup>39</sup>

4.33 Only one submission was open to a ban on guarantees. It claimed that lenders could manage their risk in other ways, such as providing credit at a higher interest rate in situations where they would otherwise require a guarantee.<sup>40</sup>

*The Commission's view*

4.34 The Commission agrees with those who oppose a ban on the use of guarantees. Such a ban is likely to force lenders to find other ways to minimise and deal with loan defaults. Lenders may, for example, use co-borrower arrangements where a third person (who would otherwise have been the third party guarantor) becomes a co-borrower with the main borrower. Alternatively, lenders might use contracts of indemnity more frequently. Co-borrower and indemnity contracts are more onerous because, unlike a guarantee where the guarantor is only secondarily liable, a person who becomes party to

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similar suggestion in the context of American law, see R Hasson, "Darkness at Noon: A Comment on the Consumer Guarantee Law in Ontario" (1995) 11 *Banking and Finance Law Review* 141 at 149-150.

32. NSWLRC IP 17 at 107 Question 33.

33. St George Bank, *Submission* at 5; Australian Finance Conference, *Submission* at 22; Women Lawyers' Association of NSW, *Submission* at 10; Commonwealth Bank, *Submission* at 14; NSW Legal Aid Commission, *Submission* at 19; NSW Young Lawyers, *Submission* at 11; University of Western Sydney, Centre for Elder Law, *Submission* at 33; Australian Credit Forum, *Submission* at 3.

34. Commonwealth Bank, *Submission* at 14.

35. NSW Department of Fair Trading, *Submission* at 3.

36. Commonwealth Bank, *Submission* at 14.

37. St George Bank, *Submission* at 5.

38. Commonwealth Bank, *Submission* at 14; University of Western Sydney, Centre for Elder Law, *Submission* at 33; Country Women's Association, *Submission* at 3.

39. NSW Legal Aid Commission, *Submission* at 20.

40. Women's Legal Resources Centre, *Submission* at 12.

a co-borrower or indemnity agreement is primarily liable, even when he or she gains no benefit from the loan.<sup>41</sup>

4.35 If guarantees were prohibited, lenders might also impose higher interest rates and/or use more stringent credit standards. An increase in interest rates and charges would place greater financial pressure on the borrower's business, due to higher repayment obligations – assuming, of course, that the borrower is able to obtain the loan. Lenders may make it more difficult for some borrowers to obtain credit by imposing more stringent credit criteria. Borrowers who have no collateral and first time borrowers seeking to establish new businesses but who have no credit history may find it harder to get approval.

4.36 A ban on the use of guarantees may, therefore, limit access to finance and prevent potentially worthwhile businesses from taking off or developing. It would be an unnecessarily severe reaction to the problems associated with guarantees. Instead of prohibiting the use of guarantees, the focus should be on formulating an effective, consistent and comprehensive regulatory regime, which addresses the problems identified in this Report and in the Lovric and Millbank study.

## Restricting the use of the family home

4.37 Using the equity in the family home is a common way of raising capital to start up or expand a business.<sup>42</sup> It is common for loans to be secured by a guarantee and mortgage over the family home. If the lender seeks to enforce the guarantee and the guarantor does not have the money to pay the debtor's debt, the guarantor risks losing his or her family home. Concerns have been raised in Australia about the use of the family home in this manner.<sup>43</sup> One possible reform option is to prohibit or limit the use of the family home as security for finance.

4.38 In some overseas jurisdictions, "homestead laws" impose limits on the extent to which residential property can be used as security for loans.<sup>44</sup> In essence, these laws exempt all or part of the home of the borrower from being used to satisfy claims by lenders. Their main purpose is to promote and preserve home ownership by protecting the family home from lenders' claims.

4.39 Should the family home continue to be used as security for business loans or should its use be limited?

### *Views in submissions*

4.40 Most submissions opposed the restriction on the use of the family home as a loan security for the following reasons:

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- 41. Australia, Trade Practice Commission, *Guarantors: Problems and Perspectives* (Discussion Paper, March 1992) at 19.
  - 42. Lovric and Millbank at para 2.27.
  - 43. See Australia, House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change: Banking and Deregulation* (AGPS, Canberra, 1991) at 414.
  - 44. See para 3.28-3.48.

- Such a restriction would be too limiting for business and investment.<sup>45</sup>
- The use of the family home as security is often the only way that some people can commence business and be financially successful.<sup>46</sup> Preventing the use of the family home as security would unnecessarily restrict economic and social opportunities for some people, particularly those who are relatively disadvantaged.<sup>47</sup>
- Many small businesses are undercapitalised and, because the family home represents many people's major capital investment, the only option available to many small businesses would be to sell the family home and use the proceeds to provide the necessary capital.<sup>48</sup>
- Countless small businesses would either pay higher interest or not receive credit at all if they could not use the family home as security.<sup>49</sup>
- In some cases, the family home has been funded as the result of small business activities.<sup>50</sup>

#### *The Commission's view*

4.41 The Commission agrees with these submissions. The family home is the main and, quite often, the only asset available for borrowers and their guarantors to secure finance. A ban or restriction on the use of the family home as security may severely limit access to finance. This may, in turn, result in decreased business investments. There is also evidence in the United States showing that homestead exemption laws increase the cost of credit, particularly for the poor.<sup>51</sup> The Commission favours the present position that allows people (especially those who do not have ready access to funds) to use their homes to achieve financial security.

## Leaving regulation solely to the financial industry

4.42 History and comparative law demonstrate a clear need for the statutory regulation of contracts of guarantee. A possible alternative is self-regulation, where relevant sections of the financial industry create, monitor and enforce rules against their own members. For example, banks and credit unions could incorporate the reforms proposed in this Report into their existing codes of practice. Other financial institutions could adopt their own codes with the appropriate rules on guarantees. Alternatively, all financial institutions might get together and adopt a uniform code of practice.

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45. St George Bank, *Submission* at 5; Australian Credit Forum, *Submission* at 3.

46. Country Women's Association of NSW, *Submission* at 3.

47. NSW Legal Aid Commission, *Submission* at 19.

48. Commonwealth Bank, *Submission* at 13-14.

49. NSW Department of Fair Trading, *Submission* at 7.

50. Australian Finance Conference, *Submission* at 21.

51. R Gropp, J K Scholz and J White, "Personal Bankruptcy and Credit Supply and Demand" (1997) 112 *Quarterly Journal of Economics* 217.

*Views in submissions*

4.43 The majority of submissions to this reference did not favour reliance on self-regulation alone.<sup>52</sup> These are some of the reasons given:

- Given the variety of legislation, common law doctrines, and industry codes that impact upon third party guarantees, a single piece of legislation would simplify regulation. Industry codes of practice may still have a significant role, but they have to be consistent with the legislation.<sup>53</sup>
- Legislation would ensure comprehensive and consistent regulation of the financial industry. It avoids the problem of inconsistency between the various industry codes of practice. It also ensures the regulation of those who are not covered by, or prepared to accede to, such codes.<sup>54</sup>
- Public regulation avoids perceptions of bias and lack of objectivity that arise in relation to the self-regulatory schemes.<sup>55</sup>
- Self-regulation is inappropriate in an industry that provides a service to vulnerable groups and where inadequate regulation may have serious consequences for guarantors.<sup>56</sup>
- There are doubts about the financial industry's capacity and willingness to develop successfully the appropriate rules in a controversial and contentious area such as guarantees.<sup>57</sup>

*The Commission's view*

4.44 The Commission is swayed by the lessons of history and the majority of submissions. Industry codes of practice, while commendable, have inherent limitations over legislation. They obviously depend on industry members individually agreeing to be bound by the codes' conditions. Even where the law makes it mandatory for lenders to adopt a code of practice and there are several codes available, some might opt for the one that is least onerous to them and least beneficial to their clients. Fringe operators may emerge who are unprepared to adopt a relevant code, and who use that opportunity to acquire a share of the market that is attractive to the most vulnerable borrowers and guarantors.

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52. NSW Legal Aid Commission, *Submission* at 6, 17; NSW Department of Fair Trading, *Submission* at 3; St George Bank, *Submission* at 2, 4; Australian Finance Conference, *Submission* at 10, 11, 18; Women Lawyers Association of NSW, *Submission* at 3, 8; Women's Legal Resources Centre, *Submission* at 4; Ryde-Eastwood Financial Counselling Service, *Submission* at 6; J L Goldring, *Submission* at 2; NSW Young Lawyers, *Submission* at 2; Financial Counsellors' Association of NSW, *Submission* at 2.

53. St George Bank, *Submission* at 2 and 3; Australian Finance Conference, *Submission* at 18.

54. Australian Finance Conference, *Submission* at 18; NSW Legal Aid Commission, *Submission* at 5; Women's Legal Resources Centre, *Submission* at 4 and 5; St George Bank, *Submission* at 4; NSW Young Lawyers, *Submission* at 7.

55. Financial Counsellors' Association of NSW, *Submission* at 4.

56. NSW Department of Fair Trading, *Submission* at 3.

57. NSW Legal Aid Commission, *Submission* at 5-6.



4.45 Further, enforcement of industry codes of practice is problematic. Self-monitoring and the sanctions that the industry associations are able to impose on their members could prove, or at least be perceived to be, inadequate. Legislation, on the other hand, is able to ensure better enforcement mechanisms. It can provide a central agency to monitor the implementation of its provisions and to which consumers can go for complaints. It can also deliver a more comprehensive range of sanctions, including administrative, civil and criminal penalties.

4.46 Finally, self-regulatory regimes find it difficult to avoid perceptions of bias. People may not trust self-regulatory bodies to apply rules in the interests of consumers and the general public. Further, as indicated in submissions, the public demands government responsibility in this area of finance because it involves vulnerable consumers.

4.47 The Commission does, however, support industry regulation in this area of the law as a supplement to, and check on, current legislative standards. Industry codes can strengthen and advance government regulation. They can be useful in influencing the behaviour of lenders. Codes that reflect requirements in the legislation will reinforce to industry members the need to comply with the law. They may also communicate better the legislative requirements by using language that is more meaningful to industry members. Further, they may, like the Banking Code, expand and improve the standards set by legislation.<sup>58</sup> Finally, they are useful in providing industry-based mechanisms for resolving complaints to supplement the dispute resolution measures provided by law.<sup>59</sup>

## HOW TO ACHIEVE REFORM

4.48 The Consumer Credit Code is the sole legislative instrument in New South Wales that contains specific provisions expressly regulating guarantees.<sup>60</sup> These provisions only protect guarantors of consumer loans.<sup>61</sup> Notwithstanding their limited operation, they largely give effect to the policy objectives that the Commission has identified as underlying this area of law. Moreover, their provisions are substantially reflected in the Banking Code, which applies more widely to guarantors of small business loans.

4.49 For these reasons, the Commission has taken the provisions of the Consumer Credit Code as the starting point for a comprehensive regulatory regime dealing with guarantees. At base, we would regard such a regime as at least extending the provisions of the Consumer Credit Code to business loans. We have, however, gone further and analysed each of the relevant provisions in the Consumer Credit Code to determine its adequacy in light of the submissions, the findings of the Lovric and Millbank study and other recent developments, including the 2003 and 2004 iterations of the Banking Code. We have also identified areas not covered in the Consumer Credit Code in respect of which we think it is appropriate to make recommendations.

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58. See para 2.42-2.44.

59. For example, banks have established a Banking and Financial Services Ombudsman. See also para 12.34-12.40.

60. For a summary, see para 2.35.

61. See para 4.23.

4.50 At least potentially, therefore, our recommendations duplicate, overlap, revise, extend or differ from various provisions of the Consumer Credit Code. This makes it essential to consider the relationship between our recommendations and the Consumer Credit Code, in particular how our recommendations should be implemented in the light of the existence of the Consumer Credit Code. Consideration of this issue reveals that the most obvious course of recommending the embodiment of our proposed regulatory regime in a single consolidating legislative instrument of the New South Wales Parliament is not free from difficulty. The Uniform Consumer Credit Laws Agreement 1993, the executive agreement that underpins the uniform credit legislation, provides that a State or Territory cannot:<sup>62</sup>

- introduce any amending legislation to the Consumer Credit Code unless approved by at least two thirds of the members of the Ministerial Council for Uniform Credit Laws ("MCUCL");<sup>63</sup> nor
- submit legislation to its Parliament which will conflict with or negate the operation of the Consumer Credit Code.<sup>64</sup>

4.51 In the light of this, three possible ways of implementing our recommendations need consideration:

- amendment of the Consumer Credit Code;
- enactment of legislation to exist alongside the Consumer Credit Code; or
- enactment of legislation as part of a uniform law initiative with other Australian jurisdictions.

## Amending the Consumer Credit Code

4.52 An obvious way to implement the Commission's recommendations is, seemingly, to amend the Consumer Credit Code. This is not, however, a simple matter. There are procedural and substantive hurdles to overcome.

### *Procedural requirements*

4.53 As pointed out above, any amending legislation to the Consumer Credit Code must be approved by at least two thirds of the members of the MCUCL.<sup>65</sup> The MCUCL consists of the Commonwealth, State, and Territory Ministers responsible for fair trading, consumer protection laws and credit laws. It receives reports from the Standing Committee of Officials of Consumer Affairs ("SCOCA"), which in turn receives reports from the Uniform Consumer Credit Code Management Committee. This Committee monitors all activities relating to the Consumer Credit Code to ensure consistency in its implementation across jurisdictions. It examines proposed amendments to the Consumer Credit Code before they are presented to the SCOCA and MCUCL. Hence, the amendment of the Consumer

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62. The text of the agreement is at [http://www.creditcode.gov.au/display.asp?file=/content/original\\_credit\\_code.htm](http://www.creditcode.gov.au/display.asp?file=/content/original_credit_code.htm) (at 1 September 2006).

63. Australian Uniform Credit Laws Agreement 1993 cl 10.

64. Australian Uniform Credit Laws Agreement 1993 cl 13.

65. Australian Uniform Credit Laws Agreement 1993 cl 10.

Credit Code to implement the recommendations in this Report would entail a complex process that needs the approval of other States and Territories.

*Extending the scope of the Consumer Credit Code*

4.54 Substantially, and more significantly, the extension of the protections of the Consumer Credit Code to small business loans needs to be compatible with the objectives of the Consumer Credit Code. The main aim of the Consumer Credit Code is to regulate consumer credit contracts, which the Consumer Credit Code defines as those provided by credit providers “for personal, domestic or household purposes”.<sup>66</sup> Examples of credit contracts that may be covered by this definition include personal loans, housing loans, bank term loans, overdraft facilities, and credit card facilities. The Consumer Credit Code contains a broad range of requirements in relation to consumer credit contracts, such as: the form of the contract, pre-contractual disclosure, matters that must be in the contract, interest charges, other fees and charges, the debtor's monetary obligations, and the credit provider's obligation to account.

4.55 To regulate all aspects of credit contracts within its ambit, the Consumer Credit Code also has provisions, particularly in Part 3 Division 2, on mortgages and guarantees that relate to such contracts. Leaving aside other recommendations in this Report, the implementation of our recommendation that any legislative regulation of contracts of guarantee should cover small business guarantees<sup>67</sup> would require that the definition in the Consumer Credit Code of “credit contract” be amended, at least as it applies to Part 3 Division 2 and any other provisions on guarantees. It may be argued that it would be odd to have one definition of “credit contract” for purposes of the general provisions of the Consumer Credit Code, and yet another that applies only to its provisions on guarantees. On the other hand, the regulation of guarantees could be seen as ancillary to the central function of Consumer Credit Code of regulating consumer credit contracts. Moreover, it could be argued that the definition of “consumer” should be broadened for the general purposes of the Consumer Credit Code in the light of the trend in traditional consumer protection statutes towards extending protection to small businesses.<sup>68</sup>

4.56 These issues are beyond the Commission's terms of reference. We express no opinion on them. It took many years to reach agreement on the uniform consumer credit legislation and the specialist expertise that has evolved in its development and administration means that the Standing Committee of Officials of Consumer Affairs is the appropriate body to initiate and consider any proposed amendment to the Consumer Credit Code.

## Enacting a NSW statute to exist alongside the Consumer Credit Code

4.57 A New South Wales statute could seek either to regulate guarantees generally or only to regulate guarantees that specifically relate to small business lending.

4.58 In the Commission's view, the enactment of a statute relating to guarantees generally would breach NSW's obligations under the Intergovernmental Agreement of

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66. *Consumer Credit (New South Wales) Code* s 6(1)(b).

67. See Recommendation 5.3.

68. For example, *Trade Practices Act 1974* (Cth) s 51AC. See also para 5.11-5.16.

1993, in particular cl 13(1) of the Uniform Consumer Credit Laws Agreement 1993. At least to the extent that the statute's provisions are more favourable to guarantors than those found in the Consumer Credit Code, the statute would “negate” (in the sense of render ineffective) the operation of the Consumer Credit Code, since guarantors would obviously rely on the provisions of the legislation most beneficial to them. There is little doubt that such legislation would also breach the spirit of the Agreement.

4.59 This leaves the possibility of enacting legislation that deals only with guarantees of small business loans. Such legislation would neither conflict with nor negate the Consumer Credit Code. It would, however, put a premium on the distinction between “small business” and other loans. More importantly, it would, in the Commission’s view, be highly undesirable because it would add a further layer of regulation in an area already subject to various sources of law and practice, thereby increasing the complexity of the overall regulatory regime, with implications for the cost of finance and the efficiency of dispute resolution. In particular, as the recommendations in this Report do not accord in all respects with the provisions of the Consumer Credit Code, a stand-alone statute on small business guarantees would result in two different sets of rules, one for small business guarantees and another for consumer guarantees. Guarantors of business loans would then have greater protection than guarantors of consumer loans, and the creation of two sets of rules located in separate statutes would detract from the aim of simplifying regulation. Further, the costs of complying with two separate regulatory regimes, substantially passed on from finance providers to borrowers, would result in an overall increase in the cost of finance in New South Wales, and probably in Australia.<sup>69</sup> More generally, to enact legislation in New South Wales dealing specifically with small business lending would be to ignore the need for uniformity in credit law in Australia.

## Pursuing a uniform law initiative

4.60 In response to the Lovric and Millbank study, the Australian Bankers’ Association noted that:

*Banks and other credit providers operate on a national basis. The Uniformity Agreement between the States and Territories that underpins the uniform Consumer Credit Code reflects the legitimate needs of industry and consumers for national uniformity on matters of credit policy and law. Such an approach enhances the efficiency of the financial system and certainty for consumers and industry alike.*<sup>70</sup>

4.61 The Commission agrees that uniformity in Australian credit law, already achieved in respect of consumer loans and guarantees, must be maintained in the interests of simplicity, certainty and efficiency. We therefore favour the reform of the law relating to the guaranteeing of another’s debt as a uniform law initiative pursued by the New South Wales Government, at least initially through the Standing Committee of Attorneys General and the Standing Committee of Officials of Consumer Affairs. We recommend that the

69. Australian Bankers’ Association, *Submission* at 2 (noting the substantial costs involved in compliance programs to meet the requirements of the 2003 version of the Banking Code).

70. Australian Bankers’ Association, *Submission* at 2.

provisions of the uniform law be modelled on the recommendations in this Report. We refer to the proposed uniform law as the "Model Law".

4.62 In making this recommendation, we stress one matter and raise one other:

- First, we expressly leave open the relationship between the Model Law and the Consumer Credit Code. In all respects that relationship needs careful study, analysis and definition so as not to compromise the uniformity already achieved in credit law in Australia.
- Secondly, we draw attention to the fact that our terms of reference are restricted to contracts that guarantee the loans of another.<sup>71</sup> It will be necessary to investigate further whether or not the Model Law should be restricted to such contracts. An alternative is a Model Law that is broader and incorporates, for example, all aspects of indemnities and performance bonds.<sup>72</sup>

## RECOMMENDATION 4.1

New South Wales should initiate discussions with other Australian jurisdictions to develop and enact a uniform law (the "Model Law") relating to contracts guaranteeing another's debt. The Model Law should implement the recommendations in this Report.

### Improving industry codes of practice

4.63 The achievement of a uniform law is likely to be a lengthy and complicated process. Pending the completion of such a process, some of the recommendations in this Report are capable of being adopted into applicable finance industry codes. For example, the recommendations dealing with entry into a guarantee would be amenable to inclusion in codes of practice, whereas the recommendations dealing with unjust contracts are not. Ideally, all relevant members of the finance industry could adopt the provisions to ensure uniform coverage across the finance industry.

4.64 Notwithstanding the problems inherent in sole reliance upon industry self-regulation, there are many positive outcomes to be achieved through industry codes of practice.<sup>73</sup> The Commission further considers that the adoption of our proposals by all, or even some, relevant sectors of the finance industry will help make legislative implementation easier. This is because financial institutions will already be complying with our proposals and their experience will influence the final form of the legislation. This would follow in the steps of the Banking Code, which has been in the vanguard of developing protections for guarantors over the past decade. Optimal regulation, often

71. See also Recommendation 5.1.

72. See generally G Andrews and R Millett, *Law of Guarantees* (4th ed, Sweet & Maxwell, London, 2005) at para 1-004-1-006, 1-012 – 1-015.

73. See para 4.47.

achievable only through the use of a variety of actors and techniques, would, we believe, be the result.<sup>74</sup>

## RECOMMENDATION 4.2

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Sectors of the finance industry that use guarantees should adopt codes of practice that are consistent with applicable recommendations in this Report.

### The Model Law and the general law

4.65 The Model Law should apply against the background of the general doctrines of the common law and of more generally applicable statutory norms. This will ensure the availability of a body of law to cover the circumstances of individual cases that fall outside the Model Law's preventive regime.<sup>75</sup> The Commission does not propose that the Model Law be a Code.

## RECOMMENDATION 4.3

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The Model Law should not derogate from rights and remedies that exist apart from the Model Law.

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74. A realisation that, amongst other matters, has promoted a “decentred” approach to the study of regulation: see especially J Black, “Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a ‘Post-Regulatory’ World” (2001) 54 *Current Legal Problems* 103; J Black, *Mapping the Contours of Contemporary Financial Services Regulation* (Economic and Social Research Council Centre for Analysis of Risk and Regulation, Discussion Paper 17, October 2003); I Ramsay, “Consumer Law, Regulatory Capitalism and the ‘New Learning’ in Regulation” (2006) 28 *Sydney Law Review* 9.

75. See para 4.22.

## 5. Scope of the model law

- Guarantees supporting credit contracts
- Not-for-profit lenders
- Guarantees relating to business loans
- Artificial persons
- Company directors as guarantors
- Related contracts
- Contracting out

5.1 This chapter identifies the types of contracts to which the Model Law should apply, as well as the guarantors, lenders and borrowers who should fall within its ambit. The chapter also considers the extent to which the Model Law should be exclusive of contractual provisions affecting its operation.

## GUARANTEES SUPPORTING CREDIT CONTRACTS

5.2 Guarantees may be used to support a variety of obligations other than the payment of a debt. For example, in construction contracts, performance bonds guarantee the performance of the contractor to the proprietor, or the performance of a sub-contractor to the main contractor.<sup>1</sup> The terms of reference of this inquiry are limited to guarantees of small business and other loans.<sup>2</sup> Guarantees that support the performance of a specified act, such as a service, are not the subject of this inquiry. The Commission, therefore, starts from the premise that the Model Law will apply only to credit contracts as defined in the *Consumer Credit (New South Wales) Code* ("Consumer Credit Code"). At the same time, we recognise that the exact scope of the Model Law requires further investigation.<sup>3</sup>

5.3 The Consumer Credit Code defines a credit contract as "a contract under which credit is or may be provided, being the provision of credit to which this Code applies".<sup>4</sup> For the purposes of the Consumer Credit Code, "credit" is provided if under a contract:

(a) payment of a debt owed by one person (the debtor) to another (the credit provider) is deferred; or

(b) one person (the debtor) incurs a deferred debt to another (the credit provider).<sup>5</sup>

5.4 The essential elements of the definition are a "debt" and its "deferral". The Consumer Credit Code does not define these terms. However, a "debt" is a monetary obligation, and a debt is deferred if it is payable in the future. Further, the deferment must be provided for under a "contract".

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### RECOMMENDATION 5.1

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1. See J O'Donovan and J Phillips, *The Modern Contract of Guarantee* (Sweet and Maxwell, London, 2003) ch 13. In Canada, this class of guarantors would be classified as compensated sureties because they undertake surety contracts for profit. Courts generally view them less benignly than accommodation sureties or those given without any expectation of personal gain: *Citadel General Assurance Co. v Johns-Manville Canada Inc* (1983) 147 DLR (3d) 593. See also P Devonshire, "The Liability of Original Mortgagors and Sureties Upon Default by a Mortgagor by Assumption" (2006) 39 *University of British Columbia Law Review* 185 at 197.
2. The terms of reference are set out at page xi.
3. See para 4.62.
4. *Consumer Credit (New South Wales) Code* s 5.
5. *Consumer Credit (New South Wales) Code* s 4(1).



The Model Law should apply to guarantees that relate to a “credit contract”, defined as a contract under which credit is or may be provided. “Credit” is provided if under a contract: (a) payment of a debt owed by one person (the borrower) to another (the lender) is deferred; or (b) one person (the borrower) incurs a deferred debt to another (the lender).

## NOT-FOR-PROFIT LENDERS

5.5 The Consumer Credit Code applies only to a guarantee if the credit contract it supports is provided by a person or company which, as a general rule, is in the business of providing credit, and which provides the credit in the course of such business in consideration of a charge.<sup>6</sup> The Model Law should adopt this requirement, since its provisions should not apply to transactions where the lender does not provide credit as a business for profit, such as, when he or she provides it as a favour for a friend or family member.

5.6 *Hungier v Grace*<sup>7</sup> provides an illustration, in the context of other legislation, of when a lender is not in the business of providing credit. Hungier made a number of loans to a friend, Grace, over a six-year period. In every case, the loan was made at the request of Grace and acceded to by Hungier if he had the funds at hand. Hungier made the loans with an eye to profit, which was expressed as a rate of interest that varied in practice with the length of time Grace took to repay the loan. The issue was whether Hungier could prove four of these loans in Grace’s bankruptcy, the answer depending on whether Hungier was carrying on the business of money-lending within the meaning of the *Money Lenders Act 1958* (Vic). The High Court held that Hungier was not in the business of money-lending and so could prove the debts in Grace’s bankruptcy. Although the court accepted that a lender could be in the business of money-lending with only one borrower, the loans in question were “disconnected” in the sense that they lacked the system and regularity required of loans that would be made in the course of carrying on the business of a money lender. This was because:

*[T]he word ‘business’ imports the notion of system, repetition and continuity ... The line of demarcation cannot be defined with closeness or indicated by any specific formula. Each case must depend on its own peculiar features. It is ever a question of degree.*<sup>8</sup>

5.7 Under the Consumer Credit Code, the provision of credit need not be the credit provider’s main business, but may be provided “as part of or incidentally to any other business of the credit provider”.<sup>9</sup> The Model Law should contain a similar provision. If, for example, a car dealer provides finance to a small business to enable it to buy company vehicles and requires the company directors to provide guarantees, the requirements in the proposed legislation should apply.

6. *Consumer Credit (New South Wales) Code* s 6(1)(c) and (d).

7. (1972) 127 CLR 210.

8. *Edgelow v MacElwee* [1918] 1 KB 205 at 206 (McCardie J), cited with approval in *Hungier v Grace* (1972) 127 CLR 210 at 216-217 (Barwick CJ).

9. *Consumer Credit (New South Wales) Code* s 6(1)(d).

## RECOMMENDATION 5.2

The Model Law should apply to guarantees relating to the provision of credit if:

- a charge is made or may be made for providing the credit; and
- the lender provides the credit in the course of a business of providing credit or as part of or incidentally to any other business of the lender.

## GUARANTEES RELATING TO BUSINESS LOANS

5.8 The Consumer Credit Code applies only to guarantees that relate to consumer credit contracts, that is, where credit is “provided or intended to be provided wholly or predominantly for personal, domestic or household purposes”.<sup>10</sup> The empirical study conducted by the Commission and the University of Sydney (“Lovric and Millbank”) has shown that an overwhelming majority of third party guarantees are undertaken to support business borrowing: 94% of the litigated cases surveyed related to a business loan; 98% of solicitors and 70% of barristers participating in the study reported that the last guarantee matter they handled had involved a business loan; and half of the guarantors in the study said they guaranteed small business loans.<sup>11</sup> Of the guarantors who supported a business loan, many of them (approximately 38%) reported that the purpose of the loan was to expand an existing business. Other purposes identified in the study included: to set up a new business (25%), to get the business through a difficult time (19%), and to refinance an existing loan (8%).<sup>12</sup>

5.9 Chapter 4 pointed out that this empirical evidence argues that the protection given to guarantors of consumer loans should be extended to small business guarantors.<sup>13</sup> Many submissions supported this view and advocated abandoning the distinction between guarantees supporting consumer loans and those supporting small business loans.<sup>14</sup> Thus:

- The Women’s Legal Resources Centre argued that power imbalance issues are just as relevant in many small business loans as they are in consumer loans.<sup>15</sup>
- The NSW Legal Aid Commission asserted that guarantors of small business loans are not necessarily more sophisticated than guarantors of consumer loans. It also said that, in some cases, consumer guarantors are in a better position to understand the nature and extent of the loan and their obligations than business guarantors. For example, a personal guarantor of a consumer loan is more likely to be with the

10. *Consumer Credit (New South Wales) Code* s 5, s 6(1)(b).

11. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* (NSW Law Reform Commission, Research Report 11, 2003) at para 2.14-2.22.

12. Lovric and Millbank at para 2.21.

13. See para 4.23-4.26.

14. St George Bank, *Submission* at 1; NSW Legal Aid Commission, *Submission* at 3-4; Women’s Legal Resources Centre, *Submission* at 3; NSW Young Lawyers, *Submission* at 1; Financial Counsellors’ Association of NSW, *Submission* at 1-2; Ryde-Eastwood Financial Counselling Service, *Submission* at 3.

15. Women’s Legal Resources Centre, *Submission* at 3.

borrower when the loan is entered into than the guarantor of a business loan, who is likely to have only arms-length dealings with regards to the primary transaction.<sup>16</sup>

- The Ryde-Eastwood Financial Counselling Service wrote that the ability to make things or provide a service does not mean that business people necessarily have any more financial understanding than consumers in general.<sup>17</sup>

5.10 On the other hand, there were two submissions that preferred to retain the distinction between consumer and small business guarantees on the basis that business loans are, in general, more complex than consumer loans.<sup>18</sup>

## Small businesses and consumer law

5.11 At one time, consumer protection laws tended to exclude small business. The difficulty with protecting small business was not with the theory of such protection, but with formulating definitions that satisfactorily drew a distinction between small business and large commercial businesses.<sup>19</sup> As far back as 1962, for example, the United Kingdom Committee on Consumer Protection wrote:

*[W]e would have no objection to (the small business person) sharing the benefit of any alteration in the law with the private consumer. It seems to us, however, that the distinction between him and the generality of commercial purchasers lies on the size of the transaction and we doubt if a definition can be made to depend on this factor.<sup>20</sup>*

5.12 In Australia, there is now a trend in consumer protection laws to cover small businesses. The *Trade Practices Act 1974* (Cth) provides a good example. The original definition of “consumer” was confined to a person who acquires goods or services of a kind ordinarily acquired “for private use or consumption” rather than the person who acquires the goods for the purpose of re-supply or services for the purposes of a profession, business, trade or occupation or for a public purpose.

5.13 The definition of consumer was amended as early as 1977 to refer to a person who acquires:

*(a) particular goods for a price not exceeding the prescribed amount of \$40,000, or — if the price exceeded \$40,000 — goods of a kind ordinarily acquired for personal, domestic or household use or consumption, or goods consisting of a commercial road vehicle, and the goods must not be acquired for the purpose of re-supply for using them up or transforming them in trade or commerce, in the course of a process of production or*

16. NSW Legal Aid Commission, *Submission* at 3-4.

17. Ryde-Eastwood Financial Counselling Service, *Submission* at 3.

18. Commonwealth Bank, *Submission* at 4; Australian Finance Conference, *Submission* at 5, 8.

19. K Tokely, *Consumer Law in New Zealand* (Butterworths, Wellington, 2000) at para 1.1.

20. *The Final Report of the Committee on Consumer Protection* (London, HMSO 1962, Cmnd 1781) at para 47.

*manufacture or of repairing or treating other goods or fixtures on land;  
and/or*

*(b) particular services for a price not exceeding the prescribed amount of \$40,000, or — if the price exceeded \$40,000 — services of a kind ordinarily acquired for personal, domestic or household use or consumption.<sup>21</sup>*

5.14 The new definition of “consumer” followed the recommendations of the Swanson Committee, which found a need to protect a range of business transactions, particularly purchases by small businesses:

*In our view one important function of the consumer protection provisions of the Act is to redress, between supplier and customer, inequalities in the technical expertise required to recognise, and negotiate, a fair bargain.*

*[T]he Committee does not agree with proposals that the definition of consumer be necessarily limited either to transactions where the goods or services involved are for ‘personal, domestic or household use’ or to transactions for ‘non-commercial purposes’. The Committee would also reject the distinction between corporate and non-corporate purchasers, on the grounds that it is illogical and promotes form over substance...<sup>22</sup>*

5.15 In 1998, Parliament revised the *Trade Practices Act 1974* (Cth) to give further protection to small businesses. A new section was added governing unconscionable conduct. It gives protection to small businesses by prohibiting unconscionable conduct in relation to the supply or acquisition of goods and services at a price not exceeding \$3 million.<sup>23</sup> When he introduced the amendment, the Minister for Workplace Relations and Small Business stated:

*This government is strengthening the Trade Practices Act 1974 to better protect the legal rights of small businesses, to ensure that small business can confidently deal with large firms in the knowledge that the rules under which they are operating are fair, and that there will be proper redress available when those rules are broken. ...*

*The government has accepted the principle that small business people are entitled to a legal protection against unconscionable conduct which is comparable to that accorded to consumers.<sup>24</sup>*

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21. *Trade Practices Act 1974* (Cth) s 4B.

22. Australia, Trade Practices Review Committee, *Report to Minister of Business and Consumer Affairs* (AGPS, Canberra, 1976) at 64.

23. *Trade Practices Act 1974* (Cth) s 51AC. The transactional limit was originally \$1 million but was increased to \$3 million in 2001: *Trade Practices Amendment Act (No. 1) 2001* (Cth). Section 12CC of the *Australian Securities and Investments Commission Act 2001* (Cth) now contains similar provisions in relation to financial market products and services.

24. Commonwealth of Australia, *Parliamentary Debates (Hansard)* House of Representatives, 30 September 1997, the Hon P Reith, Minister for Workplace

5.16 The *Trade Practices Act 1974* (Cth) does not contain a definition of small business. It has taken the approach of focusing on the value of transactions, rather than the nature of the parties to them. Hence, the relevant provisions set transactional limits, which represent the maximum level of a transaction that a small business is likely to enter into.

## Defining “small business”

5.17 In 2001, the Commonwealth Parliament passed the *Financial Services Reform Act 2001* (Cth) (“*Financial Services Act*”), which amended the *Corporations Act 2001* (Cth), the *Australian Securities and Investments Commission Act 2001* (Cth) and other related legislation. The *Financial Services Act* introduced a new regulatory framework governing the licensing, conduct and disclosure obligations of providers of financial products and services. Its provisions are designed to benefit consumers of financial products by: (a) enhancing their capacity to understand and compare different financial products and evaluate financial advice; and (b) giving them access to complaint handling mechanisms for resolving disputes with financial service providers.<sup>25</sup>

5.18 The *Financial Services Act* added provisions to the *Corporations Act 2001* (Cth) and *Australian Securities and Investments Commission Act 2001* (Cth), both of which state:

**small business** means a business employing less than:

(a) if the business is or includes the manufacture of goods — 100 people; or

(b) otherwise — 20 people.<sup>26</sup>

5.19 In 2003, the Code of Banking Practice (“Banking Code”) was substantially amended as a result of a major review.<sup>27</sup> Among other things, the provisions of the Banking Code on guarantees have been changed to apply, as a general rule, to guarantees obtained for the purposes of any financial facility provided to an individual or a *small business*. The Banking Code defines “small business” in much the same way as the

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Relations and Small Business, Second Reading Speech at 8799. See also Parliament of the Commonwealth of Australia, *Finding a balance: towards fair trading in Australia: A Report by the House of Representatives Standing Committee on Industry, Science and Technology* (Australian Government Publishing Service, Canberra, 1997).

25. See Commonwealth of Australia, *Parliamentary Debates (Hansard)* House of Representatives, the Hon J Hockey, Minister for Financial Services and Regulation, Second Reading Speech at 26521.
26. *Corporations Act 2001* (Cth) s 761G(12); *Australian Securities and Investments Commission Act 2001* (Cth) s 12BC(2).
27. See R Viney, *Review of the Code of Banking Practice: Final Report* (RTV Consulting Pty Ltd, October 2001).

*Financial Services Act* amendments,<sup>28</sup> but refers more specifically to “100 full time (or equivalent) people” and “20 full time (or equivalent) people” respectively.<sup>29</sup>

5.20 Other regulatory definitions of small business use different criteria, such as turnover value or gross assets value. For example, the *Privacy Act 1988* (Cth) defines a small business by reference to whether its annual turnover for the previous financial year is \$3,000,000 or less.<sup>30</sup>

5.21 The Australian Bureau of Statistics (ABS) has undertaken a study to determine the optimum definition of small business. It recommended the following definition:

*Small business consists of those businesses which are not subsidiaries of another company and are neither public companies, unincorporated cooperatives or incorporated associations and employ less than 20 Full Time Equivalent (FTE) persons.*<sup>31</sup>

5.22 The definition has qualitative and quantitative elements. Those who participated in the ABS study identified the following qualitative characteristics of small businesses:

- they are independently owned and operated;
- they are closely controlled by owners/managers who also contribute most, if not all, of the operating capital; and
- the principal decision-making functions rest with the owner/managers.

5.23 The ABS said that these characteristics are not easily measurable and are not generally recorded for statistical or administrative purposes. Instead, it came to the conclusion that the exclusion of certain types of legal structure under which certain businesses operate is a more workable measure of the qualitative characteristics of small business. Based on an industry survey and a separate data analysis, the ABS found that if a business is a subsidiary company, public company, unincorporated cooperative or unincorporated association, it is not a small business.<sup>32</sup>

5.24 The ABS also concluded that the optimum quantitative test of small business is employment of fewer than 20 full-time employees. It found that this test, when used with the qualitative test described above, covers 95% of all small businesses in Australia. It did not favour a financial test, such as the turnover value of a business, because this needs to

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28. See R Viney, *Review of the Code of Banking Practice: Final Report* (RTV Consulting Pty Ltd, October 2001) at 5, 26-27, Final Recommendation 6; Australian Bankers' Association, *Annexure to the Submission to the Issues Paper dated February 2001 for The Review of Code of Banking Practice* at 5.

29. Code of Banking Practice (2004) cl 40.

30. *Privacy Act 1988* (Cth) s 6D(1). For other examples, see *Income Tax Assessment Act 1997* (Cth) s 960-335 (average turnover for an income year is less than \$1,000,000); *First Corporate Law Simplification Act 1995* (Cth) Sch 3 (gross assets of less than \$5,000,000 at the end of the year).

31. Australian Bureau of Statistics, *Small Business in Australia 1999* (ABS Catalogue No. 1321.0, 2000) at 149.

32. Australian Bureau of Statistics, *Small Business in Australia 1999* (ABS Catalogue No. 1321.0, 2000) at 137-142.

be adjusted over time to account for inflation. Further, the ABS asserted that the “less than 20 full-time employees” test is “readily understandable and easily visualised” by most people.<sup>33</sup>

5.25 The ABS examined whether its proposed definition can be applied across all industries or whether the employment cut-off point should be raised for some industries. It found that the less than 20 full-time employees test is satisfactory across all industries, including those in manufacturing.<sup>34</sup> The special rule for manufacturing businesses found in the *Financial Services Act* and the Banking Code is therefore not justified.

5.26 A report commissioned by the Small Business Coalition<sup>35</sup> recommended a definition of small business that is similar to the ABS definition:

*A business which is independently owned and operated, with close control over operations and decisions held by the owners. Business equity is not publicly traded and business financing is personally guaranteed by the owners. The business will have less than twenty employees.*<sup>36</sup>

5.27 The purposes underlying the Model Law require a definition of “small business” that is capable of general application and is not otherwise restricted. The Commission, therefore, adopts the definition recommended by the ABS. The definition is the product of consultations with government and industry stakeholders, as well as a thorough examination of data on businesses available to the ABS. It is straightforward to implement: both its qualitative and quantitative components can be understood and measured easily. It is consistent with the definition proposed by the Small Business Coalition. It is also compatible with (but more thorough than) the definition found in the Banking Code and *Financial Services Act*. Hence banks and other financial institutions will find it easy to implement.

### RECOMMENDATION 5.3

The Model Law should apply to every guarantee that secures credit provided, or intended to be provided, wholly or predominantly for personal, domestic or household purposes, or for the purpose of a trade or business carried on by a small business.

“Small business” means a business that employs fewer than 20 full time (or equivalent) people and that is not a publicly listed company, unincorporated cooperative or incorporated association, or a subsidiary of another company.

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33. Australian Bureau of Statistics, Small Business Unit, *Defining Businesses by Size* (Discussion Paper, unpublished, 1999) at 16; Australian Bureau of Statistics, *Small Business in Australia 1999* (ABS Catalogue No. 1321.0, 2000) at 142-147.
  34. Australian Bureau of Statistics, *Small Business in Australia 1999* (ABS Catalogue No. 1321.0, 2000) at 147-149.
  35. The Small Business Coalition is a grouping of 27 industry associations in Australia with an interest in small business issues.
  36. S Holmes and B Gibson, *Definition of Small Business* (Final Report, 2001).

## Guarantees relating to other business loans

5.28 The recommendations in this Report do not cover guarantees relating to credit provided neither for personal, domestic or household purposes nor for small business purposes.<sup>37</sup>

5.29 The terms of reference specifically require the Commission to review the law relating to small business lending.<sup>38</sup> The case law and the literature on guarantees is mainly concerned with domestic and small business credit. The Lovric and Millbank study has also identified guarantors of small business credit as the group that requires special legal protection. No evidence has been presented to the Commission that guarantees relating to "big business" credit are susceptible to unfair conduct. Special protection is therefore not justified and we make no recommendations on guarantees that support "big business" credit.

## ARTIFICIAL PERSONS

5.30 For the Consumer Credit Code to apply to a guarantee, both the debtor and guarantor must, as a general rule, be natural persons.<sup>39</sup> However, many small businesses use a variety of legal structures. For example, in 2004, of the 754,484 businesses operating in Australia that were employing fewer than 20 people, more than 50% operated under a corporate structure, 18% as trusts, and 16% as partnerships. Only about 14% operated their businesses as sole proprietors.<sup>40</sup> Requiring the borrower and guarantor to be natural persons would defeat the purpose of extending legal protection to guarantees relating to small business. This restriction should, therefore, not be included in the Model Law.

## RECOMMENDATION 5.4

The Model Law should apply to guarantees whether or not the borrower and guarantor are natural persons.

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37. Businesses that are larger than small businesses may be subdivided into different categories. For example, the Australian Bureau of Statistics defines "medium business" as one that is not small business but employs fewer than 200 people, while "large business" consists of a business that employs more than 200 people: Australian Bureau of Statistics, *Small Business in Australia 1999* (ABS Catalogue No. 1321.0, 2000) at 149.
38. The terms of reference are set out at p xi.
39. *Consumer Credit (New South Wales) Code* s 6(1), 9(1)(b).
40. Australian Bureau of Statistics, *Australian Bureau of Statistic Business Register: Counts of Businesses – Summary Tables* (2004) at 17. For statistics on small businesses, which in 2004 numbered 1,269,000 across Australia, see Australian Bureau of Statistics, *Characteristics of Small Businesses, Australia* (Reissue, 2004).



## COMPANY DIRECTORS AS GUARANTORS

5.31 Where the guarantor of a loan to a company is a director, or even an officer, of that company, it is arguable that at least some of the provisions of any regulatory regime should be relaxed. The argument applies to obligations to disclose information or provide documents because the guarantor is, or may already be, in possession of them and may have had time to consider them, so that their disclosure or production is, or at least may be, unnecessary.

5.32 Submissions variously put this argument. Based on its belief that “the overwhelming majority of guarantees are from persons who are directors of a corporate borrower”, the Australian Finance Conference submitted that to require financial institutions to provide all information about the circumstances of the borrower (including why a guarantee has been sought) to such guarantors is “unwarranted and excessive”, of dubious benefit to the majority of guarantors and administratively onerous. The Australian Finance Conference submitted that provision of a basic level of information should only be supplemented with additional information where necessary, assessed on a case-by-case basis.<sup>41</sup> More widely, the NSW Legal Aid Commission argued for relevant exclusion from the regulatory regime of guarantors who have a “direct beneficial interest in the transaction”. It gave the example of a managing director of a company who guarantees a loan to that company.<sup>42</sup> In contrast, St George Bank supported the exclusion of the regulatory regime only where a sole director of a company is guaranteeing a loan to that company.<sup>43</sup>

5.33 The Banking Code excludes or modifies the operation of some of its provisions relating to pre-contractual disclosure and the cooling off period. In doing so, it draws a distinction between sole director guarantors<sup>44</sup> and director guarantors.<sup>45</sup> In the case of a sole director guarantor, this leads to the automatic exclusion of the lender’s obligations to provide information or documents that the director must have, and to the absence of a cooling off period. In the case of a director guarantor, where the director may or may not be in possession of the relevant documents, the Banking Code requires the lender to inform the guarantor of the right to receive the documents and gives the guarantor the option of waiving the cooling-off period.

5.34 The Commission agrees with the approach of the Banking Code in the case of a sole director guarantor, who must be in possession of the specified information or documents and have had time to consider them. However, the Commission does not support the exclusion of the regulatory regime where the guarantor is merely one of a number of directors of a company nor where the guarantor has a “direct beneficial interest in the transaction”. Such guarantors are still vulnerable to unfair conduct, which, in the Commission’s view, is not necessarily overcome by informing them of the right to receive information or documents or giving them the option of waiving a cooling off period.

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41. Australian Finance Conference, *Submission* at 13.

42. NSW Legal Aid Commission, *Submission* at 8-9.

43. St George Bank, *Submission* at 1.

44. Code of Banking Practice (2004) cl 28.15.

45. Code of Banking Practice (2004) cl 28.16.

5.35 For example, it is arguable that a wife receives a benefit from a guarantee if she is a shareholder or a director of a company seeking a loan, or even if that company merely provides income to her and her family. She may, however, not have any involvement in the business. When her husband asks her to provide security for a financial facility to the company, it is insufficient to tell her that she has the right to receive certain information or documents or that she can waive a cooling off period, the more so if this is done in the presence of her husband. In short, there is no substitute for ensuring that she has the information or documents to enable her to make an informed decision about the transaction.<sup>46</sup> The Lovric and Millbank study shows that this example is not an isolated one. Of the guarantors of business loans surveyed in that study, only 16% were active directors; 20% were silent directors, 37% had no role in the business and 9% had no formal role.<sup>47</sup> Moreover, an English study into family businesses also found that a large proportion of women who provided third party guarantees were directors, secretaries or shareholders of the family business, but identified themselves as having no day-to-day involvement in the business.<sup>48</sup>

5.36 Except in the case of sole guarantor directors, the Commission cannot think of an exception to the regime proscribed by the Model Law that could be formulated with sufficient precision – for example, one limited to “active” guarantor directors – to avoid injustice to those vulnerable guarantors identified in the empirical research.

## Recommendation 5.5

Recommendations 6.1, 6.2, 6.3, 6.6, 6.8, 9.1 and 9.2 do not apply to a sole director guarantor.

## RELATED CONTRACTS

### Indemnity

5.37 Guarantees are closely related to indemnities. Both are comprehended in the term “surety”. The essence of the distinction between them is that a guarantee is a collateral obligation while an indemnity is a principal obligation. A guarantor’s promise to answer for the “debt, default or miscarriage” of another involves an obligation that is secondary or ancillary to the obligation of that other, who is primarily liable to the person to whom the guarantee is given. A promisor under an indemnity agrees, in terms that create a primary liability in the promisor, to keep the other party to the contract harmless against loss as a result of that party’s entry into a transaction with a third party.<sup>49</sup>

46. See Lovric and Millbank at 2.7-2.12.

47. Lovric and Millbank at para 2.15-2.18. A further 18% was classified as “other”.

48. B Fehlberg, “Women in Family Companies” (1997) 15 *Companies and Securities Law Journal* 348 at 360.

49. See *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245 at 254 (Mason CJ), and authorities there cited.

5.38 Two important consequences follow from this distinction. First, a guarantor is generally discharged from liability if the principal contract is void or unenforceable.<sup>50</sup> the liability of a guarantor is co-extensive with that of the principal debtor, so that if the principal debtor is not liable, neither is the guarantor.<sup>51</sup> In contrast, an indemnifier generally remains liable even if the associated transaction in question is unenforceable or void.<sup>52</sup> Secondly, a guarantee is generally discharged by certain conduct of the lender, such as giving an extension of time to the borrower, or making substantial variations to the principal contract that are not beneficial to the guarantor.<sup>53</sup> An indemnity is not, however, necessarily discharged by giving time to the lender, or by other variations of the contract between the lender and borrower.<sup>54</sup>

5.39 It is not always easy to determine whether a contract is one of guarantee or indemnity. The issue is one of construction of the contract in any case. For example, an agreement is likely to be construed as an indemnity if the contract operates to render the promisor liable in circumstances in which the principal debtor is not in default.<sup>55</sup> However, if the agreement contains a provision preserving the liability of the guarantor in the event of the lender giving time to the borrower to perform the principal obligation, the contract is likely to be one of guarantee since, if the contract were one of indemnity, there would be no such provision, an indemnifier generally not being discharged by such conduct of the lender.<sup>56</sup>

5.40 Where an agreement, on its true construction, is a contract of guarantee, or a composite contract including a guarantee,<sup>57</sup> the provisions of the Model Law will, of course, be attracted. A distinct issue is whether or not the proposed provisions of the Model Law should also apply to contracts of indemnity on the basis that an indemnifier is, like a guarantor, vulnerable to unfair conduct on the part of the lender and/or borrower. It may even be argued that an indemnifier is in a worse position than a guarantor since his or her liability is primary.

5.41 There is increasing recognition in credit law and practice that indemnifiers, like guarantors, should be protected from unfair conduct. The Banking Code includes indemnities in its provisions on guarantees.<sup>58</sup> That means its requirements on disclosure of information, the cooling off period, notice that a guarantor should seek legal and

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50. For example, *Corser v Commonwealth General Assurance Co Ltd* [1963] NSW 225 (principal contract void due to uncertainty); *Temperance Loan Fund Ltd v Rose* [1932] 2 K B 522 (principal contract unenforceable).

51. See para 8.40-8.53.

52. For example, *Yeoman Credit Ltd v Latter* [1961] 1 WLR 828.

53. Consider *Ankar Pty Ltd v National Westminster Finance (Aust) Ltd* (1987) 162 CLR 549. And see *Hancock v Williams* (1942) 42 SR (NSW) 252 at 255 (Jordan CJ).

54. See G Andrews and R Millett, *Law of Guarantees* (4th ed, Sweet & Maxwell Ltd, London, 2005) at 11, 296.

55. *Direct Acceptance Finance Ltd v Cumberland Furnishing Pty Ltd* [1965] NSW 154.

56. *Western Credit Ltd v Alberry* [1964] 2 All ER 938 at 940 (Davies LJ).

57. Consider *Citicorp Pty Ltd v Hendry* (1985) 4 NSWLR 1 (guarantee contract containing separable additional liability under indemnity clause which did not, however, preserve the liability of the guarantor since sums payable under the principal contract were irrecoverable because they were in the nature of a penalty).

58. Code of Banking Practice (2004) cl 28.1.

financial advice on the effects of the guarantee, among others, would need to be observed by banks when obtaining an indemnity as a security for a loan or other financial accommodation.

5.42 The Consumer Credit Code defines a guarantee to include an indemnity.<sup>59</sup> Hence, the regulatory requirements in the Consumer Credit Code relating to guarantees apply to indemnities given in relation to credit contracts made for consumer purposes. Under the general law, liability under a contract of guarantee generally depends on the validity of the principal contract between the lender and borrower.<sup>60</sup> A guarantee may, however, contain clauses that preserve the liability of a guarantor in the event of circumstances resulting in the borrower not being liable to the lender, such as where the principal contract turns out to be void or unenforceable, or where the lender releases the borrower from liability. However, clauses designed to preserve the liability of the guarantor in such circumstances are, subject to exceptions, void in accordance with s 55(1) (which incorporates the principle of co-extensiveness).<sup>61</sup> As liability under an indemnity is not affected by any such events, there is not a corresponding need for the inclusion of such clauses in indemnities. However, the consequence of defining guarantee to include indemnity under the Consumer Credit Code is to entrench the co-extensiveness principle for indemnities as well as for guarantees, and thus remove the incentive for lenders to seek indemnities rather than guarantees for transactions within the Code.

5.43 The construction of a contract as one of guarantee or one of indemnity is often so fine that a difference in their respective regulation cannot be justified. The Commission is therefore of the view that the regulatory regime proposed in the Model Law should generally extend to indemnities. The Banking Code and the Consumer Credit Code extend their respective regimes to indemnities without exception. In our view, this goes too far under the Consumer Credit Code in so far as s 55(1) of the Code operates to change the very nature of liability under a contract of indemnity and hence to eviscerate such contracts. In the Commission's view, parties should be free to enter into contracts of indemnity provided there is compliance with the general protective regime of the Model Law. We therefore recommend that the provisions of the Model Law dealing with co-extensiveness (Recommendation 8.2) and with the requirement that, as a general rule, the lender must bring enforcement action against both the borrower and the guarantor (Recommendation 10.4) should not apply to contracts of indemnity.

## RECOMMENDATION 5.6

Except in relation to the matters covered by Recommendations 8.2 and 10.4, the Model Law should apply to contracts of indemnity.

59. *Consumer Credit (New South Wales) Code* Sch 1 cl 1(1).

60. See para 8.40.

61. See para 8.43-8.53.

## Third party mortgages

5.44 A form of agreement closely related to a third party guarantee is a third party mortgage. Third party mortgages are the means by which a third party guarantees the debts of a borrower without strictly entering into a personal undertaking to pay the secured money (ie, a contract of guarantee). Third party mortgages are, in substance, guarantees even if not strictly so in form or name. Accordingly, the courts treat third party mortgages as if they were third party guarantees.<sup>62</sup> Such mortgages will, therefore, be subject to the Model Law.

5.45 The issue is whether or not any special regulation is necessary.

5.46 The Banking Code and the Consumer Credit Code contain provisions regulating third party mortgages.

5.47 The Banking Code requires banks, when accepting a third party mortgage, to give the mortgagor a copy of the loan and guarantee contracts and obtain the mortgagor's written consent:

*A third party mortgage will be unenforceable in relation to a future credit contract or future Guarantee unless we have:*

*(a) given the mortgagor a copy of the contract document of the future credit contract or future Guarantee; and*

*(b) subsequently obtained the mortgagor's written acceptance of the extension of the third party mortgage.<sup>63</sup>*

5.48 The Banking Code defines a third party mortgage as a mortgage or charge given for the purpose of securing any financial accommodation provided by a bank to an individual or a small business or guarantee. It does not include a security which contains a personal undertaking by the mortgagor to pay the secured money (ie, a contract of guarantee).<sup>64</sup>

5.49 The Commission can think of no reason why the Banking Code subjects third party mortgages to a different regulatory regime to that applicable to contracts of guarantee.

5.50 In contrast to the provisions of the Banking Code, s 44 of the Consumer Credit Code provides:

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62. For example, *Re Conley* [1938] 2 All ER 127; *Jowitt v Callaghan* (1938) 38 SR (NSW) 512 at 517 (Jordan CJ); *AGC (Advances) Ltd v West* (1984) 5 NSWLR 590 at 602-603. A third party mortgage must be distinguished from the situation where the mortgagor undertakes primary liability under the mortgage: see *Sorrell v National Australia Bank* [1998] WASCA 69.

63. Code of Banking Practice (2004) cl 28.12.

64. Code of Banking Practice (2004) cl 40.

*(1) A credit provider must not enter into a mortgage to secure obligations under a credit contract unless each mortgagor is a debtor under the contract or a guarantor under a related guarantee.*

*(2) A credit provider must not enter into a mortgage to secure obligations under a guarantee unless each mortgagor is a guarantor under the guarantee or a debtor under the related credit contract.*

*(3) A mortgage which does not comply with this section is unenforceable.*

5.51 Section 44 effectively prohibits the use of third party mortgages in relation to credit contracts within the ambit of the Consumer Credit Code. Hence, in the event of a third party electing to charge his or her property as security for the obligations of a debtor under a credit contract, this charge must be given by way of a guarantee and first party mortgage and not by way of third party mortgage. Section 44 therefore seeks to prevent situations where one co-mortgagor of, for instance, the family home finds that the amount secured by the mortgage has been inflated as a result of the other co-mortgagor's having entered into a guarantee. By prohibiting a person other than the debtor or guarantor from providing security in the form of a mortgage, s 44 ensures that only those parties fully aware of the circumstances of the credit contract can be burdened with security obligations.

5.52 The Commission considers it unnecessary to establish any special regulatory regime for third party mortgages. Since the courts treat third party mortgages as third party guarantees,<sup>65</sup> they will be subject to the Model Law. All the safeguards included in the Model Law that are intended to ensure that guarantors are treated with fairness – such as those on disclosure of information, warning for guarantors to seek independent legal and financial advice, cooling off periods before and after the execution of the guarantee, requirements on variations of obligations, etc – will apply to third party mortgages.

## CONTRACTING OUT

5.53 Settling the appropriate scope of the Model Law would be futile if a party could simply contract out of its provisions. A number of statutes contain provisions regulating contractual terms that seek to circumvent, avoid or modify their effect or key provisions in them.<sup>66</sup> Section 169 of the Consumer Credit Code is an example. It provides:

*(1) A provision of a contract or other instrument by which a person seeks to avoid or modify the effect of this Code is void.*

*(2) A provision of a contract or other instrument by which a person seeks to have the debtor or guarantor indemnify the credit provider for any loss or liability arising under this Code is void.*

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65. See para 5.44.

66. See, for example, s 68 of the *Trade Practices Act 1974* (Cth) which declares void contractual provisions excluding certain rights or liabilities conferred or created by the Act.

(3) A credit provider that is a party to any such contract or other instrument is guilty of an offence.

Maximum penalty – 100 penalty units.

(4) Subsection (2) does not affect the operation of section 55(2).

5.54 The effect of this section is this. If a term of a contract, on its true construction, is inconsistent in its operation with a relevant Consumer Credit Code provision, the contractual term is void, and a lender would obviously be unable to rely on such a term in seeking to enforce the contract against a guarantor. Further, where the guarantor has promised to indemnify the lender for any loss or liability arising under the Consumer Credit Code, the lender cannot rely on such an indemnity,<sup>67</sup> except to the extent that s 55(2) applies because the indemnity is in respect of a liability unenforceable under the contract solely because of the borrower's death, insolvency or incapacity.<sup>68</sup> Moreover, s 169(3) makes it an offence for a lender to be a party to a contract containing terms specified in the section.

5.55 With appropriate alteration of detail, the Commission is of the view that the Model Law should contain a section similar to s 169 of the Consumer Credit Code to enable that Law to achieve its policy objectives, in particular that of protecting third party guarantors from unfairness.<sup>69</sup> In one respect, however, we consider that s 169 does not go far enough in its application to the law of guarantees. The section makes no provision for what is to happen if the guarantor has paid money or transferred property under the guarantee or indemnity – for example, where the guarantor has made a payment under the guarantee unaware that some provisions in the guarantee are void by reason of s 169(1) or s 169(2). The Consumer Credit Code no doubt assumes that established principles at common law would achieve a satisfactory outcome in such a situation.

5.56 The Commission does not, however, consider that the common law is the best means of providing for payments that have been made by a guarantor under a guarantee that contains the clauses identified in s 169(1) or s 169(2). The common law, reflecting the detailed and peculiar circumstances of each case, is extraordinarily complex, making its simple statement difficult. Its application depends, among other matters, on whether or not the impugned provisions of the contract are against public policy; on the extent to which those provisions are “severable”; on whether or not the guarantor was innocent or in equal guilt with the lender; and, if the latter, on the extent to which the legislation was passed for the benefit of guarantors as a class; and, more generally, on the extent to which an action

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67. An indemnity for any liability under the Code is not generally void as against public policy: *Consumer Credit (New South Wales) Code* s 169A(1) and (2). However, s 169A(3) of the *Consumer Credit (New South Wales) Code* makes s 169A subject to s 169(2). Section 169A of the Code, introduced in 1998 to ensure the enforceability of indemnities in the context of securitisation programs involving a number of parties, applies to indemnities given by persons other than the debtor or guarantor, and so is outside the scope of the Model Law. See generally D McGill and L Wilmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 998-1008.

68. Recommendation 8.2 incorporates s 55(2) into the Model Law.

69. See para 4.2-4.12.

in restitution (however framed) lies at the instance of the guarantor to prevent the lender being unjustly enriched at the expense of the guarantor.<sup>70</sup>

5.57 In our view, the detail of the common law is not necessary in this context. The Model Law should simply contain a statement that a guarantor should be able to recover any money paid or property transferred by him or her under a contract that contains a clause that seeks to avoid or modify the effect of the Model Law, or a clause that seeks to indemnify the lender for any loss or liability arising under the Law. Given that the Model Law will apply to guarantors who seek guarantees in the course of providing credit for profit as part of their business,<sup>71</sup> the provision will not be productive of injustice but will enhance the deterrent value of the section and avoid costly litigation.

5.58 This provision will, of course, be subject to general law doctrines; for example, that payments made as part of a voluntary compromise of a disputed claim are irrecoverable,<sup>72</sup> even if that principle is of limited application in the present context.<sup>73</sup>

## Recommendation 5.7

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The Model Law should render void contractual terms that seek to exclude or modify its effect. The Law should be expressed in terms similar to s 169 of the *Consumer Credit Code* and should include a provision for the recovery by the guarantor of any money paid or property transferred under a contract containing such provisions.

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70. For detailed consideration of the general law, see especially J W Carter and D J Harland, *Contract Law in Australia* (4th edition, Butterworths, Chatswood NSW, 2002) ch 17; K Mason and J W Carter, *Restitution Law in Australia* (Butterworths, Sydney, 1995) ch 26; G H Treitel, *The Law of Contract* (11th ed, Sweet & Maxwell, London, 2003) at 480-512; Lord Goff and G Jones, *The Law of Restitution* (6th ed, Sweet & Maxwell, London, 2002) ch 24. See also A Vrisakis and J W Carter, "Restitution of Payments Made Under Contracts Prohibited by Statute" (2000) 15 *Journal of Contract Law* 1.

71. See Recommendation 5.2.

72. See Mason and Carter *Restitution Law in Australia* (Butterworths, Sydney, 1995) at para 1328; Goff and Jones *The Law of Restitution* (6th ed, Sweet & Maxwell, London, 2002) at para 1-070-1.071.

73. Consider *David Securities Pty Ltd v Commonwealth Bank of Australia* (1992) 175 CLR 353 at 383-384 (Mason CJ, Deane, Toohey, Gaudron and McHugh J), 399-400 (Brennan J).



## 6. Entering into the contract

- Introduction
- Pre-contractual disclosure
- Independent legal and financial advice
- Signing the documents

## INTRODUCTION

6.1 This chapter explores two issues central to regulating conditions preceding the signing of a guarantee and to the rights of prospective guarantors. It also discusses an ancillary issue pertaining to the circumstances in which the guarantee is signed. These issues are concerned with giving the guarantor a measure of protection from the risks of guaranteeing a loan and enabling him or her to make an informed decision about a proposed transaction. While all guarantees carry the risk that the borrower will default, leaving the guarantor liable for the debt, the regulatory measures proposed in this chapter are aimed at assisting a guarantor to fully appreciate, and guard against, these risks, and the risks of the particular transaction, while not stifling commercial activity.

6.2 The first issue addressed in this chapter relates to the information and advice a lender ought to provide to the prospective guarantor about the loan to the borrower. Paragraphs 6.3-6.13 examine current obligations and practice and consider whether the law should be modified to increase the level of disclosure and strengthen warnings to the guarantor. The second relates to whether a guarantor should obtain independent legal and/or financial advice, and the consequences (if any) of the absence of such advice. The third relates to the ideal conditions for settlement of the guarantee transaction, namely the place where execution of the documents should take place and in the presence of whom.

## PRE-CONTRACTUAL DISCLOSURE

### Current requirements

#### *Common law*

6.3 Generally, at common law, the lender is not required to disclose information to the prospective guarantor about the principal loan, *except* where the transaction has what the case law describes as “unusual features”.<sup>1</sup> The main rationale provided for this rule relates to potential breaches of the duty of confidentiality owed by the lender to the borrower (who, unlike the guarantor, is the lender’s customer).<sup>2</sup> The notion of “unusual facts” can leave a lender in a situation where it has to balance between deciding whether to disclose what may be an “unusual fact” to the prospective guarantor as against maintaining its duty of confidentiality to its customer, the borrower,<sup>3</sup> and in a situation where a difficult judgment may have to be made as to whether a fact is “unusual” or not.

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1. See *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 455 and 457 (Gibbs CJ). Unusual features include not only the loan itself, but also the circumstances surrounding it: see J O’Donovan and J Phillips, *The Modern Contract of Guarantee* (3rd edition, LBC Information Services, Sydney, 1996) at 127.
  2. *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 457 (Gibbs J).
  3. This was pointed out by the Martin Committee: Australia, House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change: Banking and Deregulation* (AGPS, Canberra, 1991) at 417-418.

6.4 A number of government reports<sup>4</sup> and research studies<sup>5</sup> have observed that the common law approach is ill-founded from both the lender's and guarantor's perspectives on two separate counts. First, there is no basis for common law assumptions about a prospective guarantor's independence, nor about their ability to inform themselves of the borrower's financial position. Secondly, there is no guidance provided as to what facts are sufficiently "unusual" so as to require their disclosure. In day-to-day commercial discourse, how does a lender know when it has come across an "unusual fact" that is unknown to the guarantor, or that places a legal obligation on it to notify the potential guarantor?

*Consumer Credit Code*

6.5 The *Consumer Credit (New South Wales) Code* ("Consumer Credit Code") sets out, in s 51, the disclosure required before a guarantee is signed in respect of a consumer credit contract (credit for personal, domestic or household purposes). Section 51 provides as follows:

*(1) Before a guarantee is signed by the guarantor, the credit provider must give to the prospective guarantor—*

*(a) a copy of the contract document of the credit contract or proposed credit contract; and*

*(b) a document in the form prescribed by the regulations explaining the rights and obligations of a guarantor.<sup>6</sup>*

*(2) A guarantee is not enforceable unless subsection (1)(a) is complied with.*

The term "contract document" means "the document or documents setting out the terms of a contract".<sup>7</sup>

6.6 The regulation made under s 50 of the Consumer Credit Code provides that a guarantee must contain a warning in the terms of Form 4 of the Schedule.<sup>8</sup> Form 4 warns

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4. See for example, Australia, House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change: Banking and Deregulation* (AGPS, Canberra, 1991) at 417-419; Australia, Expert Group on Family Financial Vulnerability, *Good Relations, High Risks: Financial Transactions Within Families and Between Friends* (Report, 1996) at 39-40.
  5. B Fehlberg, *Sexually Transmitted Debt: Surety Experience and English Law* (Clarendon Press, Oxford, 1997) and S Singh, *For Love Not Money: Women, Information and the Family Business* (Consumer Advocacy and Financial Counselling Association of Victoria Inc, Melbourne, 1995).
  6. Section 21 of the *Consumer Credit (New South Wales) Regulations* provides that the document must be in the form of Form 5A set out in the Schedule. This contains 25 questions and answers explaining guarantees generally and the guarantor's rights and obligations, as well as giving advice, such as what the guarantor can do in the event of a default by the borrower.
  7. *Consumer Credit (New South Wales) Code* Sch 1 cl 1(1).
  8. *Consumer Credit (New South Wales) Regulations* s 20.

that the guarantor may be personally liable for the debt, and that this could jeopardise the guarantor's assets, including his or her home. It also advises the guarantor that it may be possible to withdraw from the guarantee or limit the liability, and of the guarantor's rights in relation to an extension of credit. It recommends that the guarantor get independent legal and financial advice and make his or her own inquiries about the debtor's financial position and credit risk.

6.7 Failure to provide a copy of the credit contract<sup>9</sup> or include the Form 4 warning renders the guarantee unenforceable.<sup>10</sup>

*Code of Banking Practice*

6.8 The Code of Banking Practice ("Banking Code") requires the bank to provide to a prospective guarantor "prominent notice" that the guarantor:<sup>11</sup>

- should seek independent legal and financial advice on the effect of the guarantee;
- can refuse to enter into the guarantee;
- has a right to limit liability under the guarantee; and
- can request information about the transaction or facility to be guaranteed.

6.9 In amendments to the Banking Code, which took effect on 1 June 2004, the bank must notify the guarantor of:

- any notice of demand made by the bank on the debtor, or any dishonour on any facility the debtor has (or has had) with the bank, in the previous twelve months (or, from 1 June 2005, in the previous twenty-four months); and
- any excess or overdrawn on any facility the debtor has (or has had) with the bank in the previous six months, and a list of any such excesses or overdrawings.<sup>12</sup>

6.10 The bank must tell the guarantor if the loan will not be made if the guarantee is not provided.<sup>13</sup> In addition to providing any information that the prospective guarantor reasonably requests (excepting the bank's internal opinions),<sup>14</sup> the bank must also provide the prospective guarantor with copies of:<sup>15</sup>

- any related credit contract, together with a list and description of any related security contract (and a copy of that security contract if requested by the guarantor);

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9. *Consumer Credit (New South Wales) Code* s 51(2). By contrast, failure to provide an information statement, while constituting an offence, does not render the guarantee unenforceable: *Consumer Credit (New South Wales) Code* s 51(2) and s 57. See also A J Duggan and E V Lanyon, *Consumer Credit Law* (Butterworths, Sydney, 1999) at para 6.3.23-6.3.24.

10. *Consumer Credit (New South Wales) Code* s 50(4).

11. Code of Banking Practice (2004) cl 28.4(a).

12. Code of Banking Practice (2004) cl 28.4(b). The latter part of the requirement came into effect on 1 February 2005.

13. Code of Banking Practice (2004) cl 28.4(c).

14. Code of Banking Practice (2004) cl 28.4(e).

15. Code of Banking Practice (2004) cl 28.4(d).

- the final letter of offer;<sup>16</sup>
- any related credit report from a credit reporting agency;
- any current credit-related insurance contract in the bank's possession;
- the latest statement of account relating to the credit facility,<sup>17</sup> and financial accounts or statement of financial position from the previous two years; and
- any unsatisfied notice of demand made in relation to the credit facility in the previous two years.

6.11 The bank must also ensure that a warning notice substantially in the terms of Form 4 of the *Consumer Credit Regulation* appears directly above the place where the guarantee is to be signed.<sup>18</sup>

#### *Other financial institutions*

6.12 The Credit Union Code requires that a prospective guarantor be provided with a written warning about the possibility of the prospective guarantor becoming liable instead of, or as well as, the borrower<sup>19</sup> and with a copy<sup>20</sup> of the primary loan contract.<sup>21</sup>

6.13 Although finance companies commonly use guarantees, they do not have an industry code of practice. They are not subject to disclosure provisions similar to those contained in the codes of practice referred to above.<sup>22</sup> The Expert Group on Family Financial Vulnerability recommended that finance companies develop a code of conduct containing provisions relating to, among other things, the disclosure of information,<sup>23</sup> but to date this has not occurred.

## Privacy

6.14 Section 18N of the *Privacy Act 1988* (Cth) ("*Privacy Act*") regulates disclosure by credit providers of personal information. Section 18N(1) provides that a credit provider must not disclose a report that is in or has been in its possession or control, or personal information derived from the report, for any purpose unless it is a purpose contained in

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16. Together with details of any conditions in an earlier version of that letter of offer that were satisfied before the final letter of offer was issued: Code of Banking Practice (2004) cl 28.4(d)(ii).
  17. Together with any other statement of account for a period during which a notice of demand was made by the bank, or a dishonour occurred: *Code of Banking Practice* (2004) cl 28.4(d)(vi).
  18. Code of Banking Practice (2004) cl 28.8.
  19. Credit Union Code of Practice (2004) s 17.4(i).
  20. Credit Union Code of Practice (2004) s 17.4(ii).
  21. The Building Society had a code with similar provisions but it ceased to operate in 2003.
  22. Australia, Expert Group on Family Financial Vulnerability, *Good Relations, High Risks: Financial Transactions Within Families and Between Friends* at 43.
  23. Australia, Expert Group on Family Financial Vulnerability, *Good Relations, High Risks: Financial Transactions Within Families and Between Friends* (Report, 1996), Recommendation 9 at 50.

one of the sub-sections that follows. Intentional contravention of that prohibition is an offence attracting a substantial fine.<sup>24</sup>

6.15 The two sub-sections relevant to this discussion are as follows. Section 18N(1)(bh) allows disclosure to a prospective guarantor for the purpose of considering whether to enter into the guarantee, providing the borrower consents to the disclosure. Section 18N(1)(g) allows disclosure if it is required or authorized by or under law.<sup>25</sup>

6.16 The *Privacy Amendment (Private Sector) Act 2000* (Cth) inserted the *National Privacy Principles*, contained in Schedule 3, into the *Privacy Act*. Clause 2.1, in so far as it is relevant, prevents an "organisation"<sup>26</sup> from disclosing personal information for a purpose ("secondary purpose") other than the primary purpose for which the information was collected unless:

- (a) both the following apply:
  - (i) the secondary purpose is related to the primary purpose of collection and, if the personal information is sensitive information, directly related to the primary purpose of collection; and
  - (ii) the individual would reasonably expect the organisation to use or disclose the information for the secondary purpose; or
- (b) the individual has consented to the use or disclosure.

Clause 2.1(g) also allows disclosure if it is required or authorised by or under law.

#### *The Consumer Credit Code and the Privacy Act*

6.17 The Commission is canvassing, as an option for reform, extending the operation of s 51 of the Consumer Credit Code or other statute-required disclosure to a guarantor. It is therefore necessary to consider a possible obstacle presented by the *Privacy Act*. This issue has emerged in relation to s 51(1)(a) of the Consumer Credit Code and provides a parallel example for analysis. The possibility has been raised that s51(1)(a) is inconsistent with s 18N(1) of the *Privacy Act* within the meaning of s 109 of the *Constitution* so as to make the Consumer Credit Code provision inoperable.

6.18 As set out above, s 18N(1) of the *Privacy Act* provides generally that a credit provider that is in possession of a report must not disclose it to another person. The term, "credit provider", within the meaning of the *Privacy Act*, is defined in s 11B of that Act.<sup>27</sup> It

24. *Privacy Act 1988* (Cth) s 18N(2).

25. Section 18N(1)(ba) allows disclosure if the information or report is disclosed to a guarantor *and* for any purpose related to the enforcement or proposed enforcement of the guarantee.

26. "Organisation" is defined as an individual, a body corporate, a partnership, any other unincorporated association or a trust that is not a small business operator, a registered political party, an agency, a State or Territory authority or a prescribed instrumentality of a State or Territory: *Privacy Act 1988* (Cth) s 6C.

27. Read together with Determination No 1 of 2003 made under *Privacy Act 1988* (Cth) s 11B(1)(b)(v)(B).

is sufficient for present purposes to say that at least some “credit providers” within the meaning of the Code will also be “credit providers” within the meaning of the *Privacy Act*.

6.19 The term, “report”, within the meaning of s 18N of the *Privacy Act*, is defined generally in s 18N(9) as including a record, or information, that has any bearing on an individual’s credit-worthiness, credit standing, credit history or credit capacity. It appears that the copy of the contract document of a credit contract or proposed credit contract required by s 51(1)(a) of the Consumer Credit Code to be given by the credit provider to the prospective guarantor falls within the definition of the term “report” for the purposes of s 18N of the *Privacy Act*, if for no other reason than because it is information that has a bearing on the actual or proposed borrower’s credit history.

6.20 Thus, the command in s 51(1)(a) of the Consumer Credit Code, in so far as it applies to a person who is a “credit provider” within the meaning both of the Consumer Credit Code and of the *Privacy Act*, appears to collide directly with the general prohibition in s 18N(1) of the *Privacy Act*. If it does, the former provision would prima facie be inoperative by reason of inconsistency with the latter provision.

6.21 However, the issue is not as simple as this, because of the exceptions to the general prohibition in s 18N(1) of the *Privacy Act*, set out above. As noted above, s 18N(1)(g) allows disclosure of the “report” to the person to whom it is disclosed for the purpose for which it is disclosed if this “is required or authorised by or under law”. If the term “law” includes a State statute such as the Consumer Credit Code, then the direct collision between the command in s 51(1)(a) of the Consumer Credit Code and the general prohibition in s 18N(1) of the *Privacy Act* becomes irrelevant; and the prima facie inoperability of s 51(1)(a) of the Consumer Credit Code, where the credit provider within the meaning of the Consumer Credit Code is also a credit provider within the meaning of the *Privacy Act*, disappears.

6.22 The Commission is of the view that there is no good reason, as a matter of ordinary language, why a State statute does not have the character of “law”, or that the Commonwealth Parliament, when using the term “law” in s 18N(1)(g) of the *Privacy Act*, intended to exclude from that term State statutes.

6.23 A similar issue arose in *Northern Territory v GPAO*.<sup>28</sup> There, s 112AD of the *Family Law Act 1975* (Cth) provided for sanctions for contraventions of certain orders made under that Act, subpoenas to produce documents being included within such orders. However, such sanctions were not available if (relevantly) a person served with the subpoena to produce documents had had a “reasonable excuse” for not complying with it. Three members of the majority in that case held that an immunity from production of documents contained in a Northern Territory statute amounted to such “reasonable excuse” within the meaning of the *Family Law Act 1975* (Cth).<sup>29</sup>

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28. *Northern Territory v GPAO* (1999) 196 CLR 553.

29. *Northern Territory v GPAO* (1999) 196 CLR 553 at 589 (Gleeson CJ and Gummow J), 650 (Hayne J). The matter was not adverted to by the other members of the majority.

6.24 Further support for the conclusion that the term "law" within the meaning of s 18N(1)(g), includes State statutes is to be found in s 3 of the *Privacy Act* and the note to that section.<sup>30</sup> Section 3 provides, and the note states, as follows:

*It is the intention of the Parliament that this Act is not to affect the operation of a law of a State or of a Territory that makes provision with respect to the collection, holding, use, correction, disclosure or transfer of personal information (including such a law relating to credit reporting or the use of information held in connection with credit reporting) and is capable of operating concurrently with this Act.*

*Note: Such a law can have effect for the purposes of the provisions of the National Privacy Principles that regulate the handling of personal information by organisations by reference to the effect of other laws.*

6.25 Section 3 of the *Privacy Act* is commonly referred to as a "GMAC" provision.<sup>31</sup> The effect of the section is: first, to exclude any indirect (or "covering the field") inconsistency which might otherwise have arisen between, on the one hand, the *Privacy Act* and, on the other hand, the Consumer Credit Code; but, secondly, not to exclude any direct constitutional inconsistency which arises between the two statutes.<sup>32</sup>

6.26 Given the Commonwealth Parliament's express intention as disclosed by s 3 of the *Privacy Act* that a State law that makes provision with respect to the collection, holding, use, correction, disclosure or transfer of personal information (including such a law relating to credit reporting or the use of information held in connection with credit reporting) should, if capable of operating concurrently with the *Privacy Act*, do so, that intention can best be given effect by construing the reference in s 18N(1)(g) to "law" as including, rather than excluding, State statutes.

6.27 Further support, if needed, for the effect suggested for the present form of s 3 of the *Privacy Act* on the construction of the term "law" in s 18N(1)(g) can be found in the second reading speech for the Bill which, without amendment of either the proposed amendment to s 3 or the proposed note, became the *Privacy Amendment (Private Sector) Act*. The Attorney-General said:

*By introducing this bill, the Commonwealth intends to establish a single comprehensive national scheme for the protection of personal information by the private sector. However, state and territory laws will continue to operate to the extent that they are not directly inconsistent with the terms of the bill.*

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30. Section 4 and items 1 and 2 of Schedule 1 to the *Privacy Amendment (Private Sector) Act 2000* (Cth) both amended s 3 of the *Privacy Act 1988* (Cth) so that it took its present form and added the note to the section as so amended.

31. See *The Queen v Credit Tribunal; Ex parte General Motors Acceptance Corporation* (1977) 137 CLR 545.

32. See *The Queen v Credit Tribunal; Ex parte General Motors Acceptance Corporation* (1977) 137 CLR 545 at 563-564 (Mason J).



*The national privacy principles recognise the operation of state and territory legislation and the common law. For example, while the principles provide for a right of access to personal information held about an individual, they also contemplate a situation in which that access may be denied if this denial is required or authorised by law.*

*While there may be some situations of direct inconsistency, I expect that, in the majority of cases, existing state and territory laws will continue unaffected by this bill. The existing law will simply be supplemented by the standards contained in the national privacy principles.<sup>33</sup>*

6.28 In the passage just quoted, the Attorney was concentrating on the effect on the operation of State statutes of the proposed new National Privacy Principles. The example which he gave of the recognition by those Principles of State legislation was plainly directed to what became s 6.1(g) of those Principles,<sup>34</sup> which provides that an organisation that holds personal information about an individual must provide that individual with access to that information on request, “except to the extent that ...denying access is required or authorised by or under law”. The phrase, “required or authorised by or under law”, just quoted is, of course, identical to the phrase in s 18N(1)(g).

6.29 The Commission concludes that State legislation that requires disclosure by credit providers of personal information to certain persons for certain purposes, in addition to those set out in the sub-sections to s 18N of the *Privacy Act*, would not be constitutionally invalid.

## Submissions

6.30 Issues Paper 17 asked a series of questions relating to the nature and extent, and necessity, of pre-contractual disclosure.<sup>35</sup> The following paragraphs outline the feedback that the Commission received.

6.31 The majority of submissions were of the view that, in order for the guarantor to make an informed choice about whether to enter into a guarantee, and to assist in obtaining independent financial advice, lenders ought to make full disclosure of information in their possession relevant to the financial position of the borrower.<sup>36</sup> It was

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33. Australia, *Parliamentary Debates (Hansard)* House of Representatives, 12 April 2000, the Hon D Williams, Attorney-General, Second Reading Speech at 15751-15752.

34. See *Privacy Act 1988* (Cth) Sch 3.

35. New South Wales Law Reform Commission, *Guaranteeing Someone Else's Debts* (Issues Paper 17, 2000) Questions 14-20 at 102-103, Question 23 at 104, and Question 32 at 106.

36. NSW Legal Aid Commission, *Submission* at 12; NSW Young Lawyers *Submission* at 3; Women Lawyers Association of NSW, *Submission* at 3; Ryde-Eastwood Financial Counselling Service, *Submission* at 4; Women's Legal Resources Centre, *Submission* at 5; Financial Counsellors' Association of NSW Inc, *Submission* at 2;

thought that, at the least, this information should include current income and expenditure, assets and liabilities, and, where applicable, profit and loss statements and balance sheets.<sup>37</sup> It was also generally thought that the lender should provide the guarantor with copies of the loan application and the proposed loan contract. Other submissions thought that the guarantor should also be provided with the risk assessment and/or credit rating of the borrower,<sup>38</sup> and that the purpose for the loan<sup>39</sup> and reason why a guarantee is sought should be disclosed.<sup>40</sup> The NSW Department of Fair Trading submitted that the lender should generally provide the guarantor with the information on which it has based its decision to lend the money and to request a guarantee.<sup>41</sup>

6.32 The NSW Department of Fair Trading also pointed out that the situation where a lender requests a guarantee over an existing loan particularly warrants disclosure to the guarantor of all information in the lender's possession, as the request suggests that the risk of the borrower defaulting is increasing.<sup>42</sup>

6.33 The majority of submissions were also of the view that the limited common law duty to disclose only "unusual" facts should be modified.<sup>43</sup> The Financial Counsellors' Association of NSW Inc and NSW Young Lawyers added that the term "unusual" is ambiguous and open to interpretation, leading to inconsistency in disclosure practices and uncertainty about what should be disclosed.<sup>44</sup>

6.34 The Commonwealth Bank of Australia ("CBA") pointed out that a lender has a duty of confidentiality to the borrower and, without the borrower's consent, the lender cannot

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The NSW Department of Fair Trading, *Submission* at 3-4; Country Women's Association of NSW, *Submission* at 2.

37. The Ryde-Eastwood Financial Counselling Service submitted that information should also include: projected analysis of business plan (if any); amount that the credit provider would lend without the guarantee and how they arrived at this calculation; what security, if any, is already held; and whether the borrower has alternative sources of credit available, not requiring a guarantee: Ryde-Eastwood Financial Counselling Service, *Submission* at 4.
38. Ryde-Eastwood Financial Counselling Service, *Submission* at 4; Women's Legal Resources Centre, *Submission* at 5; Financial Counsellors' Association of NSW Inc, *Submission* at 2.
39. NSW Legal Aid Commission, *Submission* at 12.
40. Women Lawyers Association of NSW, *Submission* at 3; Women's Legal Resources Centre, *Submission* at 5; Financial Counsellors' Association of NSW Inc, *Submission* at 2; NSW Young Lawyers *Submission* at 3; The NSW Department of Fair Trading, *Submission* at 4; NSW Legal Aid Commission, *Submission* at 13.
41. The NSW Department of Fair Trading, *Submission* at 4.
42. The NSW Department of Fair Trading, *Submission* at 4.
43. Ryde-Eastwood Financial Counselling Service, *Submission* at 4; Women Lawyers Association of NSW, *Submission* at 3; Women's Legal Resources Centre, *Submission* at 6; Financial Counsellors' Association of NSW Inc, *Submission* at 3; NSW Legal Aid Commission, *Submission* at 13; NSW Young Lawyers, *Submission* at 3; NSW Department of Fair Trading *Submission* at 3.
44. Financial Counsellors' Association of NSW Inc, *Submission* at 3; NSW Young Lawyers, *Submission* at 3.

disclose information about its customer to any other party, including a guarantor.<sup>45</sup> Accordingly, it is the CBA's practice to seek to obtain the borrower's consent before it discloses any information to a borrower. It noted, however, that many borrowers would object to disclosure to prospective guarantors of the borrower's full financial details. Providing the CBA obtains the borrower's consent, then its practice is to provide the guarantor with a copy of the loan offer. The CBA always recommends to the prospective guarantor that he or she obtain independent legal and financial advice.

6.35 If a requirement were introduced to provide to the guarantor all information about the circumstances of the borrower (including why a guarantee has been sought), the CBA submitted that, even if this were limited to information in the lender's possession, this would still be administratively difficult. Further, the CBA argued that, if a prospective guarantor was dissuaded from providing the guarantee due to incorrect advice about the reason it was required, this could result in legal action against the lender. This, the CBA argued, would make lenders more "circumspect in advising why a guarantee has been sought" and may lead to more stringent lending criteria for complex transactions.

6.36 The Australian Finance Conference ("AFC") submitted that lenders should (and do) provide the prospective guarantor with sufficient information to enable the guarantor or his or her legal adviser, to understand the transaction and the guarantor's obligations under it. Such documents would usually include the guarantee, and the primary transaction document (and where relevant, a letter of offer). Often, in practice, the guarantee forms part of the finance agreement.<sup>46</sup>

6.37 The St George Bank ("St George") submitted that the requirements under the Consumer Credit Code should be extended to small business, but with a strengthening of the warnings contained in Forms 4 and 5A that the guarantor should investigate the borrower's financial position. Providing the lender has obtained the borrower's consent, St George does not oppose a "passive obligation" to provide the proposed guarantor, at his or her request, with a copy of the borrower's application form.<sup>47</sup> St George submitted that "any greater obligation on a lender's behalf would place too high a duty in relation to a non-customer". St George emphasised that it sees its primary concern as the confidentiality it owes to its customer.

6.38 St George also submitted that if it were required to disclose all information about the borrower's circumstances then this would result in increased administrative costs, which would have to be passed on to the borrower; and a greater potential for the guarantee to be avoided if the lender failed to disclose all required information. This, St George submitted, would in turn result in decreased loan approvals and would encourage the guarantor to place too much reliance on the information provided by the lender rather than relying on his or her own assessment of the borrower's credit-worthiness.<sup>48</sup>

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45. Commonwealth Bank of Australia, *Submission* at 7. The issue of obtaining the borrower's consent was also raised by The Financial Counsellors' Association of NSW Inc, *Submission* at 2; the Women Lawyers Association of NSW, *Submission* at 3; and NSW Young Lawyers, *Submission* at 3.

46. Australian Finance Conference, *Submission* at 13.

47. St George Bank, *Submission* at 2.

48. St George Bank, *Submission* at 2.

6.39 St George suggested that, rather than providing a specific reason in each case as to why the guarantee has been sought, a warning in a prescribed form could appear on the guarantee document to the effect that “your guarantee is required to support this loan because the debtor has insufficient security”.<sup>49</sup>

## Conclusion

6.40 The Commission is persuaded by the feedback from a majority of submissions that lenders ought to make full disclosure of information in their possession relevant to the financial position of the borrower. It is hard to see how a guarantor can otherwise make an informed choice about whether or not to enter into a guarantee. In addition, effective and relevant independent financial advice, if such is to be obtained, has to be based on proper disclosure. Numerous commentators have argued that legal advice on the effect of a guarantee is of very little assistance in the absence of financial information on the borrower's position and financial advice on the implications of the transaction.

6.41 As is stressed throughout this Report, guarantors can be vulnerable to incurring significant financial loss and should be afforded the fullest opportunity to assess the risk of the proposed transaction. Even if the prospective guarantor is not dissuaded from giving the guarantee, to assume a known risk voluntarily and being well informed is empowering. The guarantor may be more likely to monitor the progress of the repayment of the loan and more able to take precautionary or pre-emptive steps if default is impending.

6.42 It is unsatisfactory for the extent of disclosure – or any disclosure at all – to be left to the discretion of the individual lender and upon whether consent from the borrower is forthcoming. It is also unsatisfactory to rely on the limited common law duty to disclose only “unusual” facts. As the submissions pointed out, the common law duty leaves lenders in a position of uncertainty about what is “unusual” and should therefore be disclosed. The majority of submissions were of the view that the common law should be modified. Lenders would benefit from legislative clarification of what is to be disclosed.

6.43 The Commission is not persuaded that the administrative inconvenience and cost of disclosure outweigh the fairness of enlightening the prospective guarantor as to the financial circumstances of the borrower and the transaction. It is also difficult to envisage legal action against the lender for wrong advice about why the guarantee was required, a concern expressed by the CBA. First, it is advice that would not, in most situations, be complex or ambiguous and, if due care is taken, could easily be conveyed accurately. Secondly, it could well be difficult for the borrower to prove that the guarantor was dissuaded from entering into the guarantee by this advice. Thirdly, the financial information about the borrower would be more revealing and essential to evaluating the risks of the guarantee than the lender's reason for requiring it. A financial advisor, advising a prospective guarantor about the proposed transaction, would focus on financial records and documents, which speak for themselves. At any rate, if, as the CBA argued, the possibility of legal liability for wrong advice leads to more stringent lending criteria for complex transactions, this is not, in the Commission's view, reason to draw back from requiring fuller disclosure.

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49. St George Bank, *Submission* at 3.

6.44 A number of submissions drew attention to privacy considerations and lenders' duty of confidentiality owed to borrowers. It is the practice of most lenders to obtain the borrower's consent to disclosing information to prospective guarantors. However, it was submitted that borrowers would most likely object to full disclosure of their financial circumstances.

6.45 The Commission contemplated a legislative requirement that lenders obtain borrowers' consent to disclosure of financial information to a prospective guarantee. However, on reflection, this requirement could place too much strain on the borrower/guarantor relationship and, in any case, in view of the Commission's conclusion as to the operation of the provisions of the *Privacy Act*, is not necessary. As analysed above, a requirement in a statute of New South Wales that lenders disclose prescribed information to guarantors would have force by reason of s 18N(1)(g) of the *Privacy Act*, which allows disclosure if it is required or authorized by or under law.

6.46 The Commission is impressed by the requirements for disclosure of the Banking Code and has concluded that these requirements, with some modification, would place guarantors in the best position to evaluate the risks of guaranteeing the loan and take on these risks with full knowledge of the facts. The disclosure requirements should apply regardless of the type of loan or the relationship between the borrower and the guarantor (except where the guarantor is a sole director guarantor).<sup>50</sup>

6.47 Accordingly, the Commission is of the view that legislation should adopt the disclosure requirements of the Banking Code to apply to all guarantees within the scope of this reference, together with a further requirement that the lender make available to the prospective guarantor the financial information concerning the borrower's circumstances that the lender treats as being relevant to the borrower's risk. At the least, the prospective guarantor should be provided with the loan application. If the loan application does not set out the assets and liabilities, income and expenditure (or the equivalent corporate documents) of the borrower, the documents provided with the loan application that contains this information should also be provided to the prospective guarantor. The Commission agrees with the approach of the Consumer Credit Code that the consequences of a failure to comply should render the guarantee unenforceable.

## RECOMMENDATION 6.1

The Model Law should provide that a lender must make available to the prospective guarantor the financial information concerning the borrower's circumstances that the lender treats as relevant to the borrower's risk. The prospective guarantor should be provided with copies of:

- any related credit contract, together with a list and description of any related security contract (and a copy of that security contract if requested by the prospective guarantor);
- any related credit report from a credit reporting agency;
- any current credit-related insurance contract concerning the borrower in the lender's possession;

50. See Recommendation 5.5.

- the latest statement of account relating to the credit facility, and financial accounts or statement of financial position of the borrower from the previous two years;
- any unsatisfied notice of demand made in relation to the credit facility in the previous two years;
- the final letter of offer; and
- the loan application.

If the loan application does not set out the assets and liabilities, income and expenditure (or the equivalent corporate documents) of the borrower, the documents provided with the loan application that contain this information should also be provided to the prospective guarantor.

## RECOMMENDATION 6.2

The Model Law should provide that the lender must notify the prospective guarantor of:

- any notice of demand made by the lender on the borrower, or any dishonour on any facility the borrower has (or has had) with the lender, in the previous 2 years; and
- any excess or overdrawn on any facility the borrower has (or has had) with the lender in the previous six months. The lender must provide a list of any such excesses or overdrawings.

The lender must tell the prospective guarantor if the loan will not be made if the guarantee is not provided.

## RECOMMENDATION 6.3

The Model Law should provide that failure to comply with the requirements set out in Recommendations 6.1 and 6.2 renders the guarantee unenforceable.

## INDEPENDENT LEGAL AND FINANCIAL ADVICE

6.48 Mahalingham has identified two distinct functions that independent advice serves in loan transactions, although she observes that its precise role is not well understood:

*For lenders it plays a protective role, shielding them from the effects of the misconduct of a third party or countering allegations of unfair conduct. For the family security provider, it is thought that independent advice will eliminate underlying unfairness by ensuring that the family security provider has made an informed, independent and voluntary decision in providing security.<sup>51</sup>*

6.49 In its submission, the AFC related that its members that require a guarantor to seek independent advice, do so for a variety of reasons:

- to inform the guarantor of the obligations and consequences of signing a guarantee;
- to allow an opportunity for the guarantor to make an informed decision about entering into the guarantee;
- to avoid the possibility of a claim of bias associated with the financial institution giving the advice, by having a disinterested party provide advice;
- to avoid the possibility of a claim that the financial institution acted in a way that misled the guarantor about the true nature of the contract;
- to avoid the guarantor entering into an unjust contract; and
- in the event the guarantor challenges the fairness of a guarantee, as one indicator of an attempt to achieve procedural fairness.

51. S Mahalingham, "Deep and meaningful: Dealing with emotionally transmitted debt" (1999) 3 *Consumer Rights Journal* 1.

6.50 This section analyses the value of a guarantor receiving independent advice.<sup>52</sup> It explores whether it would deter some from entering into risky transactions and whether the current requirements and protocols in place are sufficient, or whether there should be a statutory requirement to obtain advice. While the discussion generally applies to both legal and financial advice, and in many respects it would be difficult to separate out the two, the main focus (and that of the submissions) is on legal advice.

## Current requirements

6.51 In determining whether a contract or a provision of a contract is unjust pursuant to the *Contracts Review Act 1980* (NSW), the court is to have regard to whether or not, and when, independent legal or other expert advice was obtained by the party seeking relief under the Act. Recommending independent legal advice is a factor that may relieve a lender of responsibility for unfairness pursuant to the High Court decision in *García v National Australia Bank*.<sup>53</sup> It is commonly thought that many lenders now insist that guarantors obtain independent legal advice.<sup>54</sup>

### *Consumer Credit Code*

6.52 The Consumer Credit Code does not require that the guarantor actually have received independent legal or financial advice. As described above, Form 4 alerts the guarantor in the following words: “You should obtain independent legal advice”; “You should also consider obtaining independent financial advice”; and “You should make your own inquiries about the credit worthiness, financial position and honesty of the debtor”. However, absence of independent legal or other expert advice is a factor which the court may take into account in a decision under s 70 of the Consumer Credit Code as to whether to re-open an unjust transaction.<sup>55</sup>

6.53 In addition, s 51 of the Consumer Credit Code requires the lender to give to the prospective guarantor a Form 5A document, which contains 25 questions and answers explaining guarantees generally and the guarantor's rights and obligations, as well as giving advice, such as what the guarantor can do in the event of a default by the borrower.<sup>56</sup>

### *Code of Banking Practice*

6.54 The Banking Code provides that the bank will give a prospective guarantor “prominent notice” that he or she should seek independent legal and financial advice on the effect of the guarantee.<sup>57</sup> Compliance with this requirement would not protect a bank

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52. See also C Chew, “Another Look at the Giving of Independent Advice to Sureties: Some Uncertainties and Evolving Concerns” (2006) 1 *Bond Law Review* 45.

53. *García v National Australia Bank* (1998) 194 CLR 395.

54. See, for example, A J Duggan, “Till debt do us part: A note on *National Australia Bank Ltd v García*” (1997) 19 *Sydney Law Review* 220 at 227.

55. *Consumer Credit (New South Wales) Code* s 70(2)(h).

56. See *Consumer Credit (New South Wales) Regulations* s 21.

57. *Code of Banking Practice* (2004) cl 28.4(a)(i).



against liability for unconscionable conduct or under the principles in *Garcia v National Australia Bank*<sup>58</sup> if the guarantor did not actually obtain independent advice.

6.55 The Banking Code allows the guarantor a one-day cooling off period after being provided with the requisite financial information and before signing the guarantee.<sup>59</sup> However, the cooling off period is not given where the guarantor has obtained independent legal advice after having received the information.<sup>60</sup>

*Rule 45 of the Professional Conduct and Practice Rules*

6.56 Rule 45 of the Professional Conduct and Practice Rules (“Rule 45”) gives guidelines for the content of the advice to be given by solicitors to third party guarantors.<sup>61</sup> Rule 45 makes it clear that solicitors must advise the client they are not qualified to provide financial (as distinct from legal) advice and that if the guarantor has any questions about financial aspects of the transaction they should seek further advice from an accountant or financial counsellor.<sup>62</sup>

6.57 Rule 45 also includes clear guidelines about conflict. It provides that the solicitor who advises a borrower or guarantor must not also act for the lender and that, in cases where there is potential conflict between parties to the transaction (that is, the borrower and guarantor), the solicitor cannot provide advice to more than one of those parties without the written consent of each party.<sup>63</sup>

## Submissions

6.58 In Issues Paper 17, the Commission asked a number of questions concerning independent legal and financial advice:

- In what circumstances should prospective guarantors be required to seek independent legal advice?
- Should lenders be required to ensure that this has occurred before being able to finalise a guarantee and, if so, what form should that advice take?
- What issues must the guarantor be advised about?

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58. *Garcia v National Australia Bank* (1998) 194 CLR 395.

59. Code of Banking Practice (2004) cl 28.5.

60. Nor is it given where the guarantor is a “commercial asset financing guarantor” or “sole director guarantor”: Code of Banking Practice (2004) cl 28.15. Further, a “director guarantor” (being a director of a company which is to be the borrower, but not a sole director: see Part F Application and definition) can notify the bank that he or she does not wish to have the benefit of the cooling off period: Code of Banking Practice (2004) cl 28.16(e).

61. Law Society of New South Wales, *Professional Conduct and Practice Rules (2001)* r 45. See also the discussion in NSWLRC IP 17 at para 3.41.

62. Law Society of New South Wales, *Professional Conduct and Practice Rules (2001)* r 45.6.4.1, 45.6.4.2.

63. Law Society of New South Wales, *Professional Conduct and Practice Rules (2001)* r 45.4, 45.9.

- Should additional requirements be imposed where the relationship between guarantor and borrower is a close personal relationship?
- Should proof that a person has received independent legal advice ever be a precondition of a guarantee's enforceability?

6.59 The following paragraphs 6.60-6.78 outline the feedback the Commission received.

6.60 A number of submissions supported a requirement to obtain independent legal and financial advice,<sup>64</sup> the latter particularly where the loan is for a business purpose and the guarantor is not involved in the business.<sup>65</sup>

6.61 Other submissions suggested that the lender should be required to give general advice together with a recommendation that the prospective guarantor seek independent advice.<sup>66</sup> Other submissions suggested that, even if independent advice is required to be obtained, the lender should also have a responsibility to give the guarantor advice about the nature of the guarantee and the circumstances surrounding it.<sup>67</sup> This view was held by the Women's Legal Resources Centre for the reason that independent legal advice does not necessarily ensure that the guarantor has made a rational financial or commercial decision about the guarantee and does not necessarily prevent him or her from entering a high-risk guarantee.<sup>68</sup> It submitted that "one of the features of relationship debt is the perceived lack of choice about whether to sign". It was generally thought that advice, whether independent or from the lender, should be given in the absence of the borrower.<sup>69</sup>

6.62 Some submissions suggested that guarantors should be required to seek independent advice in the following circumstances:

- where guarantors are old, poorly educated, have a poor understanding of English or are in a close relationship with the borrower (for example, marital or parental);<sup>70</sup>
- where the security for the loan is to be the matrimonial home or family home, and particularly when the guarantor has dependants;<sup>71</sup> and

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64. Country Women's Association of NSW, *Submission* at 2; Financial Counsellors' Association of NSW, *Submission* at 3; Ryde-Eastwood Financial Counselling Service, *Submission* at 5.

65. Financial Counsellors' Association of NSW, *Submission* at 3; Ryde-Eastwood Financial Counselling Service, *Submission* at 5.

66. NSW Young Lawyers, *Submission* at 4; NSW Legal Aid Commission, *Submission* at 14; Women's Legal Resources Centre, *Submission* at 6-7; NSW Legal Aid Commission, *Submission* at 14.

67. NSW Legal Aid Commission, *Submission* at 14; Women's Legal Resources Centre, *Submission* at 7.

68. Women's Legal Resources Centre, *Submission* at 7.

69. NSW Young Lawyers, *Submission* at 4; NSW Legal Aid Commission, *Submission* at 14; Women Lawyers Association of NSW, *Submission* at 4.

70. St George Bank, *Submission* at 3; Commonwealth Bank, *Submission* at 9.

71. Women Lawyers Association of NSW, *Submission* at 4; NSW Legal Aid Commission, *Submission* at 14 (in relation to independent financial advice); Women's Legal Resources Centre, *Submission* at 7; Commonwealth Bank, *Submission* at 9. See also St George Bank, *Submission* at 3.

- where the potential liability of any guarantor exceeds a certain amount<sup>72</sup> (one submission thought this amount should be \$100,000.<sup>73</sup>)

6.63 The Women Lawyers Association suggested that a requirement to obtain independent advice should not depend on categorising the relationship, but rather on the nature of the particular relationship.<sup>74</sup>

6.64 The CBA and the NSW Department of Fair Trading submitted that there should not be a blanket requirement that independent advice be obtained. Circumstances where independent advice should not, or may not, be necessary include:

- where the loan being guaranteed was for a small amount and the guarantors had an intimate knowledge of the borrower's financial affairs (for example, parents guaranteeing a loan for their child to purchase his or her first car);<sup>75</sup>
- where a guarantor is a director of the borrower company and is involved in the day to day running of the company;<sup>76</sup> and
- where the guarantor has business experience.<sup>77</sup>

6.65 St George has made it mandatory that all guarantors, in all circumstances, seek independent legal advice.<sup>78</sup> Despite this, St George was in agreement with the CBA and the NSW Department of Fair Trading that a legislative requirement that independent advice be obtained in all circumstances is too restrictive as "there are many occasions when a guarantor would have a perfect understanding of a guarantee without legal advice";<sup>79</sup> and that requiring independent financial advice should be at the lender's discretion. Its own practice is to require independent financial advice when the borrower's capacity to service the debt is partially reliant on the guarantor's cash flow or if the guarantee is to be supported by tangible security. For example, if the wife's guarantee of her husband's business is supported by a mortgage over the family home, then the wife is required to obtain both independent legal and financial advice.<sup>80</sup>

6.66 One of the submissions against requiring independent legal advice to be obtained argued that it may not be practical; would add substantially to the costs of a transaction;

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72. NSW Legal Aid Commission, *Submission* at 14 (in relation to independent financial advice).

73. J L Goldring, *Submission* at para 5.

74. Women Lawyers Association of NSW, *Submission* at 4.

75. Commonwealth Bank, *Submission* at 9.

76. Commonwealth Bank, *Submission* at 9.

77. NSW Department of Fair Trading, *Submission* at 4; St George Bank, *Submission* at 3.

78. St George Bank, *Submission* at 3. The requirement is waived in certain circumstances, such as if the guarantor is a practising legal practitioner or if legal advice was given to the guarantor within the last 12 months. On those occasions, the guarantor must sign a certificate of waiver and the waiver must be approved by Group Credit or a nominated commercial lender.

79. St George Bank, *Submission* at 3.

80. St George Bank, *Submission* at 3.

may only reinforce the view that it was just a formality; and in any case, would not solve many of the problems associated with "relationship debt".<sup>81</sup>

6.67 While the Legal Aid Commission believed that independent financial advice could be of even more assistance than independent legal advice in many cases, it also warned that it may be costly to obtain. It also expressed concern that "obtaining independent financial advice may become, as independent legal advice arguably has, a means of shifting liability for any injustice to financial advisors rather than providing the guarantor with useful information".<sup>82</sup>

6.68 The AFC suggested that nothing more than the directions in the Consumer Credit Code were necessary so far as independent advice went. It specifically did not support a direct legislative requirement for independent legal advice, neither did it support prescribing the type of advice to be given to a guarantor (on the basis that this will vary with the circumstances of each transaction).<sup>83</sup>

*Additional requirements for close personal relationships*

6.69 One submission supported imposing additional requirements when there is a close relationship between the borrower and guarantor to "ensure that the guarantor's will is voluntary and not been subjected to any 'undue influence'".<sup>84</sup>

6.70 St George suggested that additional requirements do not need to be imposed since most of their guarantees involve close personal relationships and "it is a matter for the solicitor advising the guarantor to ensure that the guarantor understands the effect of what he/she is signing".<sup>85</sup>

6.71 Young Lawyers pointed out that there would be difficulties associated with identifying whether there is a "close personal relationship" between the guarantor and borrower.<sup>86</sup> The NSW Department of Fair Trading observed that requiring a lender to inquire into any relationship between a borrower and guarantor would be "onerous and clumsy".<sup>87</sup> A number of submissions expressed the view that, in any case, independent advice is not necessarily going to offset emotional pressures.<sup>88</sup> No matter what additional requirements or precautions are taken, it is likely that the guarantor would nevertheless give the guarantee.<sup>89</sup>

*People from non-English speaking backgrounds*

6.72 Some submissions considered that lenders should insist that guarantors from non-English speaking backgrounds be required to seek independent legal and financial

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81. NSW Young Lawyers, *Submission* at 3-4.

82. NSW Legal Aid Commission, *Submission* at 14-15.

83. Australian Finance Conference, *Submission* at 14.

84. Financial Counsellors' Association of NSW, *Submission* at 3.

85. St George Bank, *Submission* at 3.

86. NSW Young Lawyers, *Submission* at 3.

87. NSW Department of Fair Trading, *Submission* at 5.

88. NSW Young Lawyers, *Submission* at 3-4; Women's Legal Resources Centre, *Submission* at 6-7.

89. NSW Young Lawyers, *Submission* at 4.

advice,<sup>90</sup> and that this should be provided through interpreters where necessary.<sup>91</sup> The Women's Legal Resources Centre suggested making a certificate of independent financial advice a prerequisite for the enforceability of a guarantee for guarantors from non-English speaking backgrounds and Aboriginal guarantors.<sup>92</sup> Other submissions considered that the right approach would depend on the individual guarantor, given that some people from non-English speaking backgrounds could read and understand English very well and could be astute business people.<sup>93</sup> The suggested alternative was to make special provision for people with "little understanding of English" rather than "of non-English speaking background".

6.73 The Legal Aid Commission suggested that lenders who provide an explanation in English to a person with little understanding of English should be considered not to have given the advice at all.<sup>94</sup>

6.74 Some submissions also drew attention to the problems posed by the borrower and/or a family member acting as translator for the guarantor and suggested that the possibility of this happening should be excluded.<sup>95</sup>

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90. St George Bank, *Submission* at 4; Women's Legal Resources Centre, *Submission* at 9.

91. Country Women's Association of NSW, *Submission* at 2; Women's Legal Resources Centre, *Submission* at 9. Including Aboriginal people without a command of English. Although NSW Young Lawyers and the Women Lawyers Association did not think that, generally, requirements should differ for NESB guarantors, they submitted that, if the lender considers that the level of comprehension on the part of the guarantor is compromised, he or she should be required to have the guarantee explained through an interpreter, not a family member of the guarantor: NSW Young Lawyers, *Submission* at 7; Women Lawyers Association of NSW, *Submission* at 7.

92. Women's Legal Resources Centre, *Submission* at 9.

93. Commonwealth Bank, *Submission* at 11; Australian Finance Conference, *Submission* at 18; Women Lawyers Association of NSW, *Submission* at 7.

94. NSW Legal Aid Commission, *Submission* at 16.

95. NSW Legal Aid Commission, *Submission* at 16; Women Lawyers Association of NSW, *Submission* at 7; Financial Counsellors' Association of NSW, *Submission* at 4; Ryde-Eastwood Financial Counselling Service, *Submission* at 6.

6.75 Other submissions made practical suggestions including:

- that any prescribed forms could be translated and be made available for downloading from a New South Wales Government website;<sup>96</sup>
- that guarantee documents should come with a multi-lingual leaflet advising the prospective guarantor of a NSW Department of Fair Trading telephone advice hotline;<sup>97</sup> and
- that a list of bilingual specialists (solicitors, accountants and financial counsellors) should be established to provide advice when required.<sup>98</sup>

*Cooling off period*

6.76 Many submissions supported a cooling off period after the guarantee had been signed, chiefly to allow guarantors the opportunity to give proper consideration to their position and to seek advice.<sup>99</sup> One of these drew attention to the particular needs of women and people from non-English speaking backgrounds.<sup>100</sup> Submissions proposed periods ranging from 5 to 14 or 21 days as a period that would allow enough time for guarantors to seek independent advice.<sup>101</sup> One submission proposed a cooling off period of 30 days to obtain advice, stating that "anything less would cause stress in obtaining appointments and availability of specialists".<sup>102</sup>

6.77 Several submissions, mainly from financial institutions, while not supporting provision of a cooling off period after signing a guarantee, supported giving a guarantor sufficient time and opportunity to consider the guarantee documents prior to execution.<sup>103</sup> Other submissions supported either allowing a period of time after the necessary information had been received and before the guarantee could be signed, ranging from 24 hours to 14 days, or otherwise a post-contractual cooling-off period.<sup>104</sup>

6.78 One submission considered that allowing a guarantor to withdraw at any time before the provision of credit to the borrower (as provided by s 53 of the Consumer Credit Code) amounted to adequate protection.<sup>105</sup>

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96. NSW Legal Aid Commission, *Submission* at 16-17.

97. Financial Counsellors' Association of NSW, *Submission* at 3.

98. Ryde-Eastwood Financial Counselling Service, *Submission* at 6.

99. NSW Legal Aid Commission, *Submission* at 17; Women Lawyers Association of NSW, *Submission* at 7; Women's Legal Resources Centre, *Submission* at 9; Country Women's Association of NSW, *Submission* at 2; Financial Counsellors' Association of NSW, *Submission* at 4, 4; Ryde-Eastwood Financial Counselling Service, *Submission* at 6.

100. Financial Counsellors' Association of NSW, *Submission* at 3.

101. Women's Legal Resources Centre, *Submission* at 9; Financial Counsellors' Association of NSW, *Submission* at 4.

102. Ryde-Eastwood Financial Counselling Service, *Submission* at 6.

103. St George Bank, *Submission* at 4; NSW Legal Aid Commission, *Submission* at 17; Commonwealth Bank, *Submission* at 11.

104. University of Western Sydney, Centre for Elder Law, *Submission* at 23; Financial Counsellors' Association of NSW, *Submission* at 3.

105. NSW Young Lawyers, *Submission* at 7.

## Empirical background

6.79 The empirical study conducted by the Commission and the Faculty of Law at the University of Sydney (“Lovric and Millbank”) found that the vast majority of guarantors who responded to their survey, and a high proportion of those in their review of the litigated cases, did not receive any legal advice prior to entering the transaction, with those from non-English speaking backgrounds being particularly unlikely to receive independent legal advice.<sup>106</sup> Only 20% of guarantors reported that anyone – including the lender – suggested that they obtain independent legal advice.

6.80 Lovric and Millbank also identified grave inadequacies in the legal advice in the limited number of transactions where it took place.<sup>107</sup> Most guarantors were of the view that it had not greatly assisted them, with only one respondent saying that the advice clarified their thoughts on the document. Guarantors reported that the meeting where advice was given was a brisk formality, the advice perfunctory,<sup>108</sup> closely followed by signing.<sup>109</sup>

6.81 Inadequacies in advice to prospective guarantors may be attributable, to some extent, to solicitors’ perceptions of what their role should be, particularly if the lender has arranged for the advice to be given, or if the solicitor is acting for another party in the transaction.<sup>110</sup> When the lawyer is retained by a party other than the guarantor,<sup>111</sup> there

106. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* (NSW Law Reform Commission and University of Sydney, Research Report 11, 2003) at para 5.51-5.53. Only 14% of respondents to the study’s guarantor survey obtained legal advice before signing a guarantee.

107. The researchers adopted the following definition of *adequate* independent legal advice: “truly independent informed advice which not only explains the transaction and its implications but also evaluates the risks involved and advises whether the surety should enter into the transaction.”: M Sneddon, “Unfair conduct in taking guarantees and the role of independent advice” (1990) 13 *University of New South Wales Law Journal* 302 at 345.

108. One guarantor noted that the meeting took less than fifteen minutes. Another reported that the documents were only partly explained: Lovric and Millbank at para 5.57. These findings are consistent with English research that found that, because solicitors restricted themselves to a brief explanation of the effects of the document, and did not canvass the risks of the transaction, guarantors did not feel adequately advised: B Fehlberg, *Sexually Transmitted Debt: Surety Experience and English Law* (Clarendon Press, Oxford, 1997) at 171.

109. Of the 10 guarantors in the survey who did receive advice, and could recall how soon afterwards they signed the contract, five reported that they signed the same day, while another two signed within two days: Lovric and Millbank at para 5.55.

110. Lovric and Millbank (at para 5.67) reviewed a number of litigated cases where the solicitor who advised the guarantor was organised by either the borrower or the lender: See *Micarone v Perpetual Trustees Ltd* (1999) 75 SASR 1; *Pasternacki v Correy* [2001] ANZ ConvR 240; *Sapuppo v Ribchenkov* [2002] ANZ ConvR 164; *Burrawong Investments v Lindsay* [2002] QSC 082; *Tong v Esanda Finance* (NSW, Supreme Court, No 20449/94, Grove J, 17 April 1996, unreported,); *Esanda Finance v Tong* (1997) 41 NSWLR 482; *Janesland Holdings Pty Ltd v Simon* [2000] ANZ

may be confusion about what exactly the lawyer's duty is and to whom it is owed, and a potential for conflict of interest.<sup>112</sup>

6.82 Most solicitors surveyed perceived their role as involving explanation of the documents, and giving advice on the legal risks of the transaction and the nature and extent of the liability.<sup>113</sup> About a quarter of the solicitors described their role as ensuring that the guarantor understood the nature of the transaction or what they were doing. A few explicitly described their role as involving the protection of the guarantor's interests. Only a few described their role as actively discouraging the client to proceed with the transaction. None of the solicitors explicitly described their role as including ensuring that the client was not subject to any undue influence or duress. Disturbingly, two solicitors perceived their role as protecting the financial institution, and a further six solicitors described their role as formal or mechanistic.<sup>114</sup>

6.83 Lovric and Millbank also identified problems with the independence of the advice from the borrower and the lender. In two instances, guarantors reported advice from lawyers that was openly partisan to the borrower. In one, only the "positive" aspects of the loan were explained, while in another, the lawyer pressured the guarantors to sign during the interview by telling them that if they did not sign quickly the loan would be reduced and the project would falter. In both of these instances, and in one additional case, the lawyer was also acting for the borrower.<sup>115</sup>

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ConvR 112. Fehlberg found that it was usually the borrower who organized the legal advice, often retaining a solicitor known to him but not to the guarantor. Even when the solicitor was not actually acting for the borrower, this gave guarantors the impression that the lawyer in question was not acting for them, but was there instead to represent the interests of the borrower or lender: B Fehlberg, *Sexually Transmitted Debt: Surety Experience and English Law* (Clarendon Press, Oxford, 1997) at 175-176.

111. Of the 11 guarantors surveyed by Lovric and Millbank who had received legal advice, three reported that they were advised by solicitors acting for the borrower, and one by a solicitor acting for the lender: Lovric and Millbank at para 5.68.

112. However, note that in *Lang v Licciardello* [1999] NSWSC 93 at para 25, Adams J expressed the view "there is no doubt that the most desirable position is that ... a mortgagor should be given independent legal advice ... . It seems to me that the supposition that a mortgagee's solicitor is in conflict with the interests of that client if he or she gives advice to the mortgagor on the legal effect of the mortgage is a significantly inaccurate over-simplification of the position".

113. J Lovric and J Millbank, *Darling, Please Sign This Form: A Report on the Practice of Third Party Guarantees in New South Wales* at para 5.58. Fehlberg argues that the term "independent legal advice" as it is understood in legal regulation of guarantees is a misnomer. She states that "basic explanation" is a more accurate description of what takes place in practice: B Fehlberg, *Sexually Transmitted Debt: Surety Experience and English Law* (Clarendon Press, Oxford, 1997) at 227-8.

114. Lovric and Millbank at para 5.60.

115. Lovric and Millbank at para 5.56.



6.84 The independence and utility of the advice may also be affected if it is provided in the presence of other parties to the transaction.<sup>116</sup> Lovric and Millbank noted that, although there has been some adverse judicial comment about the propriety of the borrower being present while the guarantors received legal advice,<sup>117</sup> the practice has not been subject to significant scrutiny to date.<sup>118</sup> Fehlberg found that, while solicitors considered that it was not “good practice” to see guarantors in the presence of borrowers because of the opportunity for pressure or influence to be brought to bear, in practice they did little to prevent it. This was because guarantors and borrowers often “presented as a package”, and because it was usually borrowers who organised the appointment and paid for the advice.<sup>119</sup>

6.85 Lovric and Millbank found a concern among the surveyed solicitors that the process of sending guarantors to get independent advice from lawyers in effect meant lenders were passing on their obligations to explain the transaction to solicitors, and exposing them to being sued by guarantors, or the subject of cross-claims by lenders if the guarantee goes wrong.<sup>120</sup> One solicitor said that they “should not be made ‘co-guarantors’ by being exposed to proceedings in this way”.<sup>121</sup>

6.86 In fact, as a result of concern about increased claims against solicitors for negligent advice to guarantors,<sup>122</sup> Rule 45 was amended in 2000 to require the guarantor, rather than the solicitor as previously, to sign a statutory declaration that the solicitor had provided him or her with independent advice. However, Lovric and Millbank’s review of LawCover claims suggested that this concern was misconceived.<sup>123</sup> Their review of

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116. The majority of solicitors Lovric and Millbank surveyed reported that on the last occasion they gave advice, only the guarantor was present: *Solicitor Survey*, Question 13(b): 88% reported that no one else was present; 6% of respondents indicated that the borrower was present when they gave the advice. However, the researchers concluded that this might not be an accurate representation. While they did not specifically ask guarantors whether anyone else was present when they received legal advice, of the 11 guarantors who had received advice, it was clear in four cases that the borrower had been present. Moreover, of all guarantors, both advised and unadvised, 47% reported that they signed in the presence of the borrower, and a further 23% in the presence of both the lender and the borrower: Lovric and Millbank at para 5.70.

117. *Micarone v Perpetual Trustees Ltd* (1999) 75 SASR 1 at para 702.

118. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* at para 5.71.

119. B Fehlberg, *Sexually Transmitted Debt: Surety Experience and English Law* (Clarendon Press, Oxford, 1997) at 224.

120. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* at para 5.75. Forty eight per cent of respondents reported that they had concerns about their professional liability in giving advice to a third party guarantor.

121. See Lovric and Millbank at para 5.64.

122. See Law Society of New South Wales, *Caveat 207*, 30 December 1999.

123. See Lovric and Millbank at para 5.73.

litigated cases confirmed that solicitors are rarely held liable for any loss suffered by guarantors.<sup>124</sup>

6.87 Many respondents to the survey gave positive feedback about Rule 45, including that the new procedure: simplified matters; provided clearer documentation; had probably lifted the quality and consistency of advice; and, for some, eased their disquiet about their own liability.<sup>125</sup>

6.88 There were criticisms of Rule 45, related to documentation requirements and the increased cost or time involved in compliance, for which solicitors received little reward, and which increased the cost of the guarantee transaction.<sup>126</sup> Some solicitors expressed the view that the requirements of the Rule (despite its protections for lawyers), together with the decision in *Garcia v National Australia Bank*,<sup>127</sup> has led to clients avoiding advice on guarantees prior to entering the transaction.<sup>128</sup>

6.89 Lovric and Millbank also investigated who it is that benefits from independent legal advice and whether it is, in fact, guarantors who obtain a benefit. They concluded that it is questionable whether the provision of legal advice actually deters vulnerable guarantors from proceeding with the transaction.<sup>129</sup>

6.90 The majority of solicitors responding to the survey had advised a client not to sign a contract in the last 10 years and almost half had done so on two to five occasions.<sup>130</sup> However, the solicitors also reported that, despite providing strong advice about the risks of the transaction, most guarantors proceeded with the transaction.<sup>131</sup> Only one solicitor reported the view that a client listens to the legal advice and then makes a commercial decision. One barrister commented that, while independent advice may act as a deterrent to signing, by the time the advice is given, the guarantor probably already feels morally committed to the borrower to execute the guarantee. Lovric and Millbank commented that other survey data also indicated that:

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124. See Lovric and Millbank at para 5.74.

125. Lovric and Millbank at para 5.77. See, for example, Respondent 82 who said: "A great help. It makes it clear we are simply 'explaining' legal issues".

126. Lovric and Millbank at para 5.78.

127. *Garcia v National Australia Bank* (1998) 194 CLR 395.

128. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* at para 5.78.

129. Lovric and Millbank at para 5.80. They also note that this reflects Fehlberg's finding that very few of her respondents would have been deterred from the transaction even by thorough and impartial legal advice: B Fehlberg, *Sexually Transmitted Debt: Surety Experience and English Law* (Clarendon Press, Oxford, 1997) at 172.

130. Seventy-three percent of solicitors who responded said that they had advised a client not to sign a contract in the last 10 years; 43% said they gave such advice on two to five occasions: Lovric and Millbank at para 5.81 note 104.

131. Of those solicitors who advised against signing, 89% reported that the client went ahead despite the warning. According to some solicitors, by the time some guarantors come for compulsory advice, they have already made up their mind: Lovric and Millbank at para 5.81 note 105.

*much of the negotiating about the loan, and the exigencies surrounding the pressing need for finance have already proceeded to such a point that the only thing required, and that is inevitable, is the guarantor's signature.*<sup>132</sup>

6.91 The empirical research also highlighted that:

*feelings of connection and obligation arising out of personal or family relationships govern the decision of the guarantor to proceed with the transaction rather than any objective advice about the dangers of the transaction.*<sup>133</sup>

6.92 One solicitor commented that, because of these pressures, “the only way to protect guarantors is to prohibit certain classes of guarantees.”<sup>134</sup>

6.93 Lovric and Millbank suggested that it is lenders who benefit from the provision of independent legal advice because they are protected from a guarantor's claim that he or she did not understand the transaction, or was at a special disadvantage. They state that their research indicates that the guarantor receives little protection; and that independent legal advice as it is currently given (if it is given at all) is insufficient to assist the guarantor to make an informed decision, particularly where the guarantor is signing out of a feeling of obligation, pressure or trust.<sup>135</sup> However, they concluded that their research indicates that there can still be a useful role for both independent legal and financial advice, but that the issue requires “further attention and deeper analysis”.

## Conclusion

6.94 Guarantee transactions are frequently very complex commercial arrangements, often involving voluminous and impenetrable legal documents. Documentation is often signed in rushed or informal circumstances, perhaps with minimal explanation, often in the presence of the borrower and in the absence of any legal or financial advice. Such circumstances are far from conducive to measured, informed and autonomous decision-making. This is exacerbated when guarantors lack basic information about the borrower's financial position.

6.95 Prospective guarantors who are poorly-educated or do not have a good command of English or who are in a close personal relationship with the borrower are particularly vulnerable to entering into transactions from a position of ignorance and/or emotional pressure or obligation.

6.96 A valid and compelling response is to insist that prospective guarantors receive independent legal and financial advice, as a means of safeguarding them against the risks of guarantee transactions.

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132. Lovric and Millbank at para 5.81.

133. Lovric and Millbank at para 5.82.

134. Lovric and Millbank at para 5.83; *Solicitor Survey*, Respondent 78.

135. Lovric and Millbank at para 5.84-5.85.

6.97 However, while there are undoubtedly benefits in obtaining independent advice, especially in the particular circumstances suggested in submissions,<sup>136</sup> the Commission has concluded that this should not be a mandatory requirement for a number of reasons.

6.98 Foremost of these, provided a prospective guarantor is strongly and clearly warned that it is advisable to obtain independent advice, the Commission is troubled by forcing an adult to do so. This ought to be a matter of (informed) free choice.

6.99 Other reasons for the Commission's conclusion centre on:

- the substantial costs of consulting legal and financial professionals, and the extra burden of this, presumably borne by the borrower;
- concern that a blanket requirement to obtain legal or financial advice may be heavy-handed, as there would be many guarantors who would understand the nature of the transaction and its implications; this view is reinforced if inclusion of a Consumer Credit Code Form 5A document is made a general requirement;
- concern that the process may become a mere (expensive) formality,<sup>137</sup> and
- reservations about the degree of usefulness of independent legal advice.

#### *Independent legal advice*

6.100 This last basis arises out of the findings in the Lovric and Millbank study. As noted above, Lovric and Millbank found that most of the guarantors surveyed felt that independent legal advice had not greatly assisted them; that the meeting where advice was given was often a brisk formality and the advice perfunctory, closely followed by signing. The authors concluded that independent legal advice, as it is currently given, is insufficient to assist the guarantor to make an informed decision, particularly where the guarantor is signing out of a feeling of obligation, pressure or trust. They questioned whether the provision of legal advice actually deters vulnerable guarantors from proceeding with the transaction. They further concluded that it is lenders who benefit from the provision of independent legal advice because, once given, it can be relied upon in answer to a guarantor's claim that he or she did not understand the transaction, or was at a special disadvantage.

6.101 Other recommendations the Commission makes in this chapter, and in Chapters 7, 9 and 11, lessen the imperative of obtaining independent legal advice in all circumstances and bolster the recommendation to advise rather than compel the guarantor to seek advice. First, the Commission makes recommendations in Chapter 7 to improve the legibility and accessibility of documentation. Secondly, this chapter and Chapter 9 make

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136. See para 6.62.

137. There are parallels here with the requirement under s 66S of the *Conveyancing Act 1919* (NSW) that, if the statutory cooling-off period for a contract for the sale of residential property is to be shortened, a purchaser must give to the vendor a certificate under s 66W that states that a solicitor or barrister has explained to the purchaser the effect of the contract, the nature of the certificate and the effect of giving the certificate to the vendor. Obtaining this certificate is often a mere formality, and the advice can in some instances be given over the phone.

recommendations for pre- and post-contractual cooling off periods. Thirdly, the Commission recommends applying, with modifications, s 51 of the Consumer Credit Code to guarantees generally. That is, guarantee documentation should contain warnings built on Form 4 and the lender should give to the prospective guarantor a document in the form of Form 5A. This document would explain guarantees generally and the guarantor's rights and obligations, as well as giving general advice, such as what the guarantor can do in the event of a default by the borrower. Fourthly, Chapter 11 recommends that the Model Law should empower a court to reopen unjust transactions and that, in determining whether a transaction is unjust, the court may have regard to whether or not independent legal or other expert advice was obtained by the guarantor.<sup>138</sup>

*Independent financial advice*

6.102 As explained above, the Commission is also reluctant to compel parties to a guarantee transaction to incur the costs of obtaining financial advice, particularly when it may not always be necessary and may become a mere formality. Furthermore, the financial information provided to the guarantor pursuant to the Commission's recommendation for disclosure may, in many cases, be sufficient for the prospective guarantor to appreciate the borrower's financial position, and the attendant financial risks of giving a guarantee.

6.103 An alternative approach, as was advocated by a number of submissions,<sup>139</sup> is to require the lender to advise the prospective guarantor about the circumstances surrounding the proposed guarantee and loan transaction. In one sense, lenders are well placed to advise on the financial consequences of the transaction, as they are the only party to have the relevant information on hand. However, there is clearly also an inherent conflict of interest in lenders providing advice on a transaction that financially benefits them. On balance, the Commission is not prepared to recommend a compulsory obligation for lenders to give advice. This should be a matter left to the discretion of the individual lender, although left open to be taken into account in the event of the guarantor seeking relief if called upon to meet the borrower's debt.

*Cooling off period*

6.104 Almost all submissions supported either a cooling off period after the guarantee had been signed or a minimum time period after provision of information before a guarantee could be signed. Several submissions, mainly from financial institutions, while not supporting a post-contractual cooling off period, supported giving a guarantor sufficient time and opportunity to consider the guarantee documents prior to execution.

6.105 Chapter 9 considers a post-contractual cooling off period and recommends that a guarantor should be allowed to withdraw from a guarantee within one clear business day from the time of signing. The Commission has concluded that time prior to signing the guarantee should also be allowed, if the proposed safeguards of full financial disclosure to the prospective guarantor, and urging obtaining independent legal and financial advice, are to be effective. The prospective guarantor must be given a real opportunity to consider the information and seek advice before committing to a guarantee.

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138. See Recommendation 11.6(j).

139. See para 6.61 above. As noted there, these submissions also suggested the lender could advise the guarantor about the nature of guarantee transactions generally.

6.106 However, this pre-contractual period has to be commercially realistic. The borrower is frequently under time pressure to move on a business transaction, or an opportunity may be lost or the borrower otherwise disadvantaged, sometimes seriously. The Commission considers that a proper balance between the borrower's and the guarantor's interests is achieved by allowing one clear business day between the lender's compliance with the disclosure requirements and the earliest time at which the guarantee can be signed.

*Consequences*

6.107 The Commission is of the view that a failure to include the warnings recommended below or to provide the guarantor with a document in the form of Form 5A, should render the guarantee unenforceable.

## RECOMMENDATION 6.4

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The Model Law should provide that the contract of guarantee should contain a warning in the terms of Form 4 of the *Consumer Credit Regulation*, with the modifications set out below. The warning should appear directly above the place where the guarantee is to be signed, be printed in bold and in a larger font than the rest of the document, and in all other respects comply with s 20 of the *Consumer Credit Regulation*. The words “You should obtain independent legal advice” and “You should also consider obtaining independent financial advice” currently appearing in Form 4 should be replaced by “You are strongly advised to obtain independent legal and financial advice, in the absence of the borrower”.

## RECOMMENDATION 6.5

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The Model Law should provide that the lender must give to the prospective guarantor an information statement in the form of Form 5A of the *Consumer Credit Regulation*.

## RECOMMENDATION 6.6

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The Model Law should provide that a guarantee should not be signed before the expiry of one business day following the provision of the information and documentation referred to in Recommendation 6.1.

## RECOMMENDATION 6.7

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The Model Law should provide that a guarantee is not enforceable unless the requirements set out in Recommendations 6.4, 6.5 and 6.6 have been complied with.

## SIGNING THE DOCUMENTS

6.108 Relevant to protecting a prospective guarantor against entering into an imprudent transaction are the practicalities of the place where and in the presence of whom the documentation is signed. Whether documentation is signed in the home of the guarantor or borrower, or in other informal surroundings, or in the office of the lender or an independent party, and whether the borrower is present, can affect the prospective guarantor’s final decision to commit.

### Empirical background

6.109 Lovric and Millbank found that it is fairly common for mortgage and guarantee documents to be signed in relatively informal surroundings such as the family home.<sup>140</sup>

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140. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* at para 5.31.

Lovric and Millbank pointed out that signing documents at home is not ideal in protecting the guarantor's position. The informality of the surroundings is inconsistent with the serious and complex nature of the obligations about to be assumed by the guarantor, and the pressures of home life, such as the demands of children, make it difficult for the prospective guarantor to give his or her full attention to the transaction. It may also mean that the presence of the borrower is more likely.<sup>141</sup>

6.110 There is clearly a risk of overt or covert pressure on the prospective guarantor if the borrower is present when he or she is to sign the documentation. In their survey of guarantors, Lovric and Millbank found that the borrower was present in 47% of cases when the guarantee documents were signed and in 23% of cases both the borrower and the lender were present.<sup>142</sup> Similarly, their review of litigated cases revealed that in 14% of the cases reviewed the borrower was present with the guarantor at the time of signing and in 60% of cases, the borrower and others (such as the lender, or other guarantor) were present.<sup>143</sup>

## Conclusion

6.111 Issues Paper 17 noted that the Expert Group on Family Financial Vulnerability proposed that legislation should require a financier to take all reasonable steps to advise a potential guarantor directly to sign a guarantee in the absence of the borrower.<sup>144</sup>

6.112 Issues Paper 17 also noted that it seems clear from judicial decisions that it is not considered appropriate for lenders to leave it to the borrower to have the documentation executed by a related prospective guarantor at their home.<sup>145</sup> However, following a number of cases where guarantees were set aside after lenders left it to the borrower/husband to arrange for the guarantor/wife's signature, this practice is said to have become rarer.<sup>146</sup>

6.113 While the Commission believes that it is important for guarantors to be aware of the issues relating to the execution of a guarantee, it is not inclined to recommend that legislation regulate the place where and the manner in which execution of the guarantee and any supporting security should take place. The Commission's recommendations to give the guarantor time to consider the documentation before signing<sup>147</sup> and to include a

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141. Lovric and Millbank at para 5.32-5.34.

142. Lovric and Millbank at para 5.36.

143. Lovric and Millbank at para 5.37.

144. Australia, Expert Group on Family Financial Vulnerability, *Good Relations, High Risks: Financial Transactions Within Families and Between Friends*, Recommendation 2.

145. NSWLRC IP 17 at para 3.31. See also A J Duggan, *A Financier's Guide to the Law of Guarantee in Australia* (4th edition, Australian Finance Conference and Australian Equipment Lessors Association, Sydney, 1998) at 41. The courts consider it a point in favour of a lender that it required attendance at its premises to sign the guarantee: see, for example, *Australian and New Zealand Banking Group Ltd v Dunosa Pty Ltd* [1995] ANZConvR 86 at 88.

146. NSWLRC IP 17 at para 3.32.

147. Recommendation 6.6. See also para 6.105-6.106.



warning to seek independent advice<sup>148</sup> offer some protection against entering into a guarantee under pressure. It would be helpful and appropriate, however, for the Form 4 warning to advise the guarantor to sign the guarantee and any supporting security in the absence of the borrower.

## RECOMMENDATION 6.8

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The Model Law should provide that the warning in the form of Form 4 of the *Consumer Credit (New South Wales) Regulation* should include the following words:  
"You are advised to sign the guarantee and any supporting security in the absence of the borrower."

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148. Recommendation 6.4. See also para 6.101.

## 7. Form of the contract

- Introduction
- Should a guarantee be in writing?
- Plain English and legibility of documents
- Submissions to Issues Paper 17
- Conclusion

## INTRODUCTION

7.1 In the recent past, contract documents securing loans, such as guarantees and mortgages, have been expressed in, to use Acting Justice Spender's words in *Australian and New Zealand Banking Group Ltd v Volmensky*, "characteristically complex, convoluted, and legalistic language."<sup>1</sup>

7.2 The language used has not been the only difficulty guarantors have faced in grappling with documents. In the *Volmensky* case, the mortgage contained 41 covenants extending "over five pages of cramped printing". The first clause alone contained over 600 words and was "entirely bereft of any form of punctuation".<sup>2</sup>

7.3 In another case, *Commonwealth Bank of Australia v Gough*, Justice Sully described the mortgage in question as:

*...cumbersome in form and unintelligible to any person who is not a trained lawyer. Indeed, I would not be surprised to find many a trained lawyer unable to come to grips easily with the convoluted language of portions of the mortgage documents.*<sup>3</sup>

7.4 This has not been the only case in which the terms used in the documents were so obscure as to be almost incomprehensible even to those with legal training. In *Karam v ANZ Banking Group Ltd*, the Court commented:

*Experienced Counsel initially had difficulty even identifying the relevant clauses, let alone their exegesis or proper explanation. How could lay people, the more so if only educated to the degree that the Karams were, be expected to understand its complex obscurities without proper legal advice?*<sup>4</sup>

7.5 In a more recent example of cumbersome documentation, the transaction at the centre of *Challenger Management Investment Ltd v Davey* involved a 58-page memorandum of mortgage, a six-page deed of guarantee/indemnity and a 25-page deed

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1. *Australian and New Zealand Banking Group Ltd v Volmensky* (1995) ANZ Conv R 202 at 207 (Spender AJ).
  2. *Australian and New Zealand Banking Group Ltd v Volmensky* (1995) ANZ Conv R 202 at 207 (Spender AJ). See also *Australian and New Zealand Banking Group Ltd v Capper* [2001] NSWSC 946 at [31]. In that case, commenting on the readability of security documents relied on by the bank in the course of its application for summary judgment and possession, Master Harrison said: "I might add that the guarantee is in tiny print, and for example, the wording of paragraph (1) is unintelligible. The document is illegible".
  3. *Commonwealth Bank of Australia v Gough* (1993) ASC ¶56-247 at ¶58,521. Sully J upheld the guarantee. Mrs Gough's appeal to the Court of Appeal was dismissed: *Gough v Commonwealth Bank of Australia* (1994) ASC ¶56-270.
  4. *Karam v ANZ Banking Group Ltd* [2001] NSWSC 709 at [215].

of loan.<sup>5</sup> The elderly guarantors, who were the mothers of the people operating the business that received the benefit of the loan, were confronted with a total of 89 pages of documents.<sup>6</sup>

7.6 This chapter considers the extent to which some of the difficulties, misunderstandings and hardships that can arise from third party guarantees can be attributed to the impenetrability of guarantee and mortgage documents. Such an inquiry has at its core a focus on taking a preventive approach to third party guarantees, rather than on remedial measures. The Commission recommends that the Model Law should adopt provisions in the *Consumer Credit (New South Wales) Code* (“Consumer Credit Code”) and the *Consumer Credit (New South Wales) Regulations* (“Consumer Credit Regulations”) to ensure the lucidity and legibility of guarantee documentation. It is hoped that these changes will make guarantee documentation more accessible to the layperson so that the guarantor need not be so heavily reliant on legal advice and interpretation, or otherwise left in a state of confusion and uncertainty as to the potential obligations that have been accepted by signing the guarantee.

7.7 This evaluation of the form of the documentation proceeds on the assumption that guarantees are in writing. However, whether this is, or should be, a requirement for a guarantee to be enforceable is a preliminary question that needs resolving.

## SHOULD A GUARANTEE BE IN WRITING?

7.8 Section 50(1) of the Consumer Credit Code expressly requires that a guarantee of a consumer credit contract be in writing. A guarantee not in writing is unenforceable.

7.9 For guarantees of other categories of credit, such as small business guarantees, there is no such statutory requirement. While the *Statute of Frauds 1677* (Imp) operates in some Australian States to require a guarantee to be in writing,<sup>7</sup> it no longer applies in New South Wales.<sup>8</sup>

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5. *Challenger Management Investment Ltd v Davey* [2002] NSWSC 430, Exhibit A in the trial.
  6. This aspect, however, was not commented on by Acting Justice Cripps. The defendants, in a cross claim, sought to rely on grounds that the enforcement proceedings taken by the plaintiff were unconscionable; or that it acted unconscionably within the meaning of the *Trade Practices Act 1974* (Cth); or that the mortgages were unjust within the meaning of the *Contracts Review Act 1980* (NSW). The main basis for these claims was that the defendants had not received independent legal advice and did not understand the nature of the transaction they were entering into. His Honour did not find in their favour.
  7. *Statute of Frauds 1677* (Imp) s 4 (emphasis added): “And be it further enacted that from and after the said 24th day of June [1677] no action shall be brought whereby to charge any executor or administrator upon any special promise, to answer damages out of his own estate; or whereby to charge the defendant upon any special promise to answer for the debt, default or miscarriages of another person; or to charge any person upon any agreement made upon consideration of marriage; or upon any contract or sale of lands, tenements or hereditaments, or any interest in or

7.10 The Code of Banking Practice ("Banking Code") does not specifically require that guarantees be in writing. However, that is arguably implied from the requirement in clause 28.4 that the guarantee include a statement that the Code applies to the guarantee, and the commitment contained in clause 28.6 that the lender will ensure that the guarantee is signed in the absence of the debtor.

7.11 In the Commission's view, there are compelling reasons for insisting that the guarantee be in writing and that it be unenforceable unless it is in writing and signed by the guarantor. Misunderstandings commonly arise in the course of completing the transaction, and the law relating to the guarantee of another's debt is complex, with potentially serious consequences, especially for guarantors, in the event of a breach of obligation. Obviously, only a guarantee in writing can be signed by the guarantor and contain the warnings and notices that the Commission has recommended, in Chapter 6,<sup>9</sup> that it contain. Moreover, on the question of written documentation, there is no sound reason for distinguishing between guarantees of consumer credit contracts and guarantees of other credit contracts. Lastly, the Banking Code is only a voluntary code. Accordingly, the Commission recommends that the provisions of s 50 of the Consumer Credit Code be extended to apply to all guarantees.

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## Recommendation 7.1

The Model Law should adopt the provisions of s 50 of the Consumer Credit Code requiring a guarantee to be in writing.

## PLAIN ENGLISH AND LEGIBILITY OF DOCUMENTS

### The common law

7.12 Chapter 2 explains the common law doctrine of unconscionability as a basis for setting a contract aside, in whole or in part.<sup>10</sup> As is noted there, unconscionable conduct applies in situations where the guarantor is under a special disadvantage or disability in relation to the other parties to the transaction so that there is "an absence of any

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concerning them; or upon any agreement that is not to be performed within the space of one year from the making thereof, *unless the agreement upon which such action shall be brought, or some memorandum or note thereof shall be in writing, and signed by the party to be charged therewith, or some other person thereunto by him lawfully authorized.*" Both the *Statute of Frauds 1677* (Imp) and the *Statute of Frauds Amendment Act 1828* (Imp) were received into Australia under s 24 of the *Australian Courts Act 1828* (Imp). For a full discussion of the development of the requirement of writing see New South Wales Law Reform Commission, *Community Law Reform Program: Fourteenth Report - Representations as to Credit* (Report 57, 1988) at para 2.1-2.15.

8. It was repealed by s 8(1) of the *Imperial Act Application Act 1969* (NSW).
9. See Chapter 6, Recommendations 6.4, 6.5, 6.8.
10. See para 2.5-2.7.

reasonable degree of equality between them”.<sup>11</sup> While certain personal characteristics, such as “poverty or need of any kind, sickness, age, sex, infirmity of body or mind, drunkenness, illiteracy or lack of education” and a “lack of assistance or explanation where assistance or explanation is necessary”<sup>12</sup> may be indicators of special disadvantage, there are other relevant indicators. One of these is the form and content of the contract. However, the disadvantage resulting to the aggrieved party must be evident to the other party and that disadvantage must be exploited in circumstances where it is prima facie unfair to do so before relief can be granted.<sup>13</sup> This usually requires proof that the lender knew of the disability or could infer it from the facts available.<sup>14</sup>

7.13 Various statutes allow a court, when determining whether a guarantee is unconscionable or unjust, to take into account factors such as the objective intelligibility of the language in which the document is expressed or the ability of a person to understand the document. These statutes include the Consumer Credit Code,<sup>15</sup> the *Contracts Review Act 1980* (NSW) (“Contracts Review Act”),<sup>16</sup> the *Fair Trading Act 1987* (NSW)<sup>17</sup> and the *Australian Securities and Investments Commission Act 2001* (Cth).<sup>18</sup>

## Consumer Credit Code

7.14 The application in New South Wales of the Consumer Credit Code has significantly reduced the incidence of unintelligible documentation in relation to consumer credit transactions. However, it is important to bear in mind that the requirements set out below do not apply to guarantees of business loans.

7.15 A guarantee covered by the Consumer Credit Code must be in writing.<sup>19</sup> Section 164A of the Consumer Credit Code permits “any contract, mortgage or guarantee referred to in [the] Code” to be made in accordance with laws relating to electronic transactions,<sup>20</sup> although specified transactions or documents may be excepted by regulation. An exception has been made in relation to a guarantee under a credit contract where the guarantor is a natural person or strata corporation.<sup>21</sup> Pursuant to s 39A of the Consumer

11. *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 474 (Deane J).

12. *Blomley v Ryan* (1956) 99 CLR 362 at 405 (Fullagar J).

13. See *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447 at 474 (Deane J).

14. This position can be compared with that under the *Contracts Review Act 1980* (NSW), which permits a court to intervene where the disability was not known to the other party: see para 2.21.

15. See *Consumer Credit (New South Wales) Code* s 70(2)(g).

16. *Contracts Review Act 1980* (NSW) s 9(2)(g) and (i).

17. *Fair Trading Act 1987* (NSW) s 43(2)(c).

18. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(c), 12CC(2)(c), 12CC(3)(c).

19. *Consumer Credit (New South Wales) Code* s 50.

20. *Consumer Credit (New South Wales) Code* s 164A(1), inserted into the *Consumer Credit (Queensland) Act 1994* (Qld) by *Consumer Credit and Trade Measurement Amendment Act 2006* (Qld) s 8.

21. Exempted guarantees are those to which the *Consumer Credit (New South Wales) Code* applies under s 9 of the Code.

Credit Regulations<sup>22</sup> such guarantees must not be made or given by electronic communication.

7.16 The Consumer Credit Code Regulations contain provisions with respect to the content of guarantees and the way they are expressed, and a guarantee is not enforceable unless it complies with these regulations.<sup>23</sup> A guarantee, other than a document transmitted by electronic communication, must be easily legible,<sup>24</sup> clearly expressed,<sup>25</sup> and with a print or typeface of at least 10 points.<sup>26</sup> A guarantee transmitted by electronic communication must also be easily legible and clearly expressed,<sup>27</sup> and must conform with the regulations as to content, legibility and accompanying information.<sup>28</sup> Section 39 of the Consumer Credit Regulations provides that, if an electronic document contains any image, message, advertisement or other feature, these: must not distract the recipient, or reduce or interfere with his or her ability to understand the documentation; and must be readily distinguishable from the transaction. In addition, the recipient must be able to scroll through the whole of the document and the credit provider must provide full address (not a post office box) and telephone contact details.

7.17 If a provision of a guarantee does not comply with the requirements of the Consumer Credit Code and its regulations, a court may prohibit the lender from using terms that are the same or similar to the offending provision in future guarantees.<sup>29</sup>

## Contracts Review Act

7.18 The Contracts Review Act allows a court to grant relief in relation to a contract or part of a contract that is "unjust in the circumstances ... at the time it was made".<sup>30</sup> In *Australian and New Zealand Banking Group Ltd v Volmensky*, the court held that the form of the mortgage contract in question constituted unfairness under the Contracts Review Act.<sup>31</sup> Justice Spender described the Contracts Review Act as being concerned with two classes of injustice: procedural and substantive injustice.<sup>32</sup> His Honour noted that "the former is concerned with the methods used to make the contract while the latter is

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22. Inserted into the *Consumer Credit Regulation 1995* (Qld) by *Consumer Credit Amendment Regulation (No 1) 2006* (Qld) s 9.

23. *Consumer Credit (New South Wales) Code* s 50(4).

24. *Consumer Credit (New South Wales) Code* s 162(1)(a).

25. *Consumer Credit (New South Wales) Code* s 162(1)(c).

26. *Consumer Credit (New South Wales) Regulations* s 39.

27. *Consumer Credit (New South Wales) Code* s 162(1A)(a) and (c).

28. *Consumer Credit (New South Wales) Code* s 162(1A)(b).

29. *Consumer Credit (New South Wales) Code* s 162(2).

30. *Contracts Review Act 1980* (NSW) s 7. Chapter 2 explains in detail the provisions of the Act relevant to guarantees: see para 2.26-2.27.

31. *Australian and New Zealand Banking Group Ltd v Volmensky* (NSW, Supreme Court, No 15542/1992, Spender AJ, 14 December 1994, unreported), reported in part in (1995) ANZ Conv R 202 at 207.

32. *Australian and New Zealand Banking Group Ltd v Volmensky* (NSW, Supreme Court, No 15542/1992, Spender AJ, 14 December 1994, unreported), reported in part in (1995) ANZ Conv R 202 at 207.

concerned with the unjust consequences or effects of the contract”.<sup>33</sup> However, his Honour emphasised that it is “the contract or its provisions which must be unjust”,<sup>34</sup> not particular transactions under the contract.

7.19 The court found that the contract constituted unfairness both as to procedural and substantive matters, basing its conclusion on, among other things, the circumstances in which the mortgage was entered into, and the form of the mortgage. In regards to the form of the mortgage, his Honour commented:

*[h]ad the Bank set out to create a document which was intended to achieve a high degree of confusion in the mind of the ordinary but intelligent lay reader, and to be largely incomprehensible to most members of the public, it has achieved that objective.*<sup>35</sup>

7.20 His Honour clarified that he was not suggesting “that banks are not entitled to protect their interest and to draw up documents which maximise the benefits which they may get and minimise the risks they may run in lending transactions”, that being their commercial right. However:

*... if they elect to use documents which, by the way in which they are expressed, are difficult to understand - and continue to do so years after the Contracts Review Act has become law - they run the risk of making themselves vulnerable, in appropriate cases, to applications under the Act.*<sup>36</sup>

## Empirical background

7.21 The empirical study conducted by the Commission and the University of Sydney (“Lovric and Millbank”) examined the intelligibility and legibility of security documents. Despite noting that plain English documentation appears to be more common than it was in the past,<sup>37</sup> Lovric and Millbank found that some lawyers still feel that the documentation remains complex, and that loan and mortgage documents have increased dramatically in size. A solicitor who participated in the study gave some useful observations:

*Over 18 years in practice, I have seen loan and mortgage documents increase dramatically in size, various forms of independent advice certificates come and go and the occasional case where a guarantor*

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33. See *West v AGC (Advances) Ltd* (1986) 5 NSWLR 610 at 620 (McHugh JA).

34. See *West v AGC (Advances) Ltd* (1986) 5 NSWLR 610 at 621 (McHugh JA).

35. *Australian and New Zealand Banking Group Ltd v Volmensky* (NSW, Supreme Court, No 15542/1992, Spender AJ, 14 December 1994, unreported), reported in part in (1995) ANZ Conv R 202 at 207.

36. *Australian and New Zealand Banking Group Ltd v Volmensky* (NSW, Supreme Court, No 15542/1992, Spender AJ, 14 December 1994, unreported), reported in part in (1995) ANZ Conv R 202 at 207.

37. J Lovric and J Millbank, *Darling Please Sign This Form: A Report on the Practice of Third Party Guarantees in New South Wales* (NSW Law Reform Commission and University of Sydney, Research Report 11, 2003) at para 5.5.



*successfully escaped liability. By and large, financiers seem to respond to successful defences of guarantee cases by focusing on closing 'loopholes' in their loan documents or pushing more responsibility on to solicitors to provide a back-stop, through use of certificates. We now have very complicated 'plain English' documents often (including) 'all moneys' securities and Consumer Credit Code disclosures which run for many pages but which average borrowers cannot understand. At the end of the day I think lenders need to accept more responsibility for their lending practices and, if they lend to 'high risk' clients, they should accept the fact that they will lose out sometimes.*<sup>38</sup>

7.22 The Lovric and Millbank study confirmed that guarantee documentation remains very poorly understood by guarantors.<sup>39</sup> It referred to the report of the Expert Group on Family Financial Vulnerability, which found evidence to suggest that guarantors may still not read the documents and instead rely on general comments made by the lender or the borrower about the nature of the obligation they are assuming.<sup>40</sup> Lovric and Millbank found that in 73% of litigated cases, the guarantor had not read the security documents. Twenty-seven percent of guarantors who responded to a survey on whether they understood or could read the guarantee documents stated that they could not. Problems identified by guarantors included the use of legal jargon; small print in contract documents; and the large volume of paper. They were particularly disadvantaged when they did not have an opportunity to take the documents away to read and consider them.<sup>41</sup>

7.23 Tied in with the issue of providing guarantors with documentation more easily read and understood was the question of providing better information about the guarantee. Lovric and Millbank found that these related issues arose through the entire course of their consultations and surveys. Chapter 6 examines in detail issues relating to information and advice, but it is relevant in this context to note briefly some of the experiences of those surveyed. The approach of protecting guarantors "by throwing more paper at them"<sup>42</sup> was doubted by some, while others thought that a greater use of plain English documentation, with clear warnings, would assist. Over half of the respondents to the guarantor survey said that more written and spoken information would have assisted them at the time they signed up to be a guarantor.<sup>43</sup>

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38. Lovric and Millbank at para 5.6.

39. Lovric and Millbank at para 5.7.

40. Australia, Expert Group on Family Financial Vulnerability, *Good Relations, High Risks – Financial Transactions within Families and Between Friends* (Report, 1996) at 32.

41. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* at para 5.7.

42. Lovric and Millbank at para 5.12.

43. Lovric and Millbank at para 5.12.

## SUBMISSIONS TO ISSUES PAPER 17

7.24 Issues Paper 17 asked whether guarantees, including those for business loans, should be subject to technical specifications such as minimum font size and so forth, and be required to be comprehensible, clear and concise.<sup>44</sup>

### Technical specifications

7.25 The majority of submissions supported making guarantees subject to technical specifications such as plain English expression, legibility and minimum font size.<sup>45</sup> These requirements were seen to be in the interest of all parties.<sup>46</sup> Two submissions, while supporting a requirement for minimum font size, considered that requiring guarantees to be comprehensible, clear and concise involved subjective assessment, and that following minimum procedures, such as giving verbal explanations to guarantors (in the absence of the borrower), would ensure that there would be no need to legislate for comprehensible, clear and concise contracts of guarantee.<sup>47</sup>

7.26 The Australian Finance Conference submitted that, while there has been a general trend in the finance industry towards the use of plain English, it remains difficult to translate some legal concepts into simple language.<sup>48</sup> There has also been a concern that attempting to simplify the language of complex documents increases the risks of conveying meanings inaccurately, thereby opening the way for legal challenge. Real property mortgages, which contain clauses covering technical issues and rules with long legal histories, are particularly difficult to put into plain English. The Australian Finance Conference also raised the issue of the costs associated with changing documentation and removing superseded documents from circulation. In relation to regulation of technical specifications, it did not consider this to be necessary.

### Consequences of failure to comply with formalities

7.27 There was considerable disagreement in the submissions on what should be the consequences of failing to comply with certain formal requirements.

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- 44. New South Wales Law Reform Commission, *Guaranteeing Someone Else's Debts* (Issues Paper 17, 2000) Question 22 at para 4.9.
  - 45. St George Bank, *Submission* at 4; Commonwealth Bank, *Submission* at 11; NSW Legal Aid Commission, *Submission* at 16; Women Lawyers Association of NSW, *Submission* at 7; Women's Legal Resources Centre, *Submission* at 9; Country Women's Association of NSW, *Submission*; Financial Counsellors' Association of NSW, *Submission* at 3; Ryde-Eastwood Financial Counselling Service, *Submission* at 6; C O'Donnell, *Submission* at 1-2. NSW Department of Fair Trading, *Submission* at 3.
  - 46. Commonwealth Bank, *Submission* at 11.
  - 47. NSW Young Lawyers, *Submission* at 6; Women Lawyers Association of NSW, *Submission* at 7.
  - 48. Australian Finance Conference, *Submission* at 17.

7.28 Some submissions did not support making a guarantee unenforceable for failure to comply with formal requirements.<sup>49</sup> One submission preferred to make it an offence that the requirements were not complied with and make failure to comply a relevant consideration in determining if there has been, for example, unconscientious dealing.<sup>50</sup>

7.29 Other submissions suggested that if certain minimum requirements were not adhered to, the guarantee should be capable of being made unenforceable.<sup>51</sup> One submission justified this approach on the grounds that the power imbalance between borrowers and lenders "is such that borrowers have little or no ability to negotiate the terms of the loan".<sup>52</sup>

## CONCLUSION

7.30 As the evidence in the Lovric and Millbank study suggests, despite plain English documentation appearing to be more common than it was in the past, guarantee and mortgage documents remain complex and appear to have increased dramatically in size. A drafting style that is convoluted, or documentation that appears to be impenetrable, even if it is in actual fact written plainly, will deter many guarantors from reading the documents, relying instead wholly on the advice of others. It is far better for guarantors to read the documentation for themselves, with their own understanding of the transaction underpinning their obtaining of advice.

7.31 The Commission considers, therefore, that the Model Law should contain provisions designed to prevent unfairness related to the form of the documents arising in the first place. At present, "small business" guarantee transactions are vulnerable to the vagaries of legal and commercial drafting. The majority of submissions supported making guarantees subject to technical specifications such as plain English expression, legibility and minimum font size. These requirements were seen to be in the interest of all parties. The Consumer Credit Code and the Consumer Credit Regulations appear to be operating well in compelling standards of comprehension and legibility. The Commission has concluded, therefore, that the Model Law should adopt the provisions of the Consumer Credit Code and Consumer Credit Regulations that require a guarantee to be in writing, easily legible, clearly expressed, and with a print or typeface of at least 10.

7.32 The Commission does not believe, however, that there should be a general provision that a guarantee is unenforceable if it fails to comply with requirements to be "easily legible and clearly expressed". These aspects involve qualitative assessments, as pointed out in submissions, as well as depending on the response and understanding of the individual guarantor. Compliance of the guarantee documentation should be tested on a case-by-case basis. Accordingly, the Commission prefers to rely on a provision similar to s 70 of the Consumer Credit Code giving a court the power to reopen unjust transactions. Section 70(g) provides that, in determining whether a transaction is unjust,

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49. St George Bank, *Submission* at 4.

50. St George Bank, *Submission* at 4.

51. Women Lawyers Association of NSW, *Submission* at 7; Women's Legal Resources Centre, *Submission* at 9; NSW Young Lawyers, *Submission* at 6; Ryde-Eastwood Financial Counselling Service, *Submission* at 6.

52. Women's Legal Resources Centre, *Submission* at 9.

the court may have regard to the form of the guarantee and the intelligibility of the language in which it is expressed; and s 71 empowers a court to issue a variety of orders when it reopens an unjust transaction. Unjust guarantees are the subject of Chapter 11 of this Report.<sup>53</sup>

## RECOMMENDATION 7.2

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The Model Law should adopt the requirements in s 162 of the *Consumer Credit Code* and s 39 and 39A of the *Consumer Credit Regulations* relating to the legibility and language of guarantees and notices.

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53. See especially Recommendation 11.6.

## 8. Terms of the contract

- "All moneys" clauses
- The principle of co-extensiveness
- Conclusive evidence clauses

8.1 Chapter 7 explored the obstacles to fair dealing that can be created by convoluted, barely intelligible, or sometimes illegible, guarantee and mortgage documentation. This chapter deals with a completely different subject matter, but the focus continues to be on reforming documentation to prevent or lessen problems and disputes from arising. The first part of the chapter discusses the difficulties, misunderstandings and hardship that can result from the inclusion of "all moneys" clauses in contracts of guarantee.

8.2 The second part of the chapter examines the principle of co-extensiveness, which states that the liability of a guarantor is co-extensive with that of the principal debtor. In the past, creditors have circumvented the principle by including a term in the guarantee that preserves the guarantor's liability in the event that the principal contract is void, voidable or unenforceable. Since the enactment of the *Consumer Credit (New South Wales) Code* ("Consumer Credit Code"), a guarantor of a consumer credit contract is protected in such circumstances. The discussion explores whether the Model Law should contain provisions similar to those of the Consumer Credit Code.

8.3 The final part of the chapter considers the use of "conclusive evidence clauses" in guarantees.

## "ALL MONEYS" CLAUSES

### Definition

8.4 An "all moneys" clause, also known as an "all accounts" clause or a "dragnet" clause, creates an unlimited guarantee. It extends a guarantor's liability to secure future credit contracts between the lender and the borrower. In this way, the guarantor may become liable for future debts or advances unrelated to the initial transaction.

8.5 The following is an example of an "all moneys" clause:

*The guarantor guarantees "all moneys and amounts at the date of the mortgage or any time hereafter owing or remaining unpaid to the bank in any manner or on any account whatsoever by the mortgagor".*

8.6 "The moneys secured" or "the obligation guaranteed" can be widely defined in the guarantee document to include, for example, "any moneys owing or unpaid or obligations incurred by the borrower *whether existing or future* and in any manner and on any account whatever". A simpler example is to define the secured money as "principal money", which includes money owing whether the "relevant transactions" took place before or after the document was executed.<sup>1</sup> However formulated, there is a tangible risk that guarantors who are asked to provide a guarantee will assume that any liability arising thereunder will be confined to the loan that is made at the time of its execution, and will fail to appreciate

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1. This approach is used in the Standard Mortgage Provisions of a major bank: NSW Legal Aid Commission, *Submission to Research Report 11* (J Lovric and J Millbank, *Darling please sign this form: a report on the practice of third party guarantees in New South Wales* (NSW Law Reform Commission and University of Sydney, Research Report 11, 2003).

the significance of an “all moneys” clause and its wider reach. This can be particularly the case where the obligation is accepted under a mortgage that operates as a guarantee.

## The common law

8.7 The common law allows the use of “all moneys” clauses in guarantees or mortgages, although courts may limit their operation in some cases. For example, in *Australian and New Zealand Banking Group Ltd v Volmensky*<sup>2</sup> the bank attempted to rely on an “all moneys” clause in the mortgage to claim from Mrs Volmensky repayment of further debts incurred in her husband’s business. The court refused to extend her liability on the basis that the mortgage was intended to serve a specific purpose, namely, the original loan of a total of \$60,000 and that “nothing else was in contemplation.”

8.8 Documentation such as the initial loan approval and the loan agreement may be capable of being used to read down the “all moneys” clause in the security document. In a commercial context, it should be appreciated that an “all moneys” clause would only be read down where the parties’ actual intentions are inconsistent with the broad words of the clause. Where an inconsistent intention is not obvious, the clause will be interpreted in its broadest sense.<sup>3</sup>

## Consumer Credit Code

8.9 Section 43 of the Consumer Credit Code regulates “all accounts mortgages”. It provides that a mortgage that initially secures credit under a credit contract, or obligations under a related guarantee, can also contain a provision securing credit provided under a future credit contract or related guarantee. However, the mortgage is unenforceable in relation to future credit or guarantees unless the credit provider has given to the mortgagor a copy of the relevant documentation and has subsequently obtained the mortgagor’s written acceptance of the extension of the mortgage.

8.10 Section 54 of the Consumer Credit Code is the equivalent section dealing with guarantees. Interestingly, it is titled “extension of guarantee” rather than “all accounts guarantees”. It provides:

### *54 Extension of guarantee*

*(1) In addition to guaranteeing obligations under a credit contract or proposed credit contract to which a guarantee initially applies, a guarantee may contain a provision that makes credit provided under another future credit contract subject to the guarantee.*

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2. [1995] ANZ Conv R 202.

3. See *Smith v Australia And New Zealand Banking Group Ltd* (1996) NSW Conv R 55-774; *Burke v State Bank of New South Wales Ltd* (1995) 37 NSWLR 53 at 72 (Santow J). See also J Pascoe, “Women’s Guarantees and ‘All moneys’ Clauses” (2004) 4 *Queensland University of Technology Law and Justice Journal* 245 at 258-262.

*(2) Any such guarantee is unenforceable in relation to such a future credit contract unless the credit provider has—*

*(a) given the guarantor a copy of the contract document of that future credit contract; and*

*(b) subsequently obtained from the guarantor a written acceptance of the extension of the guarantee or obtained acceptance in some other form provided for by the regulations.*

*(3) Section 50 (Form of guarantee) and section 51 (Disclosure) do not apply to an extension of a guarantee under this section.<sup>4</sup>*

## Codes of practice

8.11 The Australian Bankers' Association endeavours to regulate the use by banks of "all moneys" clauses through its voluntary Code of Banking Practice ("Banking Code"). The 2003 Banking Code (as amended in May 2004) provides, in cl 28.2, that a bank may only accept a guarantee if the guarantor's liability is limited to, or in respect of a specific amount (together with other liabilities, such as interest and recovery costs) described in the guarantee.

8.12 Clause 28.4(a)(iv) provides that the bank will give guarantors a notice that they have a right to limit their liability. Clause 28.9 provides that the guarantor may, by written notice, limit the amount or nature of the liabilities guaranteed. Clauses 28.12 and 28.13 require the written consent of the guarantor for an extension to a third party mortgage or a guarantee, respectively. Clause 28.13 provides:

*A Guarantee given by you will be unenforceable in relation to a future credit contract unless we have:*

*(a) given you a copy of the contract document of the future credit contract; and*

*(b) subsequently obtained your written acceptance of the extension of the Guarantee,*

*except to the extent the future credit contract (together with all other existing credit contracts secured by that Guarantee), is within a limit previously agreed in writing by you and we have included in the notice we give you under clause 28.4(a) a prominent statement that the Guarantee can cover a future credit contract in this way.*

This clause was introduced in 2003 as a result of a major review of the Banking Code and is based on s 54 of the Consumer Credit Code.<sup>5</sup> However, unlike s 54, cl 28.13 exempts

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4. See also *Consumer Credit (New South Wales) Code* s 56 in relation to conditions to be met before a guarantor is liable for further credit advances under a variation to an existing credit contract. This is examined in para 9.36-9.40, Recommendation 9.5.



lenders from complying from the requirements if certain conditions are present.<sup>6</sup> Nevertheless, it has broader application than s 54 because it applies not only to guarantees that support consumer credit contracts but also to those related to small business credit contracts.<sup>7</sup>

8.13 The Credit Union Code of Practice permits certain extensions of guarantees to future credit contracts if specific procedures are followed.<sup>8</sup>

## Empirical background

8.14 The empirical research into guarantees conducted jointly by the Commission and the University of Sydney (“Lovric and Millbank”) found that, although lenders report that such clauses are rarely used, guarantees for unlimited amounts are in fact common:

*Eighteen per cent of guarantors reported they guaranteed an unlimited or indefinite amount of money. Furthermore, 27% of guarantors reported they discovered they had given a mortgage over their home that contained an “All Moneys” clause only after problems arose with the loan. It appears that guarantors who receive legal advice may in fact be more, rather than less, likely to be entering into such transactions. Forty-six per cent of respondents in the solicitor survey said that on the last occasion they gave advice to a guarantor the security documents contained an “All Moneys” clause.<sup>9</sup>*

8.15 Lovric and Millbank also found that over half the litigation concerning third party guarantees involved security documents that contained an “all moneys” mortgage and that 83% of barristers who responded to their survey stated that on the last occasion they acted in a third party guarantee matter the loan included an “all moneys” clause.<sup>10</sup>

## Submissions to Issues Paper 17

8.16 In Issues Paper 17, the Commission sought submissions on whether there is prevalent use of “all moneys” or “all accounts” clauses in contracts of guarantee,<sup>11</sup> and

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5. R Viney, *Review of the Code of Banking Practice: Final Report* (RTV Consulting Pty Ltd, October 2001) at 61, Recommendation 52.
  6. For an analysis of the differences between the Banking Code and Consumer Credit Code provisions, see J Pascoe, “Women’s Guarantees and ‘All moneys’ Clauses” (2004) 4 *Queensland University of Technology Law and Justice Journal* 245 at 250-254.
  7. See para 2.43.
  8. Credit Union Code of Practice (1994) s 17.3.
  9. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* at para 5.18.
  10. Lovric and Millbank at para 5.19.
  11. NSW Law Reform Commission, *Guaranteeing Someone Else’s Debts* (Issues Paper 17, 2000), Question 3 at para 4.5.

whether legislation and industry codes of practice should generally prohibit such clauses in all contracts of guarantee.<sup>12</sup>

8.17 In the experience of the NSW Legal Aid Commission ("Legal Aid"), many standard form contracts of guarantee contain provisions for the guarantee to be either unlimited or capped at a particular level, but the incidence of unlimited guarantees may be falling.<sup>13</sup> However, Legal Aid submitted that the use of "all moneys" clauses in mortgages remained "common, if not standard" and that these could be used to override the provisions in some guarantees that limit the liability of a guarantor.<sup>14</sup>

8.18 It gave the following example of potential hardship where a wife signs a contract of guarantee in relation to an overdraft account for her husband's business:

*The contract of guarantee may contain a clause limiting her liability under the guarantee to a specified sum. However, she and her husband have also given a mortgage over their home to the lender for an earlier home loan. The mortgage contains an all monies clause the effect of which is that the mortgage will secure all future lending to the husband and the wife. In these circumstances, even though the wife's personal liability under the guarantee contract is limited, the lender will have unlimited access to her home as security for all advances made to the husband's business.*<sup>15</sup>

8.19 Legal Aid observed that the unfairness of "all moneys" clauses "lies in the fact that a mortgagor who signs a mortgage with a particular loan in mind can find that their mortgage secures future advances which they know little if anything about".<sup>16</sup> It submitted that the potential for unfairness provides a strong argument for prohibiting these clauses.

8.20 However, it further submitted that "it makes financial sense (particularly in the business context), to have mortgage documentation that is flexible enough to allow further loans or advances without a rewriting of the mortgage". In its view, "all monies clauses should be regulated so that the mortgagee must obtain the written consent of the mortgagor for each further advance or potential increase in liability". Legal Aid argued that if this consent is not obtained, the mortgage should be rendered unenforceable. It noted that this approach has already been adopted with the enactment of s 43 of the Consumer Credit Code.

8.21 The St George Bank ("St George") reported that the inclusion of an "all moneys" clause was "standard" for the bank's commercial guarantees, but that such a clause was not included in "retail" guarantees because of clause 17.2 of the Code of Banking Practice, as it then was.<sup>17</sup> This clause provided:

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12. NSWLRC IP 17, Question 34 at para 4.12.

13. NSW Legal Aid Commission, *Submission* at 7.

14. NSW Legal Aid Commission, *Submission* at 7-8.

15. NSW Legal Aid Commission, *Submission* at 8.

16. NSW Legal Aid Commission, *Submission* at 20.

17. St George Bank, *Submission* at 1.

*A Bank may only accept a guarantee if the amount of the guarantor's liability is limited to, or is in respect of, a specific amount plus other liabilities (such as interest and recovery costs) that are described in the guarantee.*

8.22 St George took a similar approach to that of Legal Aid. Rather than prohibit “all moneys” clauses from guarantees, St George submitted that the guarantor could be protected by imposing requirements on the creditor similar to those already provided for in the Consumer Credit Code. The guarantor would be provided with a copy of the future credit contract and would need to acknowledge in writing any further obligations, extensions and increases in order for the guarantee to be enforceable against the extensions.

8.23 The Commonwealth Bank reported that, for lending other than that under the Consumer Credit Code, its usual practice was to obtain an unlimited guarantee, while at the same time advising the guarantor of the current maximum liability at the time the guarantee is signed. If a debtor then wished to obtain further facilities or finance, the Bank would obtain an acknowledgment from the guarantor agreeing to an increase in the guarantor's liability under the guarantee. In some cases, if requested by a guarantor, the Bank would obtain a limited guarantee up to a specific amount.<sup>18</sup> In the Bank's view, this has the advantage of sufficient flexibility while at the same time requiring the guarantor's consent to be obtained to any increase in his or her liability.

8.24 In the circumstances, the Commonwealth Bank opposes a prohibition of “all moneys” clauses. It argues that any prohibition would result in increased costs and delays due to the need for new documentation and rearrangement of a borrower's facilities. It also submitted that the taking of separate guarantees for each change of financial accommodation to a business could lead to a multiplicity of guarantees being taken, some of which might at any one time be in force while other have been superseded. In its view, the potential for confusion could well be greater than if one “all accounts” document were held with a specific acknowledgment of the total amount presently secured by it.<sup>19</sup>

8.25 The Ryde-Eastwood Financial Counselling Service submits that, based on its experience, the use of “all moneys” clauses in contracts of guarantee have lessened in recent years. It said that these clauses have usually been well hidden in lease contracts, loan contracts and mortgage documents and often not brought to the attention of the clients. It supports the prohibition of “all moneys” clauses.<sup>20</sup> The Financial Counsellors' Association of NSW Inc also supports the prohibition of these clauses, finding them “abhorrent”.<sup>21</sup>

8.26 Judge Goldring submitted that, if independent legal advice is given, “all moneys” clauses would not be a problem because the guarantor would be aware of their existence and ramifications, “or might even decline to become a guarantor”. Judge Goldring suggested, however, that an exception should be made where the guarantor is in a close

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18. Commonwealth Bank, *Submission* at 3.

19. Commonwealth Bank, *Submission* at 15.

20. Ryde-Eastwood Financial Counselling Service, *Submission* at 8.

21. Financial Counsellors' Association of NSW Inc, *Submission* at 4; See also M E Drummond, *Submission* at 1: “I am staggered that the recommendation to scrap unlimited guarantees has been shelved;” and C O'Donnell, *Submission* at 2.

personal relationship with the borrower. In these cases, Judge Goldring submitted that “all moneys” clauses should be prohibited, as “[n]o amount of independent advice would overcome the dependency relationship”.<sup>22</sup>

8.27 The NSW Young Lawyers supports the prohibition of “all moneys” clauses in the case of small business and consumer guarantees, but not for guarantees given by large businesses or corporations. It submits that, if “all moneys” clauses are to continue in relation to small businesses and consumers, the guarantor should nominate the security that such person or entity wishes to provide under the guarantee. This “would assist in drawing the nature and scope of the security being provided under the guarantee to the attention of the guarantor”, thus giving the guarantor “a greater understanding of their obligations, and the risks associated with signing the guarantee”.<sup>23</sup>

8.28 The Women Lawyers Association of NSW also supported a prohibition of “all moneys” clauses in contracts for small business and consumer third party guarantees, and suggested that guarantors should be able to nominate the security under the contract. It reiterated that there is a danger in unlimited guarantees that guarantors will jeopardise assets they never intended to provide as security:

*For example, a guarantor may receive a personal injury compensation payment or inheritance after providing the guarantee. Unscrupulous borrowers may seek to exploit a guarantor's good fortune by deliberately defaulting on the loan.*<sup>24</sup>

8.29 The Women's Legal Resources Centre submitted that, “although ‘all moneys’ clauses appear less in recent contracts of guarantees, many contracts relied upon were signed some years ago and may include these clauses”. In that case, given the long term and open-ended nature of contracts of guarantee, and the difficulty in terminating a guarantee, it is certainly a live issue.<sup>25</sup> It also supports the prohibition of “all moneys” clauses:

*The history of the use of these clauses and consequent court action underlines the difficulties in ensuring that guarantors understand the implications of these clauses. At the time of signing any information about these clauses is likely to be hypothetical and therefore it is difficult to get independent financial or legal advice, even if sought. Also, given the concerns about information given to guarantors and privacy legislation, it is difficult to properly inform borrowers and guarantors.*

*Many women seek advice from WLRC at time of family breakdown. In these situations in particular, all moneys clauses are insidious as there is often a difficulty in obtaining information about the loan and associated information*

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22. J L Goldring, *Submission* at 2.

23. NSW Young Lawyers, *Submission* at 11.

24. Women Lawyers Association of NSW, *Submission* at 10.

25. Women's Legal Resources Centre, *Submission* at 2.

*so the woman is left not knowing what her potential financial obligations are.*<sup>26</sup>

8.30 The NSW Department of Fair Trading pointed out that, under an “all moneys” clause, a bank can not only extend credit far beyond that which the guarantor anticipated, but can do so at a time when the guarantor’s circumstances may have deteriorated. It supported the inclusion in small business guarantees of a provision similar to s 54 of the Consumer Credit Code. It further supported a requirement that guarantees specify the maximum amount that is guaranteed, given that many small business loans are lines of credit with variable credit limits. This, it submitted, would avoid the problem of open-ended liability, and would mean that, if provisions similar to s 54 of the Consumer Credit Code were applied to small business guarantees, amounts above the specified maximum would need to be agreed to by the guarantor.<sup>27</sup>

8.31 The Australian Finance Conference (“AFC”) reported that some of its members have made a policy decision not to take “all moneys” guarantees and mortgages in the context of small business transactions. It, too, acknowledged that unlimited guarantees have the potential to increase the debt exposure of guarantors well beyond their original commitment and without the guarantor’s knowledge. Nonetheless, it does not support a prohibition of “all moneys” clauses, but supports the approach taken in s 54 of the Consumer Credit Code. It submitted that this approach varies little from the practice adopted by AFC in relation to commercial transactions. For commercial guarantees and mortgages containing “all moneys” clauses, AFC members invariably seek the written consent of the guarantor or mortgagor to any further advances, or the guarantor’s prior written acknowledgment that the proposed further advance is a transaction to which the mortgage or guarantee applies.<sup>28</sup>

## Conclusion

8.32 The use of “all moneys” clauses is of significant concern because of the open-ended liability created, which the guarantor may not be aware of or fully appreciate.<sup>29</sup> They are complex clauses and their construction may depend on reading a number of documents together.<sup>30</sup> The clause is often contained in the memorandum of common provisions, a separate document to the mortgage and the guarantee.<sup>31</sup> The complexity surrounding “all moneys” clauses heightens the danger that a guarantor will not be aware

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26. Women’s Legal Resources Centre, *Submission* at 12.

27. NSW Department of Fair Trading, *Submission* at 7.

28. Australian Finance Conference, *Submission* at 6.

29. A significant proportion of guarantors who were surveyed did not discover that they had even signed an “all moneys” guarantee until it was called upon: J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* at para 5.18.

30. See B Collier, “‘All Debts’ Clauses in Commercial Contracts of Guarantee: Principles of Construction and Limitations on the Ambit of Clauses of this Nature” (1998) 24 *Monash University Law Review* 7; R Edwards, “Problems with ‘All Moneys’ Mortgages” (2002) 17 *Australian Banking and Finance Law Bulletin* 151.

31. See, for example, *Australian and New Zealand Banking Group Ltd Banking Group v Capper* [2001] NSWSC 946.

that, at the time he or she enters a transaction, he or she is providing a guarantee for all moneys owed presently and all money loaned in the future, even many years hence.<sup>32</sup>

8.33 *Johncorp Industries v Sussman*<sup>33</sup> provides an illustration of the complexity and potential ambit of "all moneys" clauses. In that case, a wife and husband executed a mortgage and also executed personal guarantees to secure certain debts. The mortgage contained an "all moneys" clause. One loan was advanced to the husband only and, although the "all moneys" clause in the mortgage did not cover that loan, the inter-relation of all of the documents was held to extend liability to the wife through a chain-reaction.<sup>34</sup>

8.34 The protection given by the common law and by voluntary codes of practice to guarantors of "small business" loans against unlimited liability is either insufficient or inconsistent.<sup>35</sup> At common law, if no special disadvantage or disability, mistake, *non est factum*, misrepresentation or undue influence is found, an "all moneys" clause of itself would not render the contract unenforceable.<sup>36</sup> Nor is escape from an "all moneys" clause likely to be provided by the *Australian Securities and Investments Commission Act 2001* (Cth).<sup>37</sup>

8.35 The Commission appreciates the strong arguments in favour of prohibiting "all moneys" clauses. However, we have concluded that it is preferable to allow parties to adopt "all moneys" clauses subject to the safeguards provided by s 54 of the Consumer Credit Code. This approach is supported by a substantial number of submissions, as discussed above.

8.36 In the Commission's view, the greatest danger of "all moneys" clauses has been that the guarantor has often not been aware or not understood, that he or she could be liable for further sums in addition to the amount of the loan specified in the documentation. As Ryde-Eastwood Financial Counselling Service pointed out, these clauses have often been well-hidden in lease contracts, loan contracts and mortgage documents and often not brought to the attention of the guarantor. Further, the guarantor may not have been made aware when this credit facility was drawn upon, increasing his or her liability. The Consumer Credit Code stipulates that the mortgagor or guarantor must give written consent to any increases in credit and must receive a copy of the relevant documentation.

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32. See *Gattellaro v Westpac Banking Corporation* [2001] NSWCA 76. Westpac sued Mr and Mrs Gattellaro in reliance on an unlimited guarantee given by Mr Gattellaro in 1985, the obligations under which were secured by a 1977 "all moneys" mortgage, despite the fact that even Westpac itself no longer had a copy of the 1977 document. The trial judge upheld the bank's claims and the defendants appealed to the Court of Appeal, where their appeal was rejected. The Gattellaros appealed, unsuccessfully, to the High Court: *Gattellaro v Westpac Banking Corporation* [2004] HCA 6 (11 February 2004).

33. [2001] NSWSC 519.

34. The court held that the personal guarantee given by the wife secured loans made solely to the husband. As the mortgage contained a reference to money owed by the mortgagor pursuant to any guarantee, it was held that the wife was liable for subsequent loans to the husband to an unlimited amount.

35. See, generally, Chapter 2.

36. See para 2.5-2.16.

37. See para 2.29.

Otherwise, the mortgage or guarantee is unenforceable in relation to the extension of credit. In this way, the guarantor (or mortgagor) has the opportunity to refuse to guarantee further sums. This protection is reinforced by the Commission's recommendation in Chapter 7 regarding the legibility of documentation,<sup>38</sup> and the recommendations in Chapter 6 regarding the inclusion of warnings and information modelled on Forms 4 and 5A of the Consumer Credit Regulation.<sup>39</sup>

8.37 At the same time, permitting mortgages and guarantees to continue to contain "all moneys" clauses has the advantage of avoiding the costs, inconvenience and time delays of renegotiating further credit, rearranging a borrower's facilities and preparing further documentation. As Legal Aid submitted, it makes commercial sense to allow this flexibility. The Commission also notes the Commonwealth Bank's point regarding the potential for confusion if separate guarantees for each change of financial accommodation of a business result in a multiplicity of guarantees, some of which might at any one time be in force and while others have been superseded.

8.38 The Commission is, however, of the view that the adoption of s 54 of the Consumer Credit Code into the Model Law should be modified in two respects. First, the copy of the proposed future credit contract given by the lender to the guarantor should contain a notice, in plain language, explaining that the extension of credit will extend the guarantor's liability under the guarantee. Secondly, the lender must give the guarantor information in writing on the current status of the original credit contract, in particular:

- the current balance of the debtor's account;
- any amounts currently overdue and when each such amount became due; and
- any amount currently payable and the date it became due.<sup>40</sup>

These modifications are intended to warn guarantors of the consequences of the extension of the guarantee and provide more information to enable them to make an informed decision on whether or not to agree to the extension.

## RECOMMENDATION 8.1

The Model Law should adopt the provisions of s 54 of the *Consumer Credit Code* relating to "all moneys" clauses.

The copy of the proposed future credit contract given to the guarantor pursuant to the adapted s 54 of the *Consumer Credit Code*, should contain a notice, in plain language, explaining that the extension of credit will extend the guarantor's liability under the guarantee.

38. Recommendation 7.2.

39. Recommendations 6.4, 6.5.

40. This proposed requirement should be distinguished from the recommendation for a general right of guarantors to obtain information from the lender regarding the current status of an existing credit contract: see para 9.20-9.28 and Recommendation 9.4, which adopts, with modifications, s 34 of the Consumer Credit Code.

In addition to giving the guarantor a copy of the proposed future credit contract, the lender should provide the guarantor with information in writing on the current status of the original credit contract, including the current balance of the debtor's account; any amounts currently overdue and when each such amount became due; and any amount currently payable and the date it became due.

## THE PRINCIPLE OF CO-EXTENSIVENESS

8.39 This common law principle states that the liability of a guarantor is co-extensive with that of the principal debtor. That is, if the principal contract were rescinded, discharged or declared void, the contract of guarantee would be affected in the same way. The creditor stands in no better position against the guarantor than against the principal debtor, so that, if the principal debtor is not liable, neither is the guarantor.<sup>41</sup>

8.40 The principal contract may be defective due to illegality, the debtor's lack of capacity, or the presence of vitiating factors such as fraud, undue influence or unconscionability. Alternatively, the contract may be unenforceable because it is statute-barred or does not comply with statutory formalities.

8.41 Co-extensiveness operates both as a principle and as a rule of interpretation. It operates as a principle in the circumstances outlined in paragraph 8.39 above. That is, it applies in those circumstances because the contract is void, voidable or unenforceable, without regard to the terms of the contract of guarantee. However, where its effect is to say that the guarantor's liability is neither greater nor less "than that of the principal, in terms of amount, time for payment and the conditions under which the principal is liable",<sup>42</sup> it operates as a rule of interpretation. This ensures that the contract of guarantee is read in such a way that it imposes no greater or lesser liability on the guarantor than is imposed on the principal under the loan – provided, of course, it is capable of being interpreted in this way.

8.42 The principle of co-extensiveness is embodied in s 55 of the Consumer Credit Code as regards consumer guarantees. Section 55(1) provides as follows:

**Total amount for which guarantor can be liable.** *A guarantee is void to the extent that it secures an amount, in relation to a credit contract to which this Code applies, that exceeds the sum of the amount of the liabilities of the debtor under the credit contract and the reasonable expenses of enforcing the guarantee, or any lesser amount agreed between the credit provider and the guarantor.*<sup>43</sup>

41. *McDonald v Dennys Lascelles Ltd* (1933) 48 CLR 457. See also Butterworth's, *Halsbury's Laws of Australia*, (at 29 September 2006) 370-Restitution, "Chapter III Ineffective Contracts" at [370-2505].

42. G Andrews and R Millett, *Law of Guarantees* (4th edition, Sweet & Maxwell, London, 2005) at 6-002.

43. See also Code of Banking Practice (2004) cl 17.2 and Credit Union Code of Practice (1994) s 17.2: the relevant financial institution may only accept a guarantee if the amount of the guarantor's liability "is limited to, or is in respect of, a specific amount



“An amount” must, by ordinary construction, refer to enforceable liabilities. The effect of s 55 is to proscribe a term in the guarantee that would leave the guarantor’s liability for the debt intact, even when the creditor is no longer liable under the rescinded, discharged or void credit contract.

8.43 Section 55(1) does more than simply restate the common law. First, because it is drafted in absolute terms, it removes some of the uncertainties at common law.<sup>44</sup> For example, the common law is not always clear on the extent of the guarantor’s liability in situations where the principal contract is unenforceable, as opposed to void.<sup>45</sup>

8.44 In *Carter v White*,<sup>46</sup> the principal obligations were unenforceable as the creditor did not sue within the statutory limitation period, but the surety was not time-barred. The court held that the surety remained liable on the guarantee. Andrews and Millett observe that where the principal contract is unenforceable because it fails to comply with a statutory requirement, the position is not so clear.<sup>47</sup> In *Eldridge and Morris v Taylor*,<sup>48</sup> the English Court of Appeal held that, in such circumstances, “the debt of the principal is gone” and therefore “the surety is also discharged”.<sup>49</sup> Lord Justice Slesser held that “if the principal debtor is not liable the surety cannot be liable either”.<sup>50</sup>

8.45 Contrast the decision in *Temperance Loan Fund Ltd v Rose*,<sup>51</sup> which dealt with similar circumstances. The same Court of Appeal, while concluding that the surety was not liable, did so only on the ground that action on the guarantee was specifically prohibited by the *Money Lenders Act 1927* because it was embodied in a promissory note and there was no memorandum of writing complying with the Act. Lord Justice Greer stated that he was bound by the decision in *Eldridge and Morris v Taylor* and that, if the surety were held liable in the circumstances, then the statute would give a defence to the principal, who has had the money, but not to the surety, who has not.<sup>52</sup>

8.46 From their analysis of these cases, Andrews and Millett concluded that:

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plus other liabilities (such as interest and recovery costs) that are described in the guarantee”.

44. For two decisions that appear to derogate from the principle of co-extensiveness, see the decision of the English Court of Appeal in *Hyundai Shipbuilding and Heavy Industries Co Ltd v Pourmarus* [1978] 2 Lloyd’s Rep 502 and the House of Lords decision in *Hyundai Heavy Industries Co Ltd v Papadopoulos* [1980] 1 WLR 1129. In these cases, the guarantor was held liable for the payment of certain accrued instalments rather than the damages that the debtor was liable to pay for breach of his obligation to pay those instalments.
45. See G Andrews and R Millett, *Law of Guarantees* (4th edition, Sweet & Maxwell, London, 2005) at 6-026-6-027. See also R Else Mitchell, “Liability of Surety” (1947) 63 *Law Quarterly Review* 355 at 358-360.
46. *Carter v White* (1884) 25 Ch D 666.
47. G Andrews and R Millett, *Law of Guarantees* at 6-027.
48. *Eldridge and Morris v Taylor* [1931] 2 K B 416.
49. *Eldridge and Morris v Taylor* [1931] 2 K B 416 at 420 (Scrutton LJ).
50. *Eldridge and Morris v Taylor* [1931] 2 K B 416 at 423 (Slesser LJ).
51. *Temperance Loan Fund Ltd v Rose* [1932] 2 K B 522.
52. *Eldridge and Morris v Taylor* [1932] 2 K B 522 at 531 (Greer LJ).

*it would be dangerous to assume that these cases are necessarily authority that the unenforceability of the principal contract renders every guarantee likewise unenforceable. Each contract and the ground of its unenforceability must be examined on a case-by-case basis.*<sup>53</sup>

8.47 Similarly, in Else Mitchell's classic 1947 review of guarantees, the author analyses the common law and concludes that:

*It can fairly be said then that there has been no rigid application of the general rule recognised by the English law that the liability of a surety is co-extensive with that of the principal; modifications have been made and exceptions created by the courts ...*<sup>54</sup>

8.48 Lord Steyn once described the extent to which a guarantor's liability is co-extensive with that of the principal debtor as "one of the more intractable problems of English law" and notes that there are numerous exceptions to the general principle of co-extensiveness. He also observed that it is not easy to find a common thread in the exceptions.<sup>55</sup>

8.49 Secondly, the Consumer Credit Code overcomes the practice by creditors of including a provision in the guarantee specifically preserving the guarantor's liability in the event that the principal contract is void, voidable or unenforceable. By virtue of s 169 of the Consumer Credit Code, parties cannot avoid or modify the effect of s 55.<sup>56</sup>

8.50 Section 55(1) is subject to s 55(2). That subsection provides that:

*[n]othing in subsection (1) prevents a credit provider from enforcing a guarantee relating to liabilities under a credit contract that is unenforceable solely because of the debtor's death, insolvency or incapacity.*

8.51 Hence, a provision in the guarantee that maintained the guarantor's obligations in these defined circumstances would be permitted under the Code.<sup>57</sup>

8.52 Section 55 of the Consumer Credit Code, read with s 169, operates to ensure that the amount secured under the guarantee will never exceed the amount (plus reasonable expenses of recovery) under the loan agreement. In other words, the Consumer Credit Code changes a rule of interpretation (which would otherwise be capable of being displaced) into a rule of law.<sup>58</sup>

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53. G Andrews and R Millett, *Law of Guarantees* at 6-027.

54. R Else Mitchell, "Liability of Surety" at 371.

55. J Steyn, "Guarantees: the Co-extensiveness Principle" (1974) 90 *The Law Quarterly Review* 246 at 246 and 266.

56. Section 169(1) of the *Consumer Credit (New South Wales) Code* provides that "a provision of a contract or other instrument by which a person seeks to avoid or modify the effect of this Code is void".

57. See *Consumer Credit Law Commentary* (CCH Australia Ltd) at [39-250].

58. See further para 5.53-5.54.

8.53 The Commission is of the view that s 55 plays a valuable role in removing the not-insignificant ambiguities of the common law and in protecting guarantors. We recommend that it be included in the Model Law. However, we do not otherwise intend to affect the operation of the co-extensiveness principle at common law, including its operation as a rule of interpretation.

## RECOMMENDATION 8.2

The Model Law should adopt the provisions of s 55 of the *Consumer Credit Code* so that the guarantor's liability cannot exceed that of the borrower (except where the borrower has died, is insolvent or incapacitated).

## CONCLUSIVE EVIDENCE CLAUSES

8.54 Standard form guarantees and mortgages often contain a provision that a certificate signed by a specific officer of the lender is conclusive evidence, as between the lender and guarantor, of the amount of the liability under the guarantee or mortgage. These are referred to as “conclusive evidence clauses”. The lender must first prove the existence and terms of the credit contract, after which a conclusive evidence clause in the guarantee provides the lender with an expeditious way of proving the borrower's liability.<sup>59</sup> These clauses are particularly useful where transactions between the lender and borrower are complex, and proving each debit and credit individually would take a long time. Without a conclusive evidence clause, the lender has to prove the relevant “debt, default or miscarriage”, or the event that triggers liability under an indemnity.<sup>60</sup>

8.55 The validity of conclusive evidence clauses has been upheld by courts on many occasions, most notably by the High Court in *Dobbs v National Bank of Australasia Ltd*.<sup>61</sup> The guarantee in *Dobbs* contained a term that a certificate signed by the principal debtor's bank manager should be conclusive evidence of the guarantor's indebtedness, in the amount set out in the certificate, as at the date of the certificate. The guarantor relied on two arguments to refute liability, one of which depended on adducing evidence notwithstanding the certificate. He argued that the cheques drawn by the borrower, and honoured by the bank, were not drawn in accordance with the authorities held by the bank, that accordingly the amounts could not have been validly debited to the customer's account, and that the customer was therefore not indebted to the bank.

8.56 The High Court, rejecting the appeal, held that conclusive evidence clauses, such as the one in question, mean what they say, that is, that a certificate of the balance due to

59. See *Bache & Co (London) Ltd v Banque Vernes et Commerciale De Paris SA* [1973] 2 Lloyd's Rep 437.

60. G Andrews and R Millett, *Law of Guarantees* at 7-033.

61. *Dobbs v National Bank of Australia Ltd* (1935) 53 CLR 643. See also *Je Maintiendrai Pty Ltd v ANZ Banking Group Ltd* (1985) 38 SASR 70; *Bache & Co (London) Ltd v Banque Vernes et Commerciale De Paris SA* [1973] 2 Lloyd's Rep 437; *Brick and Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* [1992] 2 VR 279 at 371; *Shergold v Tanner* (2000) 62 ALD 584.

the bank by the borrower is conclusive evidence of the amount and existence of the borrower's debt. The court said that the object of such clauses is to provide a ready means of establishing these matters, so that a court does not have to go through the process of examining evidence of the debits that make up the indebtedness.<sup>62</sup>

8.57 The High Court further held, in answer to an argument relied on by the appellant, that the clause was not void as being contrary to public policy in ousting the jurisdiction of the court. In coming to this conclusion, the court distinguished between negative restrictions on the right to invoke the jurisdiction of the court and positive provisions giving efficacy to the award of an arbitrator. It found that the clause belonged to the latter category, which are permissible provisions, and not the former, which "have always been invalid". The court made this further observation:

*Parties may contract with the intention of affecting their legal relations, but yet make the acquisition of rights under the contract dependent upon the arbitration or discretionary judgment of an ascertained or ascertainable person.*<sup>63</sup>

8.58 In *Bache & Co (London) Ltd v Banque Vernes et Commerciale De Paris*,<sup>64</sup> the English Court of Appeal held that, where a conclusive evidence clause has been included, the guarantor must pay the certified amount of the liability and, if it subsequently transpires that he or she has paid too much, he or she can institute separate proceedings against the creditor to recover the excess.

8.59 O'Donovan and Phillips have criticised conclusive evidence clauses on the grounds that their inclusion in a guarantee has the effect of turning the guarantee into a "performance bond". A performance bond (also known as a performance guarantee or demand guarantee) is essentially an unconditional undertaking "to pay a specified amount to a named beneficiary, usually on demand, and sometimes on presentation of certain specified documents".<sup>65</sup> Andrews and Millett have described performance bonds as "more akin to a promissory note than a true guarantee". According to these authors, a true guarantee can be distinguished from a performance bond because the former is conditioned on proof of actual breach or non-performance.

8.60 O'Donovan and Phillips argue that, solely on its terms, a guarantee would not have the character of a performance bond in the absence of a conclusive evidence clause. The problem with this consequence, they argue, relates to the fact that guarantors of performance bonds are usually banks. The bank, having taken a counter-security from the borrower, may easily exercise its right of indemnity against the borrower. On the other hand, if the guarantor is an individual, there is usually no such security and he or she may not be able to recover sums paid to the lender from an insolvent borrower, and will have

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62. *Dobbs v National Bank of Australia Ltd* (1935) 53 CLR 643 at 651-654 (Rich, Dixon, Evatt, McTiernan JJ).

63. *Dobbs v National Bank of Australia Ltd* (1935) 53 CLR 643 at 652 (Rich, Dixon, Evatt, McTiernan JJ).

64. *Bache & Co (London) Ltd v Banque Vernes et Commerciale De Paris* [1973] 2 Lloyd's Rep 437.

65. G Andrews and R Millett, *Law of Guarantees* at 16-001.

no redress if the amount which he or she has paid is in excess of the amount for which the borrower is liable.<sup>66</sup>

8.61 Moreover, in *Bache & Co (London) Ltd v Banque Vernes et Commerciale De Paris*, the court found the practice of inserting conclusive evidence clauses acceptable only “because the bankers or brokers who insert them are known to be honest and reliable men of business who are most unlikely to make a mistake”.<sup>67</sup> Andrews and Millett question whether different considerations might apply to conclusive evidence clauses where the lender does not fall within the category of reputable banking institution or other trustworthy professional, and the guarantor’s “safeguard in terms of recouping any overpayment might prove illusory”.<sup>68</sup> Also referring to the court’s rationale in *Bache & Co (London) Ltd v Banque Vernes et Commerciale De Paris*, O’Donovan and Phillips state that “[a]ny rule of such construction which rests on such tenuous basis is questionable”.<sup>69</sup> They advocate legislative reform, making a certificate, statement or opinion of indebtedness prima facie (as opposed to conclusive) proof of that fact only.<sup>70</sup>

8.62 Decisions since *Dobbs v National Bank of Australasia Ltd* have clarified or qualified the effect of conclusive evidence clauses in the following ways:

- Certificates intended to be supported by a conclusive evidence clause must be strictly construed because the parties are entitled to assume that such a certificate will be given fairly and in proper form.<sup>71</sup>
- A certificate must therefore be prepared by a person properly qualified or authorised by the conclusive evidence clause to do so, and following on proper investigation into the transactions.<sup>72</sup>
- Estoppel may prevent a bank from relying on a certificate if it is inconsistent with the position previously asserted by the bank and relied on by the guarantor.<sup>73</sup>
- Certificates purporting to be conclusive evidence of the amount due or owing upon, or secured by, a mortgage cannot be conclusive evidence against a claim of

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66. J O’Donovan & J Phillips, *The Modern Contract of Guarantee* (3rd edition, LBC Information Services, Sydney, 1999) at 262.

67. *Bache & Co (London) Ltd v Banque Vernes et Commerciale De Paris* [1973] 2 Lloyd’s Rep 437 at 440 (Denning LJ).

68. G Andrews and R Millett, *Law of Guarantees* at 7-032.

69. J O’Donovan & J Phillips, *The Modern Contract of Guarantee* (3rd edition, LBC Information Services, Sydney, 1999) at 262.

70. See, for example, *Property Law Act 1974* (Qld) s 57.

71. *National Australia Bank Ltd v Sampson (No 2)* (NSW, Supreme Court, 4434/1991, Young J, 9 September 1991, unreported).

72. In *Shomat v Rubinstein* (1995) 124 FLR 284, a certificate prepared without reference to all the material relevant to the amount of liability, put together in haste, and which did not comply with the terms of the clause (for example, as to who should make the certificate) was found not to have been intended by the parties to be a conclusive determination of the quantum of their liability.

73. *Cook v Bank of New South Wales* (1982) ASC ¶155-223.

equitable set-off that operates to absolve the mortgagor in whole or in part from liability.<sup>74</sup>

8.63 In addition, since *Dobbs v National Bank of Australasia Ltd* was decided, the Contracts Review Act 1980 (NSW) ("*Contracts Review Act*") has been enacted, under which the validity of a conclusive evidence clause may be successfully challenged. In *Cook v Bank of New South Wales*,<sup>75</sup> Justice Wooten, after holding that estoppel may prevent a bank from relying on a certificate made pursuant to a conclusive evidence clause, also held that such a clause could, in certain circumstances or between certain parties, be unjust under that Act. His Honour held that it may be unfair to enforce a conclusive evidence clause against an individual who was "an ordinary member of the public", unless the presence and effect of the clause had been drawn to the person's attention at the time of entering into the guarantee.

8.64 In *National Australia Bank Ltd v Sampson (No 2)*, where the defendant sought to rely on the Contracts Review Act, Justice Young commented that, based on the decision in *Cook v Bank of New South Wales*, the potential unfairness of enforcing a conclusive evidence clause against an individual was now firmly established in practice.<sup>76</sup>

8.65 In *Westpac Banking Corporation v Sugden*,<sup>77</sup> Justice Brownie held that, if a clause makes a certificate prima facie evidence of the liability, this could generally be supportable under the Contracts Review Act. On the other hand, his Honour found that a clause making such a certificate "conclusive evidence" of the liability is, in general terms, "a clause which goes far beyond what is reasonably necessary for the protection of the legitimate interests of a Bank".<sup>78</sup> In the case before him, his Honour found that there was nothing to suggest that the certificate was anything other than completely accurate and that, therefore, there was no unjust consequence or result that ought to be remedied under the Contracts Review Act.

8.66 The Commission recognises the convenience, and savings in time and administrative costs, of admitting as conclusive evidence of indebtedness a certificate prepared by or on behalf of a lender. However, on balance, we have concluded that allowing such certificates, or statements or opinions, to be received by a court as conclusive evidence of the facts certified is undesirable. While evidence clauses should continue to be allowed in guarantees because of their expediency, certificates prepared pursuant to them should be received as prima facie evidence only of the facts contained therein.

8.67 The reason for our conclusion relates to the uncertainty in application of conclusive evidence clauses. This uncertainty arises from the fact that the various ways of addressing conclusive evidence clauses, including the possibility of addressing them under the Commission's recommendations for "unjust guarantees",<sup>79</sup> involve consideration

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74. *Long Leys Co Pty Ltd v Silkdale Pty Ltd* (1991) [1992] NSW Conv R ¶59,476.

75. *Cook v Bank of New South Wales* (1982) ASC ¶55-223.

76. *National Australia Bank Ltd v Sampson (No 2)* (NSW, Supreme Court, 4434/1991, Young J, 9 September 1991, unreported).

77. *Westpac Banking Corporation v Sugden* (1988) NSW Conv R ¶55-377.

78. *Westpac Banking Corporation v Sugden* (1988) NSW Conv R ¶55-377 at 57,472.

79. See Chapter 11.

of the circumstances of individual cases and reliance on general doctrines. The Commission prefers a general rule that makes it clear that such clauses have only prima facie effect. Accordingly, if the correctness of facts certified is challenged, the lender will bear the burden of proving that the amounts are right. In our view, this provides a proper balance between securing fairness to guarantors and commercial expedience.<sup>80</sup>

### RECOMMENDATION 8.3

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The Model Law should provide that a term of a guarantee to the effect that a certificate, statement or opinion of any person is to be received as conclusive evidence of any fact contained therein should be construed to mean only that such certificate, statement or opinion is to be received as prima facie evidence of that fact.

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80. See para 4.14.

## 9. Aspects of the life of the contract

- Cooling off period
- Disclosure of information
- Changes to obligations



9.1 In this chapter, the Commission deals with issues that arise subsequent to the execution of the guarantee. First, we examine whether guarantors should have a right to a cooling off period, that is, a specific time frame within which they should be allowed to withdraw unilaterally from the contract. Secondly, we explore the types of information a guarantor should be entitled to receive from the lender during the life of the contract. Finally, we look at what the rights and obligations of the parties should be if there are changes to the principal contract or the contract of guarantee.

## COOLING OFF PERIOD

### Current law and industry standards

9.2 Under the general law, as soon as a contract has been entered into, the parties are bound by its terms, provided the legal requirements for a valid contract have been met and the contract is not attended by vitiating factors. A guarantee is governed by these general principles and, consequently, once the guarantor has entered into the contract, which in practice occurs at the signing of the guarantee document, he or she cannot unilaterally withdraw from it.

9.3 The *Consumer Credit (New South Wales) Code* ("Consumer Credit Code") modifies the common law with respect to guarantees within its ambit, that is, those that relate to loans taken out by a natural person and intended for personal, domestic or household purposes. Section 53(1)(a) provides that a guarantor can "withdraw from the guarantee at any time before credit is first provided under the credit contract". The withdrawal must be made in writing to the credit provider.<sup>1</sup> The limited application of the Consumer Credit Code means many guarantors miss out on the benefits of a cooling off period. This is demonstrated by the results of the empirical research conducted by the Commission and the University of Sydney ("Lovric and Millbank")<sup>2</sup> discussed below.

9.4 The Code of Banking Practice ("Banking Code"), as a result of a recommendation from a major review, adopted the provisions of s 53(1)(a) of the Consumer Credit Code.<sup>3</sup> Unlike the Consumer Credit Code, the Banking Code requires banks to give a cooling off period in respect of guarantees that relate to loans taken out not only for consumer purposes but also for small business purposes.<sup>4</sup> The Credit Union Code of Practice does not require credit unions to grant a cooling off period to guarantors.

### Empirical background

9.5 Lovric and Millbank found that many people are rushed into entering into a contract of guarantee and given little opportunity to consider the transaction:

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1. *Consumer Credit (New South Wales) Code* s 53(1).
  2. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* (NSW Law Reform Commission and the University of Sydney, Research Report 11, 2003).
  3. R Viney, *Review of the Code of Banking Practice* ((RTV Consulting Pty Ltd, 2001) at 62.
  4. Code of Banking Practice (2004) cl 28.11(a).

*“There was always urgency in my signing and (my husband) had always told me that if I didn’t sign the “deal would not go through”.... I was, I think without one exception, given only a few hours notice; no regard was given to the fact I had two young children or the fact that I didn’t live or work in the City. I was never asked what times would be suitable or convenient for me. I was simply told when and where [to sign].”<sup>5</sup>*

9.6 One guarantor who participated in the Lovric and Millbank study signed a guarantee for her husband after being taken to the bank by him without any prior notice or discussion. She did not have her glasses with her as she was not expecting to sign any papers and consequently she was not able to read the documents clearly. She returned to the bank the following day to ask it to ignore the documents she had signed. The bank officer reassured her but took no action.<sup>6</sup>

9.7 In one litigated case, the wife said she received a telephone call from her husband who asked her to go to the bank to sign some documents.<sup>7</sup> Prior to the telephone call the wife knew nothing about the proposal to use the family home to secure the debts of her husband’s business. She went to the bank with her two-year-old child and signed a mortgage in front of a bank officer who gave no explanation of the mortgage. The court ultimately held that the mortgage should be set aside.<sup>8</sup>

9.8 Not surprisingly, Lovric and Millbank found strong support from guarantors for the introduction of a cooling off period to allow time to reconsider guarantee transactions before they take effect.<sup>9</sup>

## Arguments for and against

9.9 A number of submissions to this inquiry have said that a cooling off period is necessary to allow guarantors the opportunity to give proper consideration to their position.<sup>10</sup> A cooling off period would also give guarantors time to gather more information

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5. Lovric and Millbank at para 5.38 quoting an extract from the guarantor wife’s evidence in *Brueckner v The Satellite Group (Ultimo) Pty Ltd* [2002] NSWSC 378.
  6. Lovric and Millbank at para 5.39.
  7. Lovric and Millbank at para 5.40.
  8. *Westpac Banking Corporation v Mitros* [2000] VSC 465. Similarly, in *Robinson v Watts* [2000] NSWSC 584, the wife found out that she was to sign documents giving security over her home for her husband’s business debts when in the car with her husband driving to the solicitor’s office. The solicitor was the lender’s solicitor who advised the wife and provided a certificate that the wife understood the documents. In addition, the husband was present at the time. The wife was unsuccessful in defending the bank’s enforcement of the security.
  9. Lovric and Millbank at para 5.41.
  10. Women Lawyers Association of NSW, *Submission* at 7; Women’s Legal Resources Centre, *Submission* at 9; Country Women’s Association of NSW, *Submission* at 2; Financial Counsellors’ Association of NSW, *Submission* at 3, 4; Ryde-Eastwood Financial Counselling Service, *Submission* at 6.

or seek further advice about the contract. One of the submissions drew attention to the particular needs of some women and people from non-English speaking backgrounds.<sup>11</sup>

9.10 On the other hand, the reasons given by the submissions opposing a cooling off period revolve around concerns about delaying and frustrating the various parties to the contract, especially where the funds borrowed were required immediately.<sup>12</sup> Some of these submissions suggested that it is better to focus on pre-contract requirements that ensure that a prospective guarantor understands the transaction before he or she agrees to be bound.<sup>13</sup>

## The Commission's conclusion

9.11 Guarantors should be given a cooling off period to allow them time to consider the transaction further. In addition, a cooling off period would assist in ensuring that the guarantor's decision to enter into the contract is not attended by undue pressure. Such pressure may come not only from officers of the lender, who might be keen to finalise the transaction, but also from the borrower, who will want to access the funds sooner rather than later. A cooling off period would allow guarantors to reconsider their decision in their own environment away from the unfamiliar and (for some people) intimidating surroundings of a commercial office and the pressures that may be felt in the presence of the borrower and the solicitor (or other officer) of the lender.

9.12 In Chapter 6, the Commission recommends that prospective guarantors should not be asked to sign a contract of guarantee until after at least one business day from the time of disclosure of the information they are entitled to receive.<sup>14</sup> Since guarantors would already be given an opportunity to consider their position before the signing of the contract, it is sufficient to give them one clear business day from the signing of the contract to exercise an option to withdraw from the contract. The Commission is concerned not to make the cooling off period too lengthy, since a delay in the finalisation of the loan and guarantee may result in lost business opportunities. A delay of one day in receiving the advance should not occasion a borrower any great difficulty.

## RECOMMENDATION 9.1

The Model Law should provide that a guarantor should be allowed to withdraw from a guarantee within one clear business day from the execution of such contract.

11. Financial Counsellors' Association of NSW, *Submission* at 3.
12. St George Bank, *Submission* at 4; Commonwealth Bank, *Submission* at 11; Australian Finance Conference, *Submission* at 18; NSW Young Lawyers, *Submission* at 7; Australian Credit Forum, *Submission* at 3.
13. St George Bank, *Submission* at 4; NSW Legal Aid Commission, *Submission* at 17; Commonwealth Bank, *Submission* at 11.
14. Recommendation 6.6.

## DISCLOSURE OF INFORMATION

### Empirical background

9.13 Lovric and Millbank found that, after the execution of the guarantee, most guarantors received no information about the loan during its term, and were surprised when the lender advised them that the loan was in default and that the guarantee would be enforced, and were further shocked to discover the extent of their liability.<sup>15</sup> These findings are consistent with other studies, which have found guarantors generally only become aware of problems when their legal responsibilities were tested in times of trouble.<sup>16</sup>

9.14 The data from the Lovric and Millbank study points to a poor level of communication between the lender and the guarantor. These failures in communication relate to all areas of the life of the guarantee, from the basic details of the obligations under the guarantee to information about the borrower's default.<sup>17</sup> For instance, many guarantors experienced problems getting information from the lender about the level of the debt they have guaranteed. Around three-quarters of respondents to a survey of guarantors reported that they personally received no information about whether the borrower was keeping up their repayments or any information about any increase in the amount guaranteed.<sup>18</sup> In some cases, guarantors found out that there was a problem with the debt quite incidentally. One guarantor reported attempting to make a purchase on credit and being informed that they were "blacklisted."<sup>19</sup> Court judgments reflect this trend. In *Charles v Parkinson*<sup>20</sup> for example, Mrs Parkinson only became aware of her husband's business debts when a writ of execution was issued and a sheriff seized goods from the family home, following a default judgment from court proceedings about which she knew nothing.

9.15 On the evidence, guarantors need better access to information from lenders during the life of the guarantee, in particular: details of guarantors' obligations and liabilities under the guarantee; information about the status of the loan; and default by the borrower.

### Obligations and liabilities

9.16 A guarantor's obligations and liabilities are found in the contract of guarantee and in the credit contract, that is, the loan contract to which it relates. In Chapter 6, we recommend that, prior to the execution of the contract of guarantee, a prospective guarantor should receive a copy of the proposed contract of guarantee as well as the

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15. Lovric and Millbank at para 6.1

16. See, for example, S Singh, *For Love Not Money: Women, Information and the Family Business* (Consumer Advocacy and Financial Counselling Association of Victoria Inc, 1995) at 18-19. See also B Fehlberg, *Sexually Transmitted Debt: Surety Experience and English Law* (Clarendon Press, 1997) at 236.

17. Lovric and Millbank at para 6.4.

18. Lovric and Millbank at para 6.8, 6.11.

19. Lovric and Millbank at para 6.12.

20. [2000] FCA 1467.

related credit contract, among other things.<sup>21</sup> Those documents are intended to inform the prospective guarantor of what he or she is being asked to guarantee. In some cases, either or both documents may be revised before the guarantor finally accepts to be bound by the guarantee. In any case, once the contract of guarantee is executed, it is important that the guarantor be given a copy of the finalised documents.

9.17 Section 52 of the Consumer Credit Code provides that a credit provider must, not later than 14 days after a guarantee is signed and given to the credit provider, give the guarantor: (a) a copy of the guarantee signed by the guarantor; and (b) a copy of the credit contract or proposed credit contract. The credit provider need not comply with these requirements if it has previously given to the guarantor a copy of the relevant document.

9.18 The Banking Code contains a provision similar to s 52<sup>22</sup> but, unlike the Consumer Credit Code, it extends to guarantees relating to small business loans. The Credit Union Code of Practice does not contain any equivalent provision.

## RECOMMENDATION 9.2

The Model Law should contain requirements (similar to those found in s 52 of the *Consumer Credit Code*) that a lender must, not later than 14 days after a guarantee is signed and given to the lender, give the guarantor: (a) a copy of the guarantee signed by the guarantor; and (b) a copy of the credit contract.

9.19 A contract of guarantee usually lasts for a substantial number of years, sometimes decades. During this period, a guarantor may need copies of the contract of guarantee and credit contract in addition to those given immediately after the execution of the guarantee contract. Section 163 of the Consumer Credit Code requires the credit provider to give the guarantor, at the written request of the latter, a copy of the credit contract or guarantee during the life of the contract. The credit provider must comply with the request within fourteen days, if the original document requested came into existence one year or less before the request is made; or within thirty days in any other case. The section allows the copy of the document to be in the form of a computer-generated facsimile.

## RECOMMENDATION 9.3

The Model Law should contain requirements (similar to those found in s 163 of the *Consumer Credit Code*) that the lender give the guarantor, at the written request of the latter, during the life of the contract, a copy of the credit contract or guarantee.

## Information on the status of the guaranteed loan

9.20 At common law, there are cases indicating that a lender has no general obligation to supply the guarantor with ongoing information about the loan to the borrower.<sup>23</sup> In *AD &*

21. Recommendation 6.1.

22. Code of Banking Practice (2004) cl 28.7.

*JA Wright Pty Ltd v Custom Credit Corp Ltd*,<sup>24</sup> a guarantor asserted an entitlement to inspect the documents in the possession of the lender relating to the indebtedness of the borrower on the basis that the guarantor wished to have the opportunity of calculating the extent of its indebtedness under the guarantee. The court concluded that there is no universal obligation upon a lender to disclose all facts relevant to dealings with the borrower or affecting the borrower's credit and that, basically, it is left to the borrower to explain his financial position to the surety. In *Ross v Bank of New South Wales*<sup>25</sup>, the New South Wales Supreme Court held that a guarantor is entitled to know any amount due from time to time on the guaranteed loan, the interest rate charged on the loan, and the amount, if any, realised by the bank under its collateral securities. However, the court also held that the guarantor was not entitled to examine the borrower's account or be given a copy of it, nor is the lender obliged to give to the guarantor details of the borrower's specific transactions.

9.21 Section 34 of the Consumer Credit Code requires a credit provider to provide, at the request of the guarantor, the following information:

- the current balance of the debtor's account;
- any amounts credited or debited during a period specified in the request;
- any amounts currently overdue and when each such amount became due; and
- any amount currently payable and the date it became due.<sup>26</sup>

9.22 The section sets a time frame within which the credit provider must comply with the guarantor's request:

- 14 days if the information relates to period of one year or less, or
- 30 days if the information relates to a period of more than one year.<sup>27</sup>

9.23 The credit provider may give the information orally, unless the guarantor's request was in writing.<sup>28</sup> If the credit provider has given a written statement in the 3-month period prior to the guarantor's request, they need not give a further written statement.<sup>29</sup> This restriction would seem to apply even if the subsequent request relates to information that is different from the information previously given by the credit provider. Moreover, the credit provider is not obliged to give information about amounts debited or credited, or which were overdue or payable more than seven years before a request is made, unless the amounts were still due and payable when the request was made.<sup>30</sup>

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23. *Davies v London & Provincial Marine Insurance Co* (1878) 8 Ch D 469 at 474-476 (Fry J); *Small v Currie* (1854) 2 Drew 102 at 120-121; 61 ER 657 at 664 (Sir R T Kindersley VC).

24. (1992) 108 FLR 45.

25. (1928) 28 SR (NSW) 539.

26. *Consumer Credit (New South Wales) Code* s 34(1). Although the provision is silent on this point, it is presumed that the 14 and 30-day periods are to be calculated from the date of receipt of the request.

27. *Consumer Credit (New South Wales) Code* s 34(2).

28. *Consumer Credit (New South Wales) Code* s 34(3).

29. *Consumer Credit (New South Wales) Code* s 34(4).

30. *Consumer Credit (New South Wales) Code* s 34(5).

9.24 If a statement is not provided within the time required, s 35 of the Consumer Credit Code empowers the court to order the credit provider to provide the statement or itself determine the amounts in relation to which the statement was sought.

9.25 Under their code of practice, credit unions are required to send to a guarantor, on request by the guarantor, a copy of the latest relevant statements of account provided to the borrower.<sup>31</sup> In contrast, banks do not appear to have such an obligation under their code. The Banking Code states that before taking a guarantee, banks must give notice to prospective guarantors that they can request information about the transaction or facility to be guaranteed.<sup>32</sup> Considering its wording, it is doubtful whether the provision can be used by guarantors as a basis for access to information after signing the contract of guarantee. Even assuming it was intended to grant such access, the provision gives inadequate guidance as it does not specify its scope and limitations, in particular the types of information banks are obliged to provide to guarantors.

9.26 A number of submissions argued for the provision to guarantors of consumer and small business loans with the latest relevant statements concerning the borrower's accounts.<sup>33</sup> It was said that the voluntary nature of the guarantee relationship was a strong reason for providing guarantors with information concerning the status of the loan.<sup>34</sup> Some submissions considered s 34 of the Consumer Credit Code to be an acceptable model.<sup>35</sup>

#### *The Commission's conclusion*

9.27 A guarantor's liability is contingent on the performance by the borrower of his or her obligations under the loan contract. Amounts that are due and unpaid can potentially trigger the enforcement of the guarantee. The borrower's current balance, especially at the time of default, may have a significant impact on the extent of the guarantor's liability. It is, therefore, in the guarantors' interests to keep themselves abreast of the progress of the loan that they have agreed to guarantee. There is probably a stronger argument for providing guarantors of small business loans with regular statements of amounts owing because the amounts involved are often much larger than consumer loans, and may fluctuate, and advances and repayments could be less regular. The common law remains unclear regarding the right of guarantors to acquire information about the status of the guaranteed loan, and the scope and limitations of such right, if it exists. As a consequence, both lenders and guarantors seem unaware or are confused about their specific obligations and entitlements in this context. For example, a guarantor who took part in the Lovric and Millbank study reported being told by the bank that she could not have access to information on the amount of debt then outstanding. It was only after she

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31. Credit Union Code of Practice (1994) s 17.6(iii).

32. Code of Banking Practice (2004) cl 28.4(v). Emphasis supplied.

33. Women's Legal Resources Centre, *Submission* at 7-8; NSW Department of Fair Trading, *Submission* at 5; Women Lawyers Association, *Submission* at 4; NSW Legal Aid Commission, *Submission* at 15; St George Bank, *Submission* at 4. See also Country Women's Association of NSW, *Submission* at 2; Financial Counsellors' Association of NSW, *Submission* at 3.

34. NSW Legal Aid Commission, *Submission* at 15.

35. St George Bank, *Submission* at 3; Australian Finance Conference, *Submission* at 15.

approached the bank on a subsequent occasion and this time armed with advice from the NSW Legal Aid Commission that the bank gave the information she needed.<sup>36</sup>

9.28 To provide clarity and consistency to all parties involved, the Model Law should contain provisions on the right of guarantors to obtain information from credit providers during the life of the contract of guarantee. Those provisions should be in terms similar to s 34 of the Consumer Credit Code as to what information guarantors can access and the circumstances under which credit providers should be required to make the disclosure. The Model Law should further provide that, if a credit provider fails to provide a statement within the time required, the court may, on application by the guarantor, order the credit provider to provide the statement or itself determine the amounts in relation to which the statement was sought.

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36. Lovric and Millbank at para 6.9.



## RECOMMENDATION 9.4

The Model Law should provide that guarantors should have a right to obtain information from lenders during the life of the guarantee, in terms similar to s 34 of the *Consumer Credit Code*. Further, the Model Law should contain a provision (similar to s 35 of the *Consumer Credit Code*) that, if a lender fails to give a statement within the time required, the court may, on application by the guarantor, order the lender to provide the statement or itself determine the amounts in relation to which the statement was sought.

### Notice of the Borrower's Default

9.29 The final type of information which guarantors should be entitled to receive from credit providers concerns default by borrowers. This is of utmost importance because it is the borrower's default that triggers the guarantor's liability and entitles the credit provider to enforce the guarantee. This matter is considered in Chapter 10.<sup>37</sup>

### Guarantor's access to information and the *Privacy Act 1988* (Cth)

9.30 Section 18N of the *Privacy Act 1988* (Cth) ("Privacy Act") regulates disclosure by credit providers of personal information in their possession or control. Section 18N(1) provides that a credit provider must not disclose a report that is in or has been in its possession or control, or personal information derived from the report. The term "report" is defined in s 18N(9) as including a record or information that has any bearing on an individual's credit-worthiness, credit standing, credit history or credit capacity. It is arguable that a copy of the credit contract which a credit provider will be required to give to a guarantor under Recommendations 6.1, as well as the information regarding the loan which a guarantor will have access to pursuant to Recommendation 6.3, would fall within the definition of the term "report", for purposes of s 18N of the *Privacy Act*, because they constitute information that have a bearing on the borrower's credit history. The issue that arises is whether State legislation implementing these recommendations would be inconsistent with s 18N(1) of the *Privacy Act*. If so, such legislation would be inoperable pursuant to s 109 of the *Constitution*, which provides that when a law of the State is inconsistent with the law of the Commonwealth, the latter shall prevail.

9.31 Section 18N(1) is, however, subject to a number of exceptions. Particularly relevant to the issue is s 18N(1)(g), which allows disclosure of personal information if it is required or authorised by or under law. For the reasons outlined in Chapter 6, the Commission is of the view that the term "law" in s 18N(1)(g) includes State legislation.<sup>38</sup> Consequently, statutory provisions implementing Recommendations 6.1 and 6.3, which require disclosure by lenders to guarantors of personal information about borrowers, would not be inconsistent with the *Privacy Act*.

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37. See para 10.11-10.19.

38. See para 6.17-6.29.

## CHANGES TO OBLIGATIONS

9.32 The general law provides for a guarantor's discharge from liability if the principal contract is changed in such a way that the guarantor could be prejudiced, whether or not the variation has in fact resulted in prejudice. If the borrower and lender, without the guarantor's consent, "agree between themselves to alter the nature of the [principal] obligation the guarantor is discharged because the obligation in its altered form is not that which he guaranteed".<sup>39</sup> However, the guarantor will remain liable where the alteration to the principal contract is either beneficial to the guarantor or is "obviously unsubstantial", that is, it cannot by its nature increase the risk of the guarantor.<sup>40</sup> Examples of variations that will not discharge the guarantee are reductions in the borrower's debt or in the interest payable by the borrower.

9.33 The principal contract may contemplate and provide for variation of its terms. An example is a mortgage permitting a variation in the interest rate. In such a case, a variation in the liabilities under the principal contract will not discharge the guarantor because there is a guarantee of a contract whose terms are not fixed and may vary from time to time.<sup>41</sup> Alternatively, the contract of guarantee may itself allow variations to the principal contract. It may have this clause for example: "we agree that the guarantee shall not be avoided, released, or affected by the creditor making any variation or alteration in the terms of the principal agreement". A clause of this nature will ensure that the guarantor continues to remain liable even if substantial changes to the principal loan are made.<sup>42</sup> Another example is the "all moneys" clause, which is discussed in detail in Chapter 8.

9.34 Where there is no provision in the guarantee or in the loan contract preserving the liability of the guarantor in case of variations, the guarantor may still consent to changes. The general law does not prescribe a form of the guarantor's consent, that is, it does not have to be in writing. In fact, the guarantor's consent need not be express but may be inferred from the circumstances of the case. For example, in a case where the guarantor was a director of the borrower company and negotiated with the lender for the variation of the debt, the court rejected his argument that he did not assent to the variation in his capacity as a guarantor but only in his capacity as a director of the principal company.<sup>43</sup> Further, the issue of whether lenders are required to disclose to the guarantor all the material facts concerning the variation remains unsettled at common law.<sup>44</sup>

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39. *Hancock v Williams* (1942) 42 SR (NSW) 22 at 255 (Jordan CJ).

40. *Ankar Pty Ltd v National Westminster Finance (Australia) Pty Ltd* (1987) 162 CLR 549; *Bond v Hongkong Bank of Australia Ltd* (1991) 25 NSWLR 286.

41. J O'Donovan and J Phillips, *The Modern Contract of Guarantee* (3rd edition, LBC Information Services, North Ryde NSW, 1996) at 346.

42. See for example *British Motor Trust Ltd v Hyams* (1934) 50 TLR 230.

43. *Winstone Ltd v Bourne* [1978] 1 NZLR 94.

44. It is possible that Australian courts may require a lender to give the guarantor a detailed explanation of the type of variation envisaged: J O'Donovan and J Phillips *The Modern Contract of Guarantee* (3rd edition, LBC Information Services, North Ryde NSW, 1996) at 353.

## Increase in liabilities

9.35 For guarantees that relate to credit contracts taken out for consumer purposes, s 56(1) of the Consumer Credit Code provides:

*56. (1) If the terms of a credit contract are changed to increase or allow for an increase in liabilities, the liabilities of a guarantor under a guarantee that secures those liabilities are not increased unless-*

*the credit provider gives to the guarantor a written notice setting out particulars of the change in the terms of the credit contract; and*

*the credit provider has subsequently obtained from the guarantor a written acceptance of the extension of the guarantee to those increased liabilities or obtained acceptance in some other form provided for by the regulations.*

9.36 Section 56 does not apply to some changes, including: a new percentage rate where the new rate is ascertainable from the contract; an increase in the amount of repayments, where the increase occurs automatically and the amount of the increase is ascertainable from the contract; change in the amount, frequency or time for payment of instalments; change in the method of calculation of instalments; increase in fees and charges.<sup>45</sup> These increases occur as a result of a right reserved to the credit provider by the contract to make the particular changes.

9.37 Unlike the common law, s 56 requires the credit provider to notify the guarantor of changes to the principal contract that result in an increase in liabilities. Moreover, the guarantor's consent to the changes must be given expressly and in writing. The enhanced protection to guarantors contained in this section ought to be a starting point for the Model Law. However, the Commission is of the view that the provisions of the Consumer Credit Code should be expanded in the manner suggested in the following paragraphs.

9.38 First, there is a need to clarify the nature of the information the lender needs to give to the guarantor. There is uncertainty regarding the requirement to give the guarantor "particulars of the change in the terms of the contract". It is likely that giving the guarantor a copy of the revised credit contract would satisfy this requirement. This may not, however, adequately inform the guarantor about the proposed changes: the document may not even mean anything to the guarantor. We consider that, in addition to furnishing the guarantor a copy of the proposed revised contract, the lender must also explain in plain language the details of the changes, in particular the old and new positions. In other words, the written notice should include details of the existing term of the contract to be changed (for example, the original amount of loan or current interest rate option) and details of the terms as changed (for example, the new loan amount or revised interest option). The lender should disclose all the material facts concerning the proposed variation to make the guarantor understand the full implications of the changes and enable him or her to make an informed decision.

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45. See *Consumer Credit (New South Wales) Code* s 56(2) in relation to s 58(2)(a), 58(2)(b), 59-61.

9.39 Secondly, s 56 of the Consumer Credit Code is silent on when the requirements it contains must be met. Can the lender notify the guarantor after it has already settled the variations to the principal contract with the borrower? Would a guarantor's acceptance after the variation has been made be effective to preserve the contract of guarantee? A liberal construction of the section would allow a lender to secure compliance with both requirements after it has already agreed with the borrower for an increase in liabilities. The better approach is for the lender to comply with these requirements before settling with the borrower the proposed increase in liabilities.

9.40 Thirdly, where a guarantor does not agree to the increase in liabilities but the lender and borrower go ahead with the changes in any event, the Model Law should provide that the guarantor will *not* be liable for the increased amount but his or her liability for the amount originally guaranteed remains. This would be a departure from the common law position under which the guarantee in its totality would be discharged.<sup>46</sup>

## RECOMMENDATION 9.5

The Model Law should contain provisions governing increases in liabilities similar to those in s 56 of the *Consumer Credit Code*, subject to some clarifications. First, the lender must give the guarantor, in addition to a copy of the proposed revised contract, a written notice explaining in plain language all the material facts concerning the proposed changes in the loan transaction to which the guarantee relates. Secondly, the lender must comply with these requirements before the changes have been settled with the borrower. Finally, failure by the lender to comply with these requirements should result in the guarantor not being liable for the increased amount although remaining liable for the amount originally guaranteed.

### Changes by agreement

9.41 Section 65 of the Consumer Credit Code requires a credit provider to notify the relevant parties of agreed changes to a credit contract, mortgage or guarantee. It contains what is essentially a post-change notice requirement intended to reinforce the Code's protections to guarantors and which therefore ought to be adopted in the Model Law. Its subsection (1) provides:

*If the parties under a credit contract, mortgage or guarantee agree to change its terms, the credit provider must, no later than 30 days after the date of the agreement, give to the other party under the agreement a written notice setting out—*

*(a) particulars of the change in the terms of the credit contract, mortgage or guarantee; and*

*(b) any information required by the regulations.*

*Maximum penalty — 100 penalty units.*

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46. See para 9.32.

9.42 Under the original provision, the time frame for a credit provider to give notice was "within 30 days" after the date of the agreement. The phrase "within 30 days" was replaced in 1998 with "no later than 30 days". The phrase "within 30 days" has been construed as indicating that the day of the agreement is excluded, the next day is the first day of the period, and the time expires on the last day of the period.<sup>47</sup> In contrast, the expression "no later than 30 days" means a clear or full period of 30 days must elapse between the two events, so the day on which the agreement was made and the last day of the 30 day period are excluded from the calculation.<sup>48</sup> The outcome is that under the 1998 amendment, a credit provider has a slightly longer time within which to comply with the obligation.

9.43 Section 65(2) provides that subsection (1) does not apply to

- a change which defers or otherwise reduces the obligations of the debtor for a period not exceeding 90 days, or
- an agreement to increase the amount of credit under the credit contract.

9.44 In the second situation, although the credit provider need not give a post-change notice under s 65(1), it will need to comply with the requirements set out in s 56, discussed above, including a notice of the changes. By Recommendation 9.5, the notice requirement in the Model Law that is intended to mirror s 56 will need to be given to the guarantor prior to the proposed changes becoming effective. Under the Model Law, in the case of an agreed increase in the amount of the loan, the credit provider must notify and obtain the consent of the guarantor concerning the proposed increase; but the credit provider need not give the guarantor a further notice after the agreement to increase the loan is made.

9.45 For purposes of the Model Law, s 65 should be improved as regards the contents of the notice. Section 65(1) provides that the notice must include "particulars of the change in the terms of the credit contract, mortgage or guarantee". However, s 65(3) allows the credit provider to give a person particulars only of a matter as changed instead of particulars of the change if the credit provider:

- makes it clear to the person that the matter has changed; or
- issues to the person a new set of terms and conditions relating to the credit provider a new set of terms and conditions.

That means, in most cases, a credit provider can simply give the guarantor a copy of the revised credit contract. This may not, however, adequately inform guarantors about the changes. The revised document, which is often in technical language, may not mean anything to the guarantor. Consistent with Recommendation 9.5, the notice of the changes must explain in plain language all the material facts concerning the proposed changes to the guarantee. That is, in addition to furnishing the guarantor a copy of the proposed revised contract, the credit provider should also explain in plain language the details of the changes, in particular the old and new positions.

## RECOMMENDATION 9.6

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47. *Morton v Hampson* [1962] VR 364 at 365.

48. *Forster v Jododex Australia Pty Ltd* (1972) 127 CLR 421 at 444 (Gibbs J).

The Model Law should adopt s 65 of the *Consumer Credit Code* concerning the notice requirement in relation to changes by agreement to the credit contract or guarantee. It should, however, state that in every case the written notice must explain in plain language all the material facts concerning the changes.

## Unilateral changes

9.46 Section 63 of the Consumer Credit Code governs unilateral changes to the terms of the guarantee by the credit provider where the guarantee contains a provision authorising the credit provider to do so.

*63. (1) A credit provider must not exercise a power under a credit contract, mortgage or guarantee to unilaterally change its terms without giving the other party, not less than 20 days before the change takes effect, written notice setting out-*

*particulars of the change in the terms of the contract, mortgage or guarantee; and*

*any information required by the regulations.*

*Maximum penalty – 100 units*

*(2) Subsection (1) does not apply to a change that reduces the obligations of the debtor, or extends the time for payment, under the credit contract. The credit provider must, however, give particulars of any change before or when the next statement of the account is sent to the debtor after the change takes effect.*

*Maximum penalty – 100 penalty units.*

9.47 This section does not apply to a number of provisions of the Consumer Credit Code containing different notice requirements that are mainly relevant to and designed for the benefit of the debtor.<sup>49</sup>

9.48 It has been suggested that it is unusual for a guarantee to contain a provision empowering the credit provider to make unilateral changes to the terms of the guarantee.<sup>50</sup> Nevertheless, the Model Law should have provisions similar to those in s 63 to regulate such situations, rare as they might be. However, the provision in s 63 concerning the contents of the notice - that it should contain “particulars of the change” - needs to be modified. Consistent with Recommendations 9.5 and 9.6, the Model Law should state that the notice must explain in plain language all the material facts concerning the proposed changes to the guarantee.

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49. See *Consumer Credit (New South Wales) Code* s 63(3).

50. *Consumer Credit Legislation Commentary* (CCH Australia Limited, Sydney, 2004) at ¶39-420.

## RECOMMENDATION 9.7

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The Model Law should contain provisions regulating unilateral changes by the lender to the terms of the guarantee, similar to those found in s 63 of the *Consumer Credit Code*. It should, however, clarify that the written notice should explain in plain language all the material facts concerning the proposed changes.

# 10. Termination and enforcement

- Introduction
- Termination by early repayment
- Notice of the borrower's default
- Pursuing the borrower before the guarantor
- Enforcement costs



## INTRODUCTION

10.1 In this chapter, the Commission deals with issues relating to the termination and enforcement of guarantees. First, we look at whether guarantors should be allowed to pay out early the guaranteed loan as a means of discharging the contract of guarantee. Secondly, we examine whether lenders should be obliged to notify guarantors of default by the borrower, and in particular whether this should be a pre-requirement to the commencement of legal proceedings to enforce the guarantee. Thirdly, we explore whether lenders should be required to exhaust their remedies against borrowers prior to the enforcement of guarantees. Finally, we analyse the extent to which lenders should be allowed to recover from guarantors the costs incurred in enforcing the guarantee.

## TERMINATION BY EARLY REPAYMENT

### General law

10.2 At common law, a debtor (including a mortgagor or guarantor) does not have a right to pay out a loan prior to the due date.<sup>1</sup> A tender of repayment early is an attempt to vary the contract. "It is...settled law that if A agrees with B in consideration of a loan from B to A to repay that loan with interest on a fixed future date, B cannot sue A for repayment of the loan before the arrival of that date, nor can A compel B to accept repayment of it before that date has arrived."<sup>2</sup>

### Consumer Credit Code

10.3 Section 75(1) of the *Consumer Credit (New South Wales) Code* ("Consumer Credit Code") has changed the law with respect to consumer contracts by granting a debtor or guarantor the right to pay out a credit contract at any time. The parties cannot contract out of this right.<sup>3</sup>

10.4 Section 75(2) provides the amount required to pay out a credit contract, which is the total of:

- the amount of credit;
- interest charges and all other fees and charges payable by the debtor to the credit provider up to the date of termination;
- reasonable enforcement expenses;<sup>4</sup> and
- early termination charges, if provided for in the contract;

less any payments made under the contract and any rebate of premiums under s 138. These rebates are rebates under credit-related insurance contracts financed under the contract for consumer credit insurance.

10.5 Section 75(2) does not apply to continuing credit contracts, which are contracts under which multiple advances of credit are contemplated and the amount of available credit ordinarily increases as the amount of credit is reduced.<sup>5</sup> The guarantor in this

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1. *Hyde Management Services Pty Ltd v FAI Insurance Ltd* (1979) 144 CLR 541.  
 2. *Knightsbridge Estates Trust Ltd v Byrne* [1938] Ch 741 at 756 (Luxmore J).  
 3. *Consumer Credit (New South Wales) Code* s 169.  
 4. See para 10.42-10.52.  
 5. See *Consumer Credit (New South Wales) Code* Sch 1 cl 1(1).

situation could request the credit provider to provide a statement under s 34 of the Consumer Credit Code, discussed in Chapter 9,<sup>6</sup> which would indicate the current balance of the debtor's account. However, the statement given under s 34 is arrived at by reference to past transactions and would not determine the amount required to be paid at a future date. Moreover, it does not include early termination fees and other fees that are debited to the account on the date the current balance is given. Consequently, the guarantor of a continuing credit contract just has to work out (with the cooperation of the financial institution) the pay out amount.

10.6 Section 76 assists a debtor or guarantor to exercise the right granted by s 75(1) by granting them the further right to require the credit provider to furnish a statement containing information of the pay out figure as at a particular date and the items which comprise that figure. The amount required to pay out the contract supplied in accordance with this section will be the same amount specified in s 75(2). The statement must also include a qualification to the effect that the amount required to pay out the credit contract may change according to the date on which it is paid. The statement must be provided within seven days after the request. In the case of joint debtors and guarantors, the statement need only be given to a debtor or guarantor who requests it. The maximum penalty for contravention of s 76 is \$5,000.

10.7 The disclosure of this information to a guarantor is outside the general prohibition imposed upon credit providers from providing reports or any personal information derived from reports to other people since it is either a disclosure required or authorised by law pursuant to s 18N(1)(g) of the *Privacy Act 1988 (Cth)*;<sup>7</sup> or a disclosure to a person who is considering discharging the debt owed by the debtor pursuant to s 18N(1)(bf) of that Act. Alternatively, if the debtor has agreed to the guarantor receiving the information, its disclosure is allowed under s 18N(1)(bg)(i) of the *Privacy Act 1988 (Cth)*.

10.8 If the credit provider does not provide a statement of the amount required to pay out a credit contract, s 77 of the Consumer Credit Code empowers a court, on application of the debtor or guarantor, to determine the amount payable, the amount by which it increases daily and the period for which the determination is applicable. The credit contract will be discharged if an amount calculated in accordance with the determination by the court is tendered to the credit provider within the applicable period.

## Industry codes of practice

10.9 The Code of Banking Practice ("Banking Code") and Credit Union Code of Practice have identical provisions allowing a guarantor to extinguish at any time his or her liability to a bank or credit union under a guarantee by paying the then outstanding liability of the borrower (including any future or contingent liability) or any lesser amount to which the liability of the guarantor is limited by the terms of the guarantee or by making other arrangements satisfactory to the bank or credit union.<sup>8</sup> Unlike s 75 of the Consumer Credit Code, the provisions in the various industry codes of practice apply to guarantees given in relation to small business loans. They do not, however, have the force and effect of law.

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6. See para 9.21-9.24.

7. See para 6.17-6.29, 9.30-9.31.

8. Code of Banking Practice (2004) cl 28.10; Credit Union Code of Practice (1994) s 17.7.

## The Commission's conclusion

10.10 Guarantors of both consumer and small business loans should be given a statutory right to pay out the loan they guaranteed as a means of discharging a possible future liability. The Consumer Credit Code provisions on the matter provide a very useful model to follow in the Model Law. They assist lenders and guarantors by giving a formula for calculating the amount required to pay out the credit contract. Further, they grant guarantors a right to require lenders to furnish information on the pay out figure or if the lender fails to provide such information, to apply to the court to determine the amount payable.

## RECOMMENDATION 10.1

The Model Law should give guarantors within its ambit the right to pay out the guaranteed loan as a means of discharging the guarantee, in terms similar to s 75-77 of the *Consumer Credit Code*.

### NOTICE OF THE BORROWER'S DEFAULT

10.11 At common law, the lender is not obliged to notify the guarantor of the borrower's default,<sup>9</sup> unless notification is required by the terms of the guarantee.<sup>10</sup> The rationale given by courts for the rule is that the guarantor, in undertaking the obligation, must realise that there is a risk that the borrower will not perform his or her contractual obligations and the burden is therefore on the guarantor to ascertain when the default has occurred.<sup>11</sup> The present state of the law is very likely a significant reason for the failure of many guarantors to learn of the borrower's default until it is too late to remedy the situation, usually when the bank has commenced court action to enforce the guarantee.<sup>12</sup> For guarantees relating to consumer transactions, s 80(1) of the Consumer Credit Code has changed the common law by requiring a credit provider to give the debtor and guarantor a default notice.<sup>13</sup>

10.12 The Banking Code and the Credit Union Code of Practice require the signatory banks and other financial institutions to send to a guarantor a copy of any notice of demand made on the borrower.<sup>14</sup>

10.13 The fact that the general law does not require lenders to notify guarantors of the borrower's default may be criticised on the basis that, if the guarantor were informed of the situation, he or she might be able to take steps to remedy the situation and prevent the guarantee from being enforced. The Law Reform Committee of South Australia made this observation:

*The giving of notice to the surety immediately on the default of the debtor would alert him to the situation as between himself and the principal debtor. In many cases, he could call on the principal debtor to pay, with some hope*

9. *Commercial Bank of Australia Ltd v Colonial Finance, Mortgage, Investment & Guarantee Corp Ltd* (1906) 4 CLR 57 at 70 (O'Connor J). See also *Coffey v DFC Financial Services Ltd* (New Zealand Court of Appeal, No 255/89, 2 October 1991, unreported).
10. See for example *Eshelby v Federated European Bank Ltd* [1932] 1 KB 423.
11. *Thomas Fuller Construction Co (1958) Ltd v Continental Insurance* (1970) 36 DLR (3d) 336 at 353.
12. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* (NSW Law Reform Commission and the University of Sydney, Research Report 11, 2003) ("Lovric and Millbank") at para 6.9, 6.10-6.14.
13. A credit provider need not give a default notice before commencing enforcement proceedings against the debtor if: (1) it made reasonable attempts to locate the debtor without success; (2) it believes on reasonable grounds that it was induced by fraud into entering into the credit contract; (3) it believes on reasonable grounds the debtor or mortgagor has removed or disposed of mortgaged goods under a mortgage related to the credit contract; or (4) the court authorised it to commence the enforcement proceedings: *Consumer Credit (New South Wales) Code* s 80(4).
14. Code of Banking Practice (2004) cl 28.4(b)(i); Credit Union Code of Practice (1994) s 17.6(ii).

*at that stage of getting payment by the debtor in whole or in part and if he could not do that he would be able to help himself.*<sup>15</sup>

10.14 A change in the general law finds support in a number of submissions, which have advocated a requirement for lenders to advise the guarantor of the borrower's default.<sup>16</sup> One submission suggested that there is widespread expectation by guarantors that they will be notified when the borrower gets into trouble paying the debt and this is a strong reason to support such a view.<sup>17</sup> On the other hand, the Australian Finance Conference reported that its members' practice is to inform guarantors about a default as soon as the default occurs and requiring such a procedure in legislation would be unnecessary.<sup>18</sup>

## The Commission's position

10.15 As noted above, s 80(1) of the Consumer Credit Code requires credit providers to give guarantors of consumer transactions notice of the debtor's default. A similar requirement should be contained in the Model Law. Guarantors should be notified of borrower's default regardless of whether the loan subject of the guarantee is for consumer or small business purposes. This is to give guarantors the opportunity to prevent their liability from arising by either assisting the borrower to remedy the default or attending to the default themselves before the situation worsens.

10.16 Section 80(1) cannot, however, be adopted wholesale in the Model Law because it is, on its face, primarily directed at the debtor. This is apparent in two important aspects - the content and effect of the notice. First, the notice must inform the debtor of the default, what action on his or her part is necessary to remedy it, and that a subsequent default of the same kind may be the subject of enforcement proceedings without further notice. The guarantor is simply given a copy of this notice without an explanation of its significance to the guarantee or what action the guarantor may take to prevent his or her liability from arising.

10.17 Secondly, s 80(1) specifies the purpose of the default notice as a pre-requisite to the initiation of enforcement proceedings against the borrower. The effect of s 80(1) is that, even if a credit provider has no present intention of taking action against a guarantor, the credit provider must give notice to the guarantor as a pre-condition of taking proceedings against the borrower. However, there is no similar restriction, requiring a preliminary default notice, on the right of the credit provider to institute enforcement proceedings against a guarantor, though the guarantor will have received the default notice given to the borrower, in accordance with s 80(1). The restrictions in the Consumer Credit Code on enforcement against a guarantor, contained in its s 82 and discussed

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15. Law Reform Committee of South Australia, *Relating to the Reform of the Law of Suretyship*, Report No 39 (1977) at 8.

16. Commonwealth Bank, *Submission* at 9-10; Country Women's Association of NSW, *Submission* at 2; Financial Counsellors' Association of NSW, *Submission* at 4; NSW Department of Fair Trading, *Submission* at 5, 6; NSW Legal Aid Commission, *Submission* at 15; Ryde-Eastwood Financial Counselling Service, *Submission* at 7; Women Lawyers Association of NSW, *Submission* at 4, 8; Women's Legal Resources Centre, *Submission* at 8, 10.

17. NSW Legal Aid Commission, *Submission* at 15.

18. Australian Finance Conference, *Submission* at 19. The Australian Finance Conference is Australia's national finance industry association. Its membership includes some banks, building societies and companies in the business of credit, finance or financiers.

below,<sup>19</sup> are concerned with the enforcement of judgements. They are not preliminary to the commencement of action.<sup>20</sup>

10.18 The notice to be included in the Model Law, which would naturally be intended for the benefit of the guarantor, should not only contain a copy of the notice given to the borrower but also explain in plain language the implications of the borrower's default on the guarantee and the action that the guarantor may take to prevent the enforcement of his or her liabilities. The form and details of the notice may be prescribed by regulations implementing the proposed legislation.

10.19 Moreover, the Model Law should spell out the effect of such notice - that it is a pre-condition to the commencement of legal proceedings to enforce the guarantee. In other words, a failure to notify the guarantor of the borrower's default should prevent the lender from taking any enforcement action against the guarantor.

## RECOMMENDATION 10.2

The Model Law should provide that lenders be required to notify guarantors regarding the borrowers' default. The notice, which should be accompanied by a copy of the default notice given to the borrower, should explain in plain language the effects on the guarantee of the borrower's default. It should be given simultaneously with the service of the default notice on the borrower. The Model Law should provide that the notice is a pre-condition to the commencement of legal proceedings to enforce the guarantee.

## Remedying the borrower's default

10.20 Section 81 of the Consumer Credit Code provides:

*(1) If a default notice states that the credit provider intends to take action because the debtor or mortgagor is in default under the credit contract or mortgage, the debtor, mortgagor or guarantor may remedy the default within the period specified in the notice, and the contract or mortgage is then reinstated and any acceleration clause cannot operate.*

*(2) A debtor, mortgagor or guarantor does not remedy the default if, at the end of the period, the debtor or mortgagor is in default under the credit contract or mortgage because of the breach specified in the notice or because of a subsequent breach of the same type.*

10.21 Subsection (1) confirms the right contained in s 80 of the debtor, mortgagor or guarantor to remedy a default after receipt of the default notice and clarifies what happens when that right is exercised. The reinstatement of the credit contract prevents the credit provider from enforcing the guarantee. Subsection (2) reiterates the right contained in s 80 of the credit provider to take enforcement action in relation to a subsequent default.

## RECOMMENDATION 10.3

19. See para 10.24-10.25.

20. See D McGill and L Willmont, *Annotated Consumer Credit Code* (LBC Information Services, Pyrmont NSW, 1999) at 590.

The Model Law should adopt s 81 of the *Consumer Credit Code* concerning the consequences of the exercise by a guarantor of his or her right to remedy the borrower's default.

## PURSuing THE BORROWER BEFORE THE GUARANTOR

### The current law

10.22 At common law, the general rule is that a guarantor who has not paid the principal debt cannot require the lender to proceed against the borrower, before having recourse to the guarantor.<sup>21</sup> It matters not that the borrower remains solvent and would therefore be in a position to discharge the debt.<sup>22</sup> Nor, subject to the terms of the contract, is it necessary for the lender to resort to any securities given for the debt by the borrower.<sup>23</sup> The doctrine is based on the proposition that it is the duty of the guarantor, not the lender, to ensure that the debtor performs the principal obligation.<sup>24</sup> It is also at least arguable that a lender should not be prevented from pursuing a right to take available legal action against any person who remains his or her debtor.<sup>25</sup>

10.23 The general rule is, however, subject to any contrary provision in the contract of guarantee, which may require the lender to exhaust any particular remedy against the borrower before the enforcement of the guarantee. It has been held, for example, that by the terms of the particular contract, it was a pre-condition to the recovery from the guarantor that "utmost efforts or legal proceedings" be taken against the borrower.<sup>26</sup>

10.24 Section 82 of the Consumer Credit Code modifies the common law by providing that the credit provider must not enforce a judgment against a guarantor unless:

- the credit provider has obtained judgment against the debtor and the judgment has remained unsatisfied for 30 days after a written demand for payment;
- the court has relieved the credit provider from the obligation to obtain a judgment against the debtor on the ground that recovery is unlikely;
- the credit provider has made reasonable attempts to locate the debtor but without success; or
- the debtor is insolvent.

10.25 Section 82 of the Consumer Credit Code only limits the enforcement of judgments against guarantors. It does not prevent a lender from suing the guarantor before proceeding against the borrower with the consequent exposure to costs. It does not bar the exercise of self-help remedies by the lender against the borrower. Hence, a bank may make a demand for payment by the guarantor without first approaching the borrower. Further, the section applies only to a guarantee that relates to a loan that is provided to a natural person and intended (wholly or predominately) for personal, domestic or

21. *Jackson v Digby* (1854) 2 WR 540; *Moschi v Lep Air Services Ltd* [1973] AC 331.

22. *Belfast Banking Co v Stanley* (1867) IR 1 CL 693; *Re Brown's Estate, Brown v Brown* [1893] 2 Ch 300.

23. *Wilks v Heely* (1832) 1 Cr & M 249, 149 ER 393; *Re Howe; Ex parte Brett* (1871) LR 6 Ch App 838 at 841 (Sir G Mellish LJ).

24. *Moschi v Lep Air Services Ltd* [1973] AC 331.

25. J O'Donovan and J Phillips, *The Modern Contract of Guarantee* (3rd edition, LBC Information Services, North Ryde NSW, 1996) at 537-538.

26. *Hall v Hadley* (1828) 5 Bing 54, 130 ER 980; *Union Bank of Australia Ltd v Barry* (1897) 23 VLR 505.

household purposes.<sup>27</sup> It is, therefore, largely inapplicable to the majority of guarantees, which are given to support small business borrowing.<sup>28</sup>

10.26 Clause 28.14 of the Banking Code mirrors s 82 of the Consumer Credit Code. Notwithstanding the recent reviews of and amendments to the Banking Code, this section expressly excludes from its application guarantees that support small business loans. The Credit Union Code of Practice does not contain equivalent provisions.

## Arguments for and against reform

10.27 Where the lender has other security for the principal debt, or where the borrower is solvent or has assets within the jurisdiction of the court, the lender has ample means to recover from the party primarily responsible for the debt. It may be argued that allowing the lender to take the option of pursuing guarantors without making reasonable attempts to recover from the borrower constitutes an unfair balancing of the rights of the parties to the transactions. For some lenders, this issue is a matter of expedience and convenience: for example, they may find guarantors who own their home easier to pursue than more mobile borrowers.<sup>29</sup> But this often results in hardship for guarantors, who may not even derive any material benefit from their undertaking.

10.28 It is true that a guarantor has a right to pursue the borrower for reimbursement of any money paid to the lender once the guarantee has been called up. However, since many guarantors undertake obligations for a close family member, they may not seek to enforce such right because this may risk further straining relationships. More importantly, guarantors do not always have sufficient resources to take action against the borrower. Hence, a guarantor's right to be reimbursed by the borrower can become illusory.

10.29 On the other hand, there are theoretical and practical arguments for the rule granting lenders a choice of going after either the borrower or guarantor. A guarantee is traditionally seen as imposing an obligation on the guarantor to see to it that the borrower performs his or her obligation, and failing this, the lender's cause of action against the guarantor arises immediately on the borrower's default.

10.30 In addition, it is arguable that a change in the law may diminish the attractiveness and utility of the guarantee by imposing upon the lender the delay and burden of pursuing the borrower first. The lender may have taken the guarantee for the precise purpose of avoiding this expense and inconvenience. Granting the guarantor a right to require the lender to exhaust its remedies against the borrower first could escalate the cost of enforcing a guarantee with no benefit to the lender.<sup>30</sup>

## The Commission's conclusion

10.31 The historical notion that it is the guarantor's duty to see to it that the borrower performs his obligations to the lender has long been regarded as "fictitious and unrealistic".<sup>31</sup> In today's business setting, where banks and other financial institutions have vast resources that enable them to enforce the transactions they have entered into with their customers, the burden of ensuring that the borrower performs the principal obligation should be on the lender and not on the guarantor. Where the lender has avenues for

27. *Consumer Credit (New South Wales) Code 1995* (NSW) s 6.

28. See Lovric and Millbank ch 2.

29. NSW Legal Aid Commission, *Submission* at 17-18.

30. O'Donovan and Phillips *The Modern Contract of Guarantee* (3rd edition, LBC Information Services, North Ryde NSW, 1996) at 542.

31. *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245 at 256 (Mason CJ).



recovering directly from the borrower, either because the borrower has sufficient assets for this purpose or the lender holds other security for the debt, allowing the lender to pursue the guarantor without making reasonable steps to recover from the borrower constitutes an unfair balancing of the rights and obligations of the various parties.

10.32 Section 82 of the Consumer Credit Code has shifted the balance in favour of guarantors of consumer loans but it may be argued that it has not gone far enough. It relates only to enforcement of judgments. As a result, a lender is free to institute legal proceedings against the guarantor before taking steps to recover from the borrower.

10.33 An alternative approach for purposes of the Model Law is that contained in s 138 of the *Credit Act 1984* (NSW), the Consumer Credit Code's predecessor, which stated:

*138. (1) A credit provider shall not bring proceedings to recover an amount from a guarantor in respect of a regulated contract unless the credit provider brings proceedings against both the debtor and the guarantor to recover the amount or unless the credit provider has obtained judgment against the debtor and a written demand made on the debtor for satisfaction of the judgement has remained unsatisfied for not less than 30 days.*

*(2) Where, in proceedings to recover an amount in respect of a regulated contract, judgment is given against both a debtor and a guarantor, the judgment is not enforceable against the guarantor unless a written demand made on the debtor for satisfaction of the judgment had remained unsatisfied for not less than 30 days.*

*(3) Subsections (1) and (2) do not apply if:*

*(a) the debtor is a bankrupt...;*

*(b) the court believes on reasonable grounds that it is not reasonably likely that any part of a judgment obtained against the debtor would be satisfied and has, on application of the credit provider, declared that subsections (1) and (2) do not apply in that case;*

*(c) the creditor is unable to locate the debtor after having made reasonable inquiries (including inquiries of the guarantor) as to the whereabouts of the debtor and has given the guarantor 14 days notice in writing in the prescribed form of the intention to bring proceedings against the guarantor.*

10.34 By instituting conditions for the commencement of proceedings against guarantors, this section embodied a more emphatic policy than that found in s 82 of the Consumer Credit Code of ensuring that the lender must try to exhaust its remedies against the borrower before enforcing the guarantee. However, it also recognised that it may be inefficient and costly to require a lender to sue the borrower first and then bring separate proceedings against the guarantor later. Hence the limitation upon the bringing of proceedings against the guarantor, which either require action to be brought joining both the borrower and guarantor, or the existence of an unsatisfied judgment obtained in earlier proceedings against the borrower.

10.35 Such a requirement was also consistent with the rules regarding the ability of a guarantor to rely on cross claims and defences which the borrower has against the lender. Where a borrower's claim against the lender is for unliquidated damages in respect of the guaranteed transaction, the guarantor cannot plead the claim as a defence to an action on

the guarantee if the borrower is not joined as a party to the proceedings, unless the borrower is insolvent.<sup>32</sup> The requirement in s 138 of the *Credit Act 1984* (NSW) for the lender to bring a joint action against the borrower and guarantor ensured that all the claims among the borrower, lender and guarantor were heard and determined together so that the rights of all parties would be protected.

10.36 Moreover, the exceptions to the general rule in s 138 of the *Credit Act 1984* (NSW) contained requirements that were more specific and stringent than those found in s 82 of the Consumer Credit Code. For example, lenders would not have been able to use the exception concerning inability to locate a borrower unless they had made reasonable inquiries about the borrower's whereabouts (including inquiries of the guarantor) and given the guarantor a written notice, in the prescribed form, of an intention to bring proceedings. The written notice prescribed by the regulations required the lender to advise the guarantor of the borrower's default, the fact that the borrower could not be found, the amount claimed from the guarantor, the right of the guarantor to discuss the matter with the lender and/or Consumer Affairs (now the Department of Fair Trading) and other relevant rights under the Act.<sup>33</sup> Hence, in this instance, where the lender was allowed to commence proceedings against the guarantor without exhausting its remedies against the borrower, s 138 provided the guarantor with a greater level of protection. We favour a return to this provision in the Model Law.

## RECOMMENDATION 10.4

The Model Law should require a lender to proceed against the borrower before enforcing the guarantee. Such requirement should be in terms similar to the provisions contained in s 138 of the *Credit Act 1984* (NSW).

## ENFORCEMENT COSTS

### Empirical background

10.37 Lovric and Millbank found that most guarantee contracts provide that it is the guarantor who is liable for the costs of enforcement. In particular, many contracts contain a provision allowing the lender to claim all reasonable costs of recovery. The costs of enforcement are often unclear on the face of the guarantee documents. Such costs can quickly increase into tens of thousands of dollars.<sup>34</sup> While not a third party guarantee matter, the case of *Ristic v Greater Building Society Ltd*<sup>35</sup> gives a good indication of how costs in mortgage cases can quickly accrue. In 1998, Mr Ristic had a \$20,000 loan. In 2001, the balance of the loan account had reached \$92,937. Of this, the solicitor's costs and costs of the enforcement proceedings totalled \$72,294.

10.38 The inclusion of "all reasonable costs of recovery" clauses in contracts of guarantee may be criticised on the ground that they transfer a significant portion of the risk of lending – the transaction costs of recovery - from lenders to guarantors. Considering that it is lenders who profit from the interest from the loan, and that many guarantors are volunteers who do not gain by the loan, it has been argued that such clauses are unfair to

32. *Cellulose Products Pty Ltd v Truda* (1970) 92 WN (NSW) 561; *Covino v Bandag Manufacturing Pty* [1983] 1 NSWLR 237.

33. *Credit Regulation 1984* (NSW) cl 16, Sch 1 Form 7.

34. Lovric and Millbank at para 6.22, 7.22, 7.23.

35. [2002] NSWCA 266.

guarantors.<sup>36</sup> However, the provision of finance is a service for which customers must expect to pay transaction costs. It is unrealistic to expect financial institutions to bear all the costs of maintaining and enforcing transactions. Outlawing enforcement costs provisions in guarantee contracts would diminish their value as risk-minimising devices for banks, which could result in more restrictive access to credit by small business.

10.39 Alternatively, such a policy may precipitate a shift in the way such costs are recovered, for example, through an increase in a financial institution's fees and charges. The outcome would be an inequitable sharing of transaction costs where customers who are compliant with their contractual obligations partake in the burden of paying for costs incurred because some other customers choose to dispute their obligations.

10.40 The solution is not to prohibit lenders from recovering enforcement costs from guarantors but to regulate the extent and manner of such recovery. The regulation of enforcement costs under the Consumer Credit Code provides a good starting point for the Model Law.

10.41 Section 99 of the Consumer Credit Code provides that "a credit provider must not recover or seek to recover enforcement expenses from a debtor, guarantor or mortgagor in excess of those reasonably incurred by the credit provider."

### What are enforcement expenses?

10.42 Enforcement expenses are expressly excluded from the Consumer Credit Code's definition of "credit fees and charges".<sup>37</sup> The Code defines "reasonable expenses" in relation to a mortgage, as including "expenses incurred by the mortgagee in preserving or maintaining property subject to the mortgage (including insurance, rates and taxes payable for the property) but only if the expenses are incurred after a breach occurs and are authorised by the mortgage".<sup>38</sup> Since this definition is only in relation to a mortgage, the broader meaning of enforcement expenses depends on the definition of "enforcement proceedings". The Code defines this term as:

- proceedings in a court to recover a payment due under the contract or a guarantee; or
- taking possession of property under a mortgage or taking any other action to enforce a mortgage.<sup>39</sup>

Enforcement expenses are, therefore, costs incurred in taking any of those steps.

10.43 Where a guarantor applies to a court to change the terms of the credit contract on the grounds of hardship, the credit provider's costs in proceedings dealing with the application will not be considered enforcement expenses since they are not proceedings to recover a payment due under the credit contract or guarantee, nor are they proceedings to take possession of the property under the mortgage or to enforce the mortgage.<sup>40</sup>

36. Lovric and Millbank at para 8.30-8.32.

37. *Consumer Credit (New South Wales) Code 1995 (NSW)* Sch 1 cl 1.

38. *Consumer Credit (New South Wales) Code 1995 (NSW)* Sch 1 cl 1.

39. *Consumer Credit (New South Wales) Code 1995 (NSW)* Sch 1 cl 1. The term "court" includes the Consumer, Trader and Tenancy Tribunal: *Consumer Credit (New South Wales) Act 1995* s 8.

40. See *McNally v Australia and New Zealand Banking Group* (2001) ASC ¶155-047. This case involved a debtor who applied for variation of the credit contract on the ground of hardship under s 68 of the Consumer Credit Code.

## Credit provider's internal costs

10.44 At common law, a mortgagee is not entitled to claim its internal costs of administration in relation to the enforcement of the mortgage. This general rule is, however, subject to any specific agreement to the contrary.<sup>41</sup> Applying this rule to s 99 of the Consumer Credit Code, it has been suggested that the cost of internally performed enforcement action is not an enforcement expense that the credit provider can recover from the guarantor.<sup>42</sup> The use of the word "incurred" in s 99 implies that the credit provider must have become liable to a third party for the cost. If the credit provider had not actually paid money to a third party, the amount expended was not an enforcement expense.

10.45 In 1998, the following sentence was added to s 99(1) of the Consumer Credit Code:

*Enforcement expenses of a credit provider extend to those reasonably incurred by the use of the staff and facilities of the credit provider.*

10.46 Its purpose was to remove the considerable doubt as to whether the section entitles a credit provider to recover expenses incurred internally by its own staff and facilities to enforce a credit contract or guarantee.<sup>43</sup> The explanatory note to the amendment also stated that, if the section permitted the recovery only of externally incurred expenses, the result is more likely than not disadvantageous to the debtor or guarantor, as it is generally believed that the expenses incurred will be higher if external agencies are engaged. The amendment removes the need for an express provision in the contract giving the credit provider the right to recover internal costs.

## Reasonably incurred *and* reasonable amount?

10.47 Section 99(1) of the Consumer Credit Code refers to "enforcement expenses ... reasonably incurred". This wording raises the issue of whether the amount of the enforcement expenses should also be reasonable. The distinction is significant in the law of costs.<sup>44</sup> For example, Part 42, rule 5(b) of the *Uniform Civil Procedure Rules 2005* (NSW) provides, that where in any proceedings costs are payable to a person on an indemnity basis, all costs incurred by that person are to be allowed except to the extent that it appears that those costs "are of an unreasonable amount or have been unreasonably incurred". In fact, the equivalent provision in the *Credit Act 1984* (NSW), the predecessor of the Consumer Credit Code, stated that a credit provider could recover an amount only if it was a "reasonable amount reasonably incurred".<sup>45</sup> It could be argued that a change in the wording from that used in the Credit Act indicated a change of meaning.<sup>46</sup>

10.48 There is a view that the term "reasonable" in s 99 refers to both the amount and to the incurring of it, in light of other provisions of the Consumer Credit Code which expressly require the amount of expenses recoverable by a credit provider to be reasonable. For example, s 55(1) provides that a guarantee is void to the extent it secures an amount that

41. *Sandtara Pty Ltd v Australian European Finance Corporation Ltd* (1990) 20 NSWLR 82.

42. S Edwards, D Brogan and A Tierney, *Accessing the Consumer Credit Code* (FT Law & Tax, South Melbourne Victoria, 1996) at 221.

43. *Consumer Credit (Queensland) Amendment Act 1998*, Explanatory Note.

44. See G E Dal Pont, *Law of Costs* (LexisNexis Butterworths, Chatswood NSW, 2003) at para 16.21.

45. *Credit Act 1984* (NSW) s 76(1).

46. D McGill and L Willmont *Annotated Consumer Credit Code* (LBC Information Services, Pyrmont NSW, 1999) at 648.

exceeds the sum of the amount of the liabilities of a debtor under the credit contract and "reasonable expenses of enforcing the guarantee".<sup>47</sup> It has been argued that s 99 should be construed similarly to those sections.<sup>48</sup> However, the fact that s 99 is worded differently to those other sections may strengthen the view that this section, unlike the others, only requires that the expenses be reasonably incurred.

## Excessive enforcement expenses

10.49 Section 99(2) of the Consumer Credit Code provides that any "provision of the credit contract, mortgage or guarantee that appears to confer a greater right [than the recovery of enforcement expenses reasonably incurred by the credit provider] is void." For example, where a contract of guarantee grants the credit provider the right to enforcement expense of \$10,000, and a court determined that this amount was not reasonable under the circumstances, the provision in the contract would be void and the credit provider would not be able to recover even a lesser amount under it.<sup>49</sup>

10.50 Section 99(2) also provides that, if a guarantor has in fact paid expenses in excess of the limitation set in the section, he or she is entitled to recover it back. This provision overcomes the common law defence of illegality to a claim for restitution, which prevents courts from aiding a participant to a contractual provision that is prohibited by law.<sup>50</sup> In other words, the credit provider cannot deny a guarantor's claim for recovery of excessive expenses on the basis that the guarantor was a participant to a contractual provision that contravened s 99.

10.51 Finally, s 99(2) provides that, if there is a dispute between the credit provider and the guarantor about the amount of enforcement expenses that may be recovered by the credit provider, the court may, on application by any of the parties to the dispute, determine the amount of that liability.

## The Commission's conclusion

10.52 Section 99 of the Consumer Credit Code provides a good basis for regulating the recovery by lenders of enforcement costs. It declares the fundamental policy that lenders may recover only reasonable enforcement expenses. It contains guidelines on what constitutes enforcement expenses, including a clarification on the status of a lender's internal costs. It renders void contractual provisions that allow the recovery of excessive enforcement expenses. It grants courts authority to determine disputes between the lender and the guarantor in relation to the amount of enforcement expenses that may be recovered by the credit provider. It gives guarantors a right to recover expenses paid in excess of what a court considers reasonable. The Model Law should, however, clarify the wording of s 99 to ensure that a lender can recover an enforcement expense if it was reasonably incurred and the amount claimed is reasonable under the circumstances.

47. See also s 78(8)(d) (the credit provider can only deduct its "reasonable enforcement expenses" from the sale proceeds of mortgaged goods) and s 45(1) (a mortgage is void to the extent it secures an amount that exceeds the amount of the liabilities of the debtor under the credit contract and the "reasonable enforcement expenses" of enforcing the mortgage).

48. D McGill and L Willmont *Annotated Consumer Credit Code* (LBC Information Services, Pyrmont NSW, 1999) at 648.

49. This is a modified example found in D McGill and L Willmont, *Annotated Consumer Credit Code* (LBC Information Services, Pyrmont NSW, 1999) at 648.

50. See *Browning v Morris* (1778) 98 ER 1364; *Parkinson v College of Ambulance Ltd* [1925] 2 KB 1.

## RECOMMENDATION 10.5

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The Model Law should regulate enforcement expenses, in terms similar to s 99 of the *Consumer Credit Code*. However, it should clarify that lenders may recover only enforcement expenses that have been reasonably incurred and in amounts that are reasonable under the circumstances.

# 11. Unjust guarantees

- Introduction
- Power to reopen unjust guarantees
- General matters to be considered by the court
- Specific matters to be considered by the court
- Granting relief

## INTRODUCTION

11.1 The focus of this Report is the establishment of a regulatory regime designed to prevent the occurrence, and reduce the incidence, of disputes that arise where one person guarantees the debts of another. Chapters 6-10 have recommended a regime similar to that of the *Consumer Credit (New South Wales) Code* ("Consumer Credit Code") and the Bankers' Code of Practice. Experience shows, however, that there will inevitably be cases that fall outside the preventive regime where guarantors seek relief on the basis that the guarantee in the context of the guarantee transaction is unjust. The Consumer Credit Code currently allows the court to reopen transactions, including guarantee transactions, which are unjust.<sup>1</sup> This chapter recommends that the Model Law should also make general provision for the courts to deal with guarantees that are, in the circumstances mentioned, unjust and set out what relief the courts may grant.

11.2 Apart from generally catching unjust guarantees that fall outside the preventive regime, two purposes are served by incorporating unjust contracts provisions in the Model Law:

- such provisions particularise the statutory factors generally relevant to unjust contracts under the *Contracts Review Act 1980* (NSW) ("*Contracts Review Act*") in the context of third party guarantees; and
- such provisions "overcome the common law's failure to provide a comprehensive doctrinal framework to deal with 'unjust' contracts"<sup>2</sup> by extending protection beyond the traditional categories of unconscionability, undue influence and duress, thereby reducing the need to have recourse to the general law.<sup>3</sup>

11.3 The provisions of the Model Law recommended in this chapter are along the lines of the unjust contract provisions in the Consumer Credit Code. The Consumer Credit Code provisions were adapted from Part 9 of the *Credit Act 1984* (NSW), which, in turn, was adapted from the provisions of the *Contracts Review Act 1980* (NSW) specifically to cover borrowers, mortgagors and guarantors. The *Contract Review Act* was the result of Professor Peden's recommendations in his 1976 report to the New South Wales government.<sup>4</sup> The current Consumer Credit Code provisions apply only to consumers, and do not protect individuals who guarantee business loans, even when they have no direct interest in the business.<sup>5</sup> The Consumer Credit Code provisions, therefore, need to be adapted to take account of the fact that they will apply to a wider range of guarantees than those given in support of consumer loans.

11.4 The identification of guarantees and provisions that are, in all the circumstances, unjust necessarily involves a consideration of the circumstances of individual cases. While

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1. *Consumer Credit Code* s 70.
  2. *AGC (Advances) Ltd v West* (1984) 5 NSWLR 610 at 621 (McHugh JA).
  3. See para 2.21-2.24.
  4. J R Peden, *Harsh and Unconscionable Contracts* (Report to the Minister for Consumer Affairs and Co-operative Societies and the Attorney-General for New South Wales, 1976).
  5. *Consumer Credit (New South Wales) Code* s 6(1). See para 2.34.



this inevitably involves some degree of uncertainty, the proposed model provisions at least provide a framework for the continued development of the law. As Professor Harland has observed:

*The statutory provisions in their 'shopping lists' of factors to be taken into account have attempted, among other things, to provide some guidance as to how the jurisdiction given to the courts should be exercised. These factors are regularly discussed by the courts (while emphasising that they are not the only factors to be taken into account). It may be that as experience grows the courts (and commentators) will develop, as the reformers intended would be the case, guiding principles that will reduce the uncertainty necessarily caused by indeterminate standards such as those established by the statutes.*<sup>6</sup>

11.5 Professor Peden also predicted that a clear list of criteria would change the way that cases are conducted by encouraging the courts and parties to relate their submissions and findings to them, “with the result that the law will develop in a more rational and therefore predictable fashion than under a single broad umbrella provision”.<sup>7</sup>

11.6 The House of Representatives Standing Committee on Industry, Science and Technology, in its 1997 report, recommended the inclusion in the *Trade Practices Act 1974* (Cth) of a list of criteria against which to judge “unfair conduct” in commercial transactions.<sup>8</sup> The recommendation was made in response to submissions suggesting that a list of criteria for the courts to assess “unfair” or unconscionable conduct would reduce uncertainty.<sup>9</sup>

11.7 However, this is not a view shared by other commentators, who have drawn attention to the indeterminacy and vagueness of the statutory criteria of unjustness,<sup>10</sup> and their potentially adverse impact on the consistency of decision making.<sup>11</sup> These arguments suggest that “unjustness” (and, indeed, its general law counterparts, particularly unconscionability) is inappropriate as the primary focus of regulation.<sup>12</sup> However, it is, in our view, an appropriate test to catch cases that fall outside the protective regulatory

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6. D Harland, “Unconscionable and Unfair Contracts: An Australian Perspective” in R Brownsword, N Hird and G Howells, *Good Faith in Contract: Concept and Context* (Dartmouth Publishing Company, Alderscot, 1998) at 265.
  7. J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980* (NSW) (Butterworths, Sydney, 1982) at 122.
  8. Australia, House of Representatives Standing Committee on Industry, Science and Technology, *Finding a Balance: Towards Fair Trading in Australia* (Report, 1997) at 181-182.
  9. Australia, House of Representatives Standing Committee on Industry, Science and Technology, *Finding a Balance: Towards Fair Trading in Australia* (Report, 1997) at 169, 172, 180.
  10. A J Duggan and E V Lanyon, *Consumer Credit Law* (Butterworths, Sydney, 1999) at 367-368; M McHugh, “The Growth of Legislation and Litigation” (1995) 69 *Australian Law Journal* 37 at 43.
  11. M McHugh, “The Growth of Legislation and Litigation” (1995) 69 *Australian Law Journal* 37 at 43.
  12. See para 2.49, 4.20-4.22.

regime that we recommend by providing, in the “shopping list” of criteria, a reference point for the application of judicial discretion to the facts of individual cases. The courts apply such lists all the time, not only under the *Contracts Review Act*, Consumer Credit Code and fair trading and financial services statutes, but also, for example, under family provision legislation and de facto relationships laws. It is true that the lists provide a challenge for the courts to ensure certainty and consistency in decision making.<sup>13</sup> But this challenge is not beyond their abilities.

11.8 The statutory list of criteria may also perform educative and other functions. Professor Peden identified a number of reasons for using a list of specific detailed criteria:

- it will “add emphasis to the intention and avoid ambiguity resulting in narrow construction”;
- it will “facilitate a general improvement in the ethical standards of the business community by spelling out in the clearest terms the potential consequences of harsh and unconscionable dealing”; and
- it will assist people without legal backgrounds to “appreciate the circumstances in which they may be entitled to relief”.<sup>14</sup>

## POWER TO REOPEN UNJUST GUARANTEES

11.9 The Consumer Credit Code expresses the court's power to reopen unjust transactions as follows:

***Power to reopen unjust transactions.*** *The Court may, if satisfied on the application of a debtor, mortgagor or guarantor that, in the circumstances relating to the relevant credit contract, mortgage or guarantee at the time it was entered into or changed (whether or not by agreement), the contract, mortgage or guarantee or change was unjust, reopen the transaction that gave rise to the contract, mortgage or guarantee or change.*<sup>15</sup>

Unjust, for the purposes of the Act includes “unconscionable, harsh or oppressive”.<sup>16</sup> This definition is inclusive and follows a similar provision in the *Contracts Review Act*.<sup>17</sup> Both provisions differ from the provision in the old *Credit Act 1984* (NSW) which employed an exhaustive (rather than inclusive) definition of “unjust”.<sup>18</sup>

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13. J Paterson, A Robertson and P Heffey, *Principles of Contract Law* (2nd ed, Lawbook Co, Sydney, 2005) at 602.

14. J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980* (NSW) (Butterworths, Sydney, 1982) at 121.

15. *Consumer Credit (New South Wales) Code* s 70(1).

16. *Consumer Credit (New South Wales) Code* s 70(7).

17. *Contracts Review Act 1980* (NSW) s 4(1).

18. On the difference between the definitions of “unjust” under the *Credit Act 1984* (NSW) and the *Contracts Review Act 1980* (NSW), see, eg, *Custom Credit Corporation Ltd v Lupi* [1992] 1 VR 99 at 103, 113.

11.10 While the Consumer Credit Code refers to the court finding that a contract, mortgage or guarantee or change is unjust, the *Contracts Review Act* refers to the court finding that a “contract or a provision of a contract” is unjust. The Consumer Credit Code provision is inconsistent with the phrasing of another Consumer Credit Code provision identifying general matters the courts may consider (which refers to the court determining whether a term of a particular contract is unjust).<sup>19</sup> The two Consumer Credit Code provisions should be made consistent in order to avoid confusion.

## Unjust guarantees

11.11 When considered as a document standing alone, the terms of a guarantee may appear to be quite unexceptional. However, a guarantee must be considered in the context of the related loan transaction. The terms of that transaction, or the circumstances in which the guarantee is given, may be such as to render the guarantee, or some of its provisions, unjust in accordance with the tests later mentioned in this chapter.<sup>20</sup> The expression “unjust guarantee” where used from now on is to be understood in this context, and to include both the guarantee and its provisions.

11.12 Allowing the court to reopen an “unjust guarantee” as defined above is consistent with the original intention of the *Contracts Review Act* to give the court a reasonably wide and flexible jurisdiction.<sup>21</sup> It should be noted that these recommendations relate only to reopening the guarantee and do not in any way seek to disturb the principal loan or to reopen any rights arising between the lender and borrower.

11.13 The power to reopen an unjust guarantee or any of its provisions accordingly includes a power to make such orders or to give such relief as might be appropriate in the light of the transaction as a whole.

## RECOMMENDATION 11.1

Where the Court considers that a guarantee or a provision of a guarantee is, in the circumstances, unjust, the court should be able to reopen it.  
“Unjust” should include “unconscionable, harsh or oppressive”.

## Time

11.14 Both the *Contracts Review Act* and the Consumer Credit Code require that the court consider the unjustness of the contract at the time it was entered into.<sup>22</sup> The time stipulation was first included in the *Contracts Review Act* in order to avoid ambiguity about

19. See para 11.29.

20. See para 11.30-11.72.

21. See J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980 (NSW)* (Butterworths, Sydney, 1982) at 117.

22. *Contracts Review Act 1980 (NSW)* s 4(1) and *Consumer Credit (New South Wales) Code* s 70(1).

the point of time at which the court is to determine the effects of the contract.<sup>23</sup> The Peden Report observed:

*Since at the time of making a contract neither party can wholly foresee the effect of every aspect of the contract, it does not seem unreasonable to limit the court's examination of the provisions of the contract within the framework of the circumstance as they existed at the time the contract was made.*<sup>24</sup>

11.15 The Consumer Credit Code also specifically allows the court to consider the unjustness of the contract at any time when the contract was changed as well as when it was entered into. This obviates the need to find that any later change was a separate contract in order to attract the jurisdiction of the court.

## RECOMMENDATION 11.2

The Model Law should provide that, in determining whether a guarantee or a provision of a guarantee is unjust, the court is to have regard to the guarantee at the time when it was entered into or changed.

### *Reasonably foreseeable circumstances*

11.16 The Consumer Credit Code also provides that, in determining whether a contract is unjust, the court is not to have regard to "any injustice arising from circumstances that were not reasonably foreseeable" when the contract was entered into.<sup>25</sup> The *Contracts Review Act* contains a provision to the same effect.<sup>26</sup>

11.17 It has been suggested that the reasonable foreseeability test allows the court "a degree of flexibility":

*General movements in prices or interest rates, or a change in a consumer's health or employment would not normally be foreseeable. However, the effect of a harsh penalty clause in the event of default would be foreseeable.*<sup>27</sup>

23. J R Peden, *Harsh and Unconscionable Contracts* (Report to the Minister for Consumer Affairs and Co-operative Societies and the Attorney-General for New South Wales, 1976) at 26.

24. J R Peden, *Harsh and Unconscionable Contracts* (Report to the Minister for Consumer Affairs and Co-operative Societies and the Attorney-General for New South Wales, 1976) at 26.

25. *Consumer Credit (New South Wales) Code* s 70(4).

26. *Contracts Review Act 1980* (NSW) s 9(4).

27. J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980* (NSW) (Butterworths, Sydney, 1982) at 140. See also J R Peden, *Harsh and Unconscionable Contracts* (Report to the Minister for Consumer Affairs and Co-operative Societies and the Attorney-General for New South Wales, 1976) at 26.

### RECOMMENDATION 11.3

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The Model Law should provide that, in determining whether a guarantee or a provision of a guarantee is unjust, the court is not to have regard to any injustice arising from circumstances that were not reasonably foreseeable when the guarantee was entered into or changed.

### Interrelated arrangements

11.18 The *Contracts Review Act* includes a provision that allows the court, in appropriate cases, to have regard to any arrangements consisting of an “inter-related combination or series of contracts” where the contract being considered is a part of those arrangements.<sup>28</sup> This provision has not been carried over into the Consumer Credit Code, presumably because consumer credit contracts would not normally be part of such complex arrangements. It has been suggested that, since the term “contract” has not been defined in the *Contracts Review Act*, it is otherwise limited to its common law meaning and would not, by itself, include collateral arrangements.<sup>29</sup> Some commentators have considered that these arrangements may be encompassed in the term “all the circumstances of the case”.<sup>30</sup>

11.19 The Commission considers that a provision allowing the court to have regard to interrelated arrangements is a useful provision to include in the Model Law. However, we would propose one adjustment, namely that the interrelated combination or series of contracts must involve the guarantor. This is necessitated by the fact that the unjust guarantee provisions in the Model Law are limited to the guarantee. The provisions are not about reopening the primary contract between the borrower and the lender.

### RECOMMENDATION 11.4

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The Model Law should provide that, in determining whether a guarantee or a provision of a guarantee is unjust, the court may have regard to any arrangements consisting of an inter-related combination or series of contracts involving the guarantor where the guarantee being considered is a part of those arrangements.

### GENERAL MATTERS TO BE CONSIDERED BY THE COURT

11.20 The Consumer Credit Code, after giving the courts power to reopen unjust contracts, goes on to state what they must consider in making a decision:

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28. *Contracts Review Act 1980* (NSW) s 15.
  29. J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980* (NSW) (Butterworths, Sydney, 1982) at 147.
  30. *Consumer Credit (New South Wales) Code* s 70(2). See D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 461-462.

*In determining whether a term of a particular credit contract, mortgage or guarantee is unjust in the circumstances relating to it at the time it was entered into or changed, the Court is to have regard to the public interest and to all the circumstances of the case ...*<sup>31</sup>

The *Contracts Review Act* also requires the court to have regard to “the public interest and to all the circumstances of the case”.<sup>32</sup> The fair trading and financial services statutes also refer to the court finding conduct to be unconscionable “in all the circumstances”.<sup>33</sup>

## Public interest

11.21 The Peden Report, in recommending the adoption of the “public interest” criterion, suggested that it was to direct the court’s “attention to the underlying purposes of the Bill, namely to prevent unjust dealings which offend against community standards of business morality”.<sup>34</sup> Two considerations have been highlighted in the application of the “public interest”, namely:

- the need to hold parties to their agreement;
- the need to protect consumers.<sup>35</sup>

The fair trading and financial services statutes make no such provision, merely listing the matters to which the court is to have regard in determining whether conduct is, in all the circumstances, unconscionable.<sup>36</sup>

11.22 The reference to the “public interest” in the Consumer Credit Code and the *Contracts Review Act* has become an accepted part of the unjust contracts provisions, and highlights the importance of balancing the public interest. Recommendation 11.5 therefore includes the “public interest” in the matters that the court must consider in deciding whether a guarantee or a provision of a guarantee is unjust.

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31. *Consumer Credit (New South Wales) Code* s 70(2).

32. *Contracts Review Act 1980* (NSW) s 9(1).

33. *Trade Practices Act 1974* (Cth) s 51AB(1); *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(1); and *Fair Trading Act 1987* (NSW) s 43(1).

34. J R Peden, *Harsh and Unconscionable Contracts* (Report to the Minister for Consumer Affairs and Co-operative Societies and the Attorney-General for New South Wales, 1976) at 28. The words in this quote have been picked up in one of the main judgments on the old Credit Acts: *Custom Credit Corporation Ltd v Lupi* [1992] 1 VR 99 at 105 (Murphy J).

35. See D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 462-463; *Baltic Shipping Company v Dillon* (1991) 22 NSWLR 1 at 20 (Kirby P); *Perpetual Trustees Co Ltd v Khashoba* [2006] NSWCA 41 at para 128 (Basten JA); *Permanent Mortgages Pty Ltd v Cook* [2006] NSWSC 1104.

36. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2), 12CC(2); *Fair Trading Act 1987* (NSW) s 43(2). See also: *Trade Practices Act 1974* (Cth) s 51AB(2), 51AC(3).

## All the circumstances of the case

11.23 The use of the phrase “all the circumstances of the case” highlights the need to consider the criteria not in isolation but as part of a context. Justice Hunt emphasised this point in a 1989 judgment:

*It is important also to emphasise that each of the criteria... must be considered in the context of all of the circumstances of the case. ... Just because the circumstances of a particular case fall within the wording of one or more of the criteria... does not mean that the contract must thereupon be found to be unjust. In very few (if any) cases would it be reasonably practical for the debtor to negotiate for the alteration of, or to reject, any of the provisions of a loan contract with a bank or a finance company. ... It would fly in the face of reality to suggest that the position were otherwise. That factor alone, therefore, cannot be sufficient to make the contract unjust. Indeed, that situation does not give rise even to an arguable case for relief.<sup>37</sup>*

Justice McHugh also traversed the question in 1986:

*... a contract may be unjust in the circumstance existing when it was made because of the way it operates in relation to the claimant or because of the way in which it was made or both. Thus a contractual provision may be unjust simply because it imposes an unreasonable burden on the claimant when it was not reasonably necessary for the protection of the legitimate interests of the party seeking to enforce the provision. ... In other cases the contract may not be unjust per se but may be unjust because in the circumstances the claimant did not have the capacity or opportunity to make an informed or real choice as to whether he should enter into the contract. ... More often, it will be a combination of the operation of the contract and the manner in which it was made that renders the contract or one of its provisions unjust in the circumstances. Thus a contract may be unjust under the Act because its terms, consequences or effects are unjust. This is substantive injustice. Or a contract may be unjust because of the unfairness of the methods used to make it. This is procedural injustice. Most unjust contracts will be the product of both procedural and substantive injustice.<sup>38</sup>*

11.24 The unjust contract provisions in all of the relevant statutes currently require the court to have regard to “all the circumstances” of the case. Recommendation 11.5 therefore enjoins the court to have regard to “all the circumstances of the case” in deciding whether a guarantee or a provision of a guarantee is unjust.

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## RECOMMENDATION 11.5

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37. *Esanda Finance Corporation Ltd v Murphy* (1989) ASC ¶155-703 at 58,354-58,355.

38. *West v AGC (Advances) Ltd* (1986) 5 NSWLR 610 at 620 (McHugh JA). See also *Perpetual Trustees Co Ltd v Khashoba* [2006] NSWCA 41 at para 1263-70 (Spigelman CJ).

In determining whether a guarantee or a provision of a guarantee is unjust, the court is to have regard to the public interest and to all the circumstances of the case.

## SPECIFIC MATTERS TO BE CONSIDERED BY THE COURT

11.25 The Consumer Credit Code lists a number of specific matters that the court may consider in determining whether a term is unjust. These are dealt with individually below.<sup>39</sup>

### General discussion

11.26 Concerns have been raised about using a non-exhaustive list of factors to identify unjust terms. Some of the criteria are commonly and inescapably associated with many consumer contracts, for example, inequality of bargaining power or lack of opportunity to negotiate. However, as already mentioned, by itself, no one criterion is determinative of unjustness. It is only relevant so far as it helps to show whether a contract or its terms are unjust.<sup>40</sup>

11.27 The list encourages a case by case approach to the question of whether particular contracts or their terms are unjust.<sup>41</sup> The criteria are by no means mutually exclusive and many of the grounds will overlap in particular fact situations.<sup>42</sup> For example, the question of the relative bargaining power of the parties may also be answered by considering the questions of the guarantor's age or physical or mental condition, whether he or she received independent advice or understood the effect of the contract.

11.28 A contract may still be unjust even though it does not satisfy any of the criteria listed in s 70(2) of the Consumer Credit Code. A ground that is not specifically covered by the list can still be used to establish that a contract is unjust. This is because the list is inclusive and also because any additional criteria can be taken up under the ground of "any other relevant factor". This is probably why there has been so little specific criticism about the shortcomings of particular clauses.

#### *A drafting point*

11.29 The Consumer Credit Code provision refers to the court determining whether "a term" of a "particular" contract is unjust.<sup>43</sup> This is inconsistent with the related Consumer Credit Code provision that gives the court the power to reopen a contract, mortgage or guarantee or change once it has found that that it is unjust.<sup>44</sup> By contrast, the equivalent *Contracts Review Act* provision refers only to the court determining whether the contract is

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39. Para 11.30-11.61.

40. A J Duggan and E V Lanyon, *Consumer Credit Law* (Butterworths, Sydney, 1999) at 338.

41. See T M Carlin, "The Contracts Review Act 1980 (NSW)-20 years on" (2001) 23 *Sydney Law Review* 125 at 136-137.

42. See J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980 (NSW)* (Butterworths, Sydney, 1982) at 123.

43. *Consumer Credit (New South Wales) Code s 70(2)*.

44. D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 457-458.



unjust. The difference between the *Contracts Review Act* and Consumer Credit Code provisions may be significant.<sup>45</sup> One commentary has suggested that “read literally” the Consumer Credit Code provision “does not extend to the court’s determining whether the contract as a whole is unjust”.<sup>46</sup> Although it seems unlikely that the literal interpretation will prevail, the model provision should state clearly that the court may determine whether a guarantee or a provision of a particular guarantee is unjust.

## Consequence of compliance or noncompliance

*(a) the consequences of compliance, or noncompliance, with all or any of the provisions of the contract, mortgage or guarantee.*

11.30 The *Contracts Review Act* contains a similar provision stating that the matters the court may have regard to include “such consequences or results” arising in the event of compliance or non-compliance with any or all of the provisions of the contract.<sup>47</sup> A provision in terms appropriate to the context of guarantees should be included in the Model Law.

## Relative bargaining power

*(b) the relative bargaining power of the parties.*

11.31 The fair trading and financial services statutes similarly refer to “the relative strengths of the bargaining positions” of the parties.<sup>48</sup> The *Contracts Review Act*, however, allows the court to consider “whether or not there was any material inequality in bargaining power between the parties to the contract”.<sup>49</sup> It has been said of the *Contracts Review Act* provision that a contract will not be unjust merely because there is an inequality of bargaining power between the parties, otherwise most contracts involving financial institutions would be unjust. An abuse of the unequal power must be implied in the *Contracts Review Act* formulation.<sup>50</sup>

11.32 Some commentators have considered it important that the Consumer Credit Code has not adopted the wording of the *Contracts Review Act*. The Consumer Credit Code formulation is said to reinforce “the notion that existence or otherwise of one or other of the s 70(2) matters does not itself result in an unjust contract but that they are indicia to be

45. See Clayton Utz, *The New Consumer Credit Code Explained* (CCH, Sydney, 1994) at 91.

46. D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 457.

47. *Contracts Review Act 1980* (NSW) s 9(1).

48. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(a), 12CC(2)(a); *Fair Trading Act 1987* (NSW) s 43(2)(a). See also: *Trade Practices Act 1974* (Cth) s 51AB(2)(a), 51AC(3)(a).

49. *Contracts Review Act 1980* (NSW) s 9(2)(a).

50. See J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980* (NSW) (Butterworths, Sydney, 1982) at 124. See also A Beatty, A Smith and A Barclay, *Annotated Consumer Credit Code and Regulations* (2nd edition, Butterworths, Sydney, 2000) at 133.

considered".<sup>51</sup> The Commission, therefore, prefers the inclusion of the Consumer Credit Code formulation in the Model Law.

## Whether provisions were subject of negotiation

*(c) whether or not, at the time the contract, mortgage or guarantee was entered into or changed, its provisions were the subject of negotiation.*

11.33 Such provisions are considered to be aimed, in part, at standard form contracts. Most financial institutions use standard form contracts and this does not necessarily make a contract unjust. The provisions are rather aimed at commonly used standard form contracts that may disguise unfair or unusual terms.<sup>52</sup>

11.34 This is similar to a provision in the *Contracts Review Act*, except that the *Contracts Review Act* also refers to negotiation prior to the time the contract was made.<sup>53</sup> The omission from the Consumer Credit Code of a reference to negotiations prior to the time the contract was made is understandable since consumer credit transactions are most likely to be subject to standard form contracts.<sup>54</sup>

11.35 Allowing a consideration of prior negotiations is important because it may be more difficult to overturn a guarantee as unjust if a party has had adequate time to consider the effect of the negotiations before the guarantee is finally entered into. A guarantee that was entered into immediately following negotiations might be easier to attack.<sup>55</sup> No other provision allows a direct consideration of the time taken to enter into a guarantee. It is appropriate, therefore, to reinsert the *Contracts Review Act* phrase so that the provision in the Model Law reads "prior to, or at the time the guarantee was entered into...".

## Capacity and willingness to negotiate

*(d) whether or not it was reasonably practicable for the applicant to negotiate for the alteration of, or to reject, any of the provisions of the contract, mortgage or guarantee or the change.*

11.36 This is similar to a provision in the *Contracts Review Act*.<sup>56</sup> The financial services legislation, however, refers only to the "extent to which the supplier was willing to negotiate the terms and conditions".<sup>57</sup> The willingness of a party to negotiate, which is not

51. S Edwards, D Brogan, A Tierney, *Accessing the Consumer Credit Code* (FT Law & Tax, Melbourne, 1996) at 169.

52. See A J Duggan, S W Begg, E V Lanyon, *Regulated Credit: The Credit and Security Aspects* (Law Book Company, Sydney, 1989) at 554-555.

53. *Contracts Review Act 1980* (NSW) s 9(2)(b).

54. D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 455.

55. See J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980* (NSW) (Butterworths, Sydney, 1982) at 125.

56. *Contracts Review Act 1980* (NSW) s 9(2)(c).

57. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CC(2)(j). See also: *Trade Practices Act 1974* (Cth) s 51AC(3)(j).

directly referred to in the Consumer Credit Code provision, is obviously an important factor for determining whether it was reasonably practicable to negotiate.<sup>58</sup> The Commission is of the view that willingness of the party taking the benefit of the guarantee to negotiate is sufficiently important to be highlighted additionally in this criterion. Its direct mention will also allow the courts to draw on any case law arising from the financial services provisions.

## Unreasonable or unnecessary provisions

*(e) whether or not any of the provisions of the contract, mortgage or guarantee impose conditions that are unreasonably difficult to comply with, or not reasonably necessary for the protection of the legitimate interests of a party to the contract, mortgage or guarantee.*

11.37 This is similar to provisions in the *Contracts Review Act* and the fair trading and financial services statutes.<sup>59</sup> As with many of the other provisions listed, some form of detriment should be proved before the ground can be established.<sup>60</sup> This provision may overlap to an extent with the provision that allows the court to consider whether “the terms of the transaction or the conduct of the credit provider is justified in the light of the risks undertaken by the credit provider”.<sup>61</sup> However, it should be included in the Model Law.

## Age, or physical or mental condition

*(f) whether or not the debtor, mortgagor or guarantor, or a person who represented the debtor, mortgagor or guarantor, was reasonably able to protect the interests of the debtor, mortgagor or guarantor because of his or her age or physical or mental condition.*

11.38 The *Contracts Review Act* contains a provision to similar effect although it refers to “capacity” rather than “condition”.<sup>62</sup> We assume that the term “condition” incorporates “capacity”. The criteria listed are illustrated in cases involving capacity in relation to unconscientious dealing.<sup>63</sup> The provision applies not only to the parties to the contract, but also to any person who represents them. It is important to include representatives to cover circumstances where, for example, the one member of the household conducts negotiations on behalf of other family members who are going to stand as guarantors.

58. A J Duggan, S W Begg, E V Lanyon, *Regulated Credit: The Credit and Security Aspects* (Law Book Company, Sydney, 1989) at 555.

59. *Contracts Review Act 1980* (NSW) s 9(2)(d); *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(b), 12CC(2)(b); *Fair Trading Act 1987* (NSW) s 43(2)(b). See also: *Trade Practices Act 1974* (Cth) s 51AB(2)(b), 51AC(3)(b).

60. A J Duggan, S W Begg, E V Lanyon, *Regulated Credit: The Credit and Security Aspects* (Law Book Company, Sydney, 1989) at 557.

61. *Consumer Credit (New South Wales) Code* s 70(2)(m).

62. *Contracts Review Act 1980* (NSW) s 9(2)(e).

63. Eg, *Wilton v Farnworth* (1948) 76 CLR 646; *Blomley v Ryan* (1956) 99 CLR 362; *Commonwealth Bank of Australia v Amadio* (1983) 151 CLR 447. See also A J Duggan, S W Begg, E V Lanyon, *Regulated Credit: The Credit and Security Aspects* (Law Book Company, Sydney, 1989) at 558.

11.39 Section 70(3) is also relevant to this provision:

*For the purposes of subsection (2)(f), a person is taken to have represented a debtor, mortgagor or guarantor if the person represented the debtor, mortgagor or guarantor, or assisted the debtor, mortgagor or guarantor to a significant degree, in the negotiations process prior to, or at, the time the credit contract, mortgage or guarantee was entered into or changed.*

There is no reason why this should not be included in the Model Law as a qualifier of the criterion to which it relates.

## Form and intelligibility of the guarantee

*(g) the form of the contract, mortgage or guarantee and the intelligibility of the language in which it is expressed.*

11.40 The *Contracts Review Act* contains a similar provision.<sup>64</sup> It is aimed at determining whether a contract is inherently intelligible, and not whether the party understood it.<sup>65</sup> Other provisions<sup>66</sup> deal with the understanding of the person by drawing attention to the educational background, literacy and mental condition of the parties or whether the terms were explained.<sup>67</sup> It should be included in the Model Law.

## Independent or other expert advice

*(h) whether or not, and if so when, independent legal or other expert advice was obtained by the debtor, mortgagor or guarantor.*

11.41 The *Contracts Review Act* contains a similar provision.<sup>68</sup> This provision is not concerned with the quality of the advice obtained.<sup>69</sup> This is dealt with by a complementary provision which allows the court to consider the extent to which the legal and practical effect of the contract was explained to the party.

11.42 The time at which the advice was obtained is also important since advice obtained early in negotiations may be of little use if new terms are later adopted.<sup>70</sup>

11.43 It has been suggested that this provision is too narrow in that it fails to take account of cases where the party is offered an opportunity to seek independent advice,

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64. *Contracts Review Act 1980 (NSW)* s 9(2)(g).

65. A J Duggan, S W Begg, E V Lanyon, *Regulated Credit: The Credit and Security Aspects* (Law Book Company, Sydney, 1989) at 559.

66. See, eg, para 11.38-11.39, 11.44-11.46, 11.49-11.51, 11.63-11.64.

67. See J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980 (NSW)* (Butterworths, Sydney, 1982) at 133.

68. *Contracts Review Act 1980 (NSW)* s 9(2)(h).

69. A J Duggan, S W Begg, E V Lanyon, *Regulated Credit: The Credit and Security Aspects* (Law Book Company, Sydney, 1989) at 559.

70. J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980 (NSW)* (Butterworths, Sydney, 1982) at 134.

but declines to do so.<sup>71</sup> It seems reasonable to allow the court to consider whether, and under what circumstances, the guarantor was given the opportunity to seek legal advice, and to include this criterion in the Model Law.

## Accurate explanation and degree of understanding

*(i) the extent to which the provisions of the contract, mortgage or guarantee or change and their legal and practical effect were accurately explained to the debtor, mortgagor or guarantor and whether or not the debtor, mortgagor or guarantor understood those provisions and their effect.*

11.44 The *Contracts Review Act* contains a similar provision.<sup>72</sup> The fair trading and financial services statutes do not directly refer to an accurate explanation being given of the legal and practical effect of the contract. However, they do allow a consideration of the ability to understand the relevant documents.<sup>73</sup>

11.45 This provision will not impose a positive obligation upon a party to explain the guarantee to the other party. It acts as a complement to the previous provision in allowing a consideration of the quality of the advice and the party's understanding of the guarantee he or she is about to enter into.<sup>74</sup>

11.46 The Consumer Credit Code is silent on who may offer the explanation, whereas the *Contracts Review Act* makes it clear that any person may offer the explanation, not only the lender. This may work in favour of a lender which has failed to offer an explanation if another person has offered an accurate explanation.<sup>75</sup> The Model Law provision should, therefore, make it clear that any person may offer the explanation.

## Unfair pressure, undue influence or unfair tactics

*(j) whether the credit provider or any other person exerted or used unfair pressure, undue influence or unfair tactics on the debtor, mortgagor or guarantor and, if so, the nature and extent of that unfair pressure, undue influence or unfair tactics.*

71. A J Duggan, S W Begg, E V Lanyon, *Regulated Credit: The Credit and Security Aspects* (Law Book Company, Sydney, 1989) at 559; J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980 (NSW)* (Butterworths, Sydney, 1982) at 135.

72. *Contracts Review Act 1980 (NSW)* s 9(2)(i).

73. *Australian Securities and Investments Commission Act 2001 (Cth)* s 12CB(2)(c), 12CC(2)(c); *Fair Trading Act 1987 (NSW)* s 43(2)(c). See also: *Trade Practices Act 1974 (Cth)* s 51AB(2)(c), 51AC(3)(c).

74. A J Duggan, S W Begg, E V Lanyon, *Regulated Credit: The Credit and Security Aspects* (Law Book Company, Sydney, 1989) at 559-560.

75. D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 456.

11.47 The fair trading and financial services statutes contain a provision to similar effect.<sup>76</sup> The *Contracts Review Act* contains a similar provision, although the proscribed tactics are limited to parties to the contract, any person acting or apparently acting on their behalf or with their knowledge.<sup>77</sup> This would be particularly, but not exclusively, aimed at agents and employees of lender companies. The Consumer Credit Code's use of the term "any other person" is, therefore, quite broad. Some commentators have suggested that "it remains to be seen whether the conscience of the lender must be in some way affected or whether the lender must even have knowledge of the alleged conduct".<sup>78</sup> However, since the list is advisory only, any court will no doubt have regard, not only to the fact that a person has exerted unfair pressure or undue influence or used unfair tactics, but also to other relevant facts such as whether the lender was aware of the conduct.

11.48 "Undue influence" is intended to cover undue influence at general law,<sup>79</sup> while "unfair pressure" and "unfair tactics" will extend the coverage of the provision to cover such matters as:

*pressure and tactics applied outside of the recognized fiduciary relationships, for example, high pressure selling techniques and psychological pressure arising out of personal, social, political or religious sensibilities.*<sup>80</sup>

Unlike undue influence, "unfair pressure" and "unfair tactics" do not require a pre-existing relationship of trust and confidence to exist between the parties.<sup>81</sup> This should be included in the criterion under the Model Law.

## Ensuring an understanding of the nature and implications of the guarantee

*(k) whether the credit provider took measures to ensure that the debtor, mortgagor or guarantor understood the nature and implications of the transaction and, if so, the adequacy of those measures.*

11.49 This provision is entirely new. It does not appear to have been contained in any other statutes. It goes further than s 70(2)(i) in that it looks beyond whether the guarantor understood the nature and implications of the guarantee to whether the lender took

76. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(d), s 12CC(2)(d); *Fair Trading Act 1987* (NSW) s 43(2)(d). See also: *Trade Practices Act 1974* (Cth) s 51AB(2)(d), s 51AC(3)(d).

77. *Contracts Review Act 1980* (NSW) s 9(2)(j). See also B Zipser, "Unjust Contracts and the Contracts Review Act 1980 (NSW)" (2001) 17 *Journal of Contract Law* 76 at 86.

78. *Consumer Credit Law Commentary* (CCH Australia Ltd) at ¶¶67-390.

79. See para 2.8-2.11.

80. J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980* (NSW) (Butterworths, Sydney, 1982) at 136.

81. See S Edwards, D Brogan, A Tierney, *Accessing the Consumer Credit Code* (FT Law & Tax, Melbourne, 1996) at 171.

measures to ensure that the guarantor understood. However, it does not impose a positive obligation on the lender to take such measures.

11.50 In creating a potential liability for the failure to give information, it has been subject to some criticism. Some commentators have suggested that it gives a lender a poor choice between providing some information and running the risk of the content of that information being challenged as inadequate or not providing any information and running the risk that a court will find that the failure to provide information was material.<sup>82</sup>

11.51 The Commission's recommendations about providing information to guarantors<sup>83</sup> should prevent many of the circumstances that are the concern of this provision. However, there may be exceptional cases in which the lender should be expected to do more and these will be covered by this provision, if it is included in the Model Law.

## Capacity to satisfy the debt

*(l) whether at the time the contract, mortgage or guarantee was entered into or changed, the credit provider knew, or could have ascertained by reasonable inquiry of the debtor at the time, that the debtor could not pay in accordance with its terms or not without substantial hardship.*

11.52 There is no directly equivalent statement in the *Contracts Review Act*.<sup>84</sup> There are also no equivalent provisions in the fair trading or financial services statutes. This provision is said to have been inserted in order to overcome the effect of a decision of the New South Wales Supreme Court in 1989 that “neither the Act nor law support the proposition that not to seek confirmatory evidence of matters going to ability to repay is alone sufficient to make a contract unjust”.<sup>85</sup>

11.53 The second reading speech in New South Wales referred to this provision as addressing the problem of “overcommitment”. The aim of the provision was to ensure no more than that the lender makes a proper assessment of the borrower’s ability to pay.<sup>86</sup>

11.54 The provision may be aimed at preventing lenders from relying on guarantees in such circumstances, since no lender is likely to enter into a contract that the borrower

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82. R McDougall, “An Introduction to the Consumer Credit Code” (1996) 15 *Australian Bar Review* 4 at 28-29.

83. Para 6.3-6.50.

84. Although there is a provision that requires the court to consider, amongst other things, the “relative economic circumstances” of the parties to the contract: *Contracts Review Act 1980* (NSW) s 9(2)(f).

85. *Australian Societies Group Financial Services (NSW) Ltd v Bogan* (1989) ASC ¶155-938. See Clayton Utz, *The New Consumer Credit Code Explained* (CCH, Sydney, 1994) at 93.

86. NSW, *Parliamentary Debates (Hansard)* Legislative Assembly, 23 May 1995, at 759. See also S Edwards, D Brogan, A Tierney, *Accessing the Consumer Credit Code* (FT Law & Tax, Melbourne, 1996) at 171.

cannot pay without the support of a guarantor.<sup>87</sup> This provision should be included in the Model Law.

## Justification of terms and conduct in light of the risks undertaken by the lender

*(m) whether the terms of the transaction or the conduct of the credit provider is justified in the light of the risks undertaken by the credit provider.*

11.55 There are no equivalent provisions in the fair trading or financial services statutes and there is no directly equivalent statement in the *Contracts Review Act*. However, another *Contracts Review Act* provision carries out the intention of this provision by allowing the court to consider “the commercial or other setting, purpose and effect of the contract”.<sup>88</sup> This *Contracts Review Act* provision is broader than the Consumer Credit Code provision and is considered below.<sup>89</sup>

## Comparable guarantee transactions

*(n) the terms of other comparable transactions involving other credit providers and, if the injustice is alleged to result from excessive interest charges, the annual percentage rate or rates payable in comparable cases.*

11.56 The fair trading and financial services statutes contain a similar provision requiring the court to consider the terms the person would have obtained from another supplier.<sup>90</sup> The *Contracts Review Act* has no equivalent provision.<sup>91</sup>

11.57 The *Contracts Review Act* has a complementary provision which allows the court to consider “the conduct of the parties to the proceedings in relation to similar contracts or courses of dealing to which any of them has been a party”.<sup>92</sup> The fair trading and financial services statutes also contain provisions which allow the Court to consider the extent to which a supplier's conduct is consistent with their conduct in other similar transactions.<sup>93</sup>

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87. R McDougall, “An introduction to the Consumer Credit Code” (1996) 15 *Australian Bar Review* 4 at 29. In such circumstances it is assumed that the borrower has assessed the guarantor as having the ability to satisfy the debt, otherwise there would be no point in seeking the guarantee.

88. *Contracts Review Act 1980* (NSW) s 9(2)(l).

89. See para 11.65-11.66.

90. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2)(e), 12CC(2)(e); *Fair Trading Act 1987* (NSW) s 43(2)(e). See also *Trade Practices Act 1974* (Cth) s 51AB(2)(e), 51AC(3)(e).

91. See D Harland, “Unconscionable and Unfair Contracts: An Australian Perspective” in R Brownsword, N Hird and G Howells (ed), *Good Faith in Contract: Concept and Context* (Dartmouth Publishing Company, 1998) at 254.

92. *Contracts Review Act 1980* (NSW) s 9(2)(k).

93. *Australian Securities and Investments Commission Act 2001* (Cth) s 12CC(2)(f). See also *Trade Practices Act 1974* (Cth) s 51AC(3)(f).



11.58 The Consumer Credit Code provision would appear merely to consider the extent to which the lender falls short of the practices of “other credit providers” in the industry in relation to comparable transactions. This is understandable on the grounds that the Consumer Credit Code offers protection in the context of consumer credit transactions. The *Contracts Review Act* provision, which concentrates on previous dealings of the parties, has different aims, such as identifying lenders who have engaged in a pattern of oppressive conduct (so that injunctive relief can be taken against them) or identifying a lack of care on the part of the borrower or guarantor in similar circumstances.<sup>94</sup>

11.59 The Commission considers that each of the forms of conduct mentioned above may be relevant in different circumstances. The courts should be able, where relevant, to consider not only the practices of other lenders but also the past conduct of the lender which has accepted the guarantee in question. It is also important to be able to consider whether there is anything in the conduct of a guarantor which may have a bearing on the court’s decision. Provision should be made accordingly in the Model Law.

### Any other relevant factor

*(o) any other relevant factor.*

11.60 This catch-all clause could cover any other factor the courts might consider but which has not been included in the list. The lists that accompany the provisions in other statutes are also not exhaustive, although they simply state that the matters to which the court shall have regard are not limited to those in the accompanying lists.<sup>95</sup>

11.61 The Commission believes that this criterion should be retained to emphasise the fact that the list is inclusive, not exhaustive.

### Other factors not covered by the Consumer Credit Code

11.62 There are a number of other matters the courts could consider, which have not been included in the Consumer Credit Code but which are included in the lists in the *Contracts Review Act* and the fair trading and financial services statutes.

#### *Relative economic circumstances, educational background and literacy*

11.63 The *Contracts Review Act* states that the court shall have regard to the “relative economic circumstances, educational background and literacy” of the parties and any person who represented any of the parties to the contract.<sup>96</sup> The consideration of this

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94. J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980 (NSW)* (Butterworths, Sydney, 1982) at 136.

95. *Contracts Review Act 1980* (NSW) s 9(2); *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB(2), 12CC(2). See also *Trade Practices Act 1974* (Cth) s 51AB(2), 51AC(3). See *West v AGC (Advances) Ltd* (1986) 5 NSWLR 610 at 620-621 (McHugh JA).

96. *Contracts Review Act 1980* (NSW) s 9(2)(f).

factor is intended to cast light on such other factors as relative bargaining power and the ability to negotiate.<sup>97</sup>

11.64 The omission of this provision from the Consumer Credit Code has not been explained. It is possible that such considerations are incorporated in factors such as relative bargaining power, ability to negotiate and understanding. However, one of the aims of the proposed list is to provide guidance to lenders about the types of situations and characteristics of guarantors that they should be alert to. Such a provision should, therefore, be included in the Model Law.

*Setting, purpose and effect of the guarantee*

11.65 The *Contracts Review Act* states that the Court shall have regard to the "commercial or other setting, purpose and effect of the contract".<sup>98</sup> This criterion was inserted with the aim of limiting the impact of the *Contracts Review Act* on purely commercial contracts. The Peden Report stated:

*...it is not intended that the legislation should affect purely commercial transactions between two or more commercial enterprises which are equally capable of protecting their own interests. By having regard to the "commercial setting, purpose and effect" of such transactions the court will readily take account of that capacity and the equality of bargaining power.*<sup>99</sup>

11.66 The second reading speech at Parliament confirmed that this clause was one of a number of provisions inserted to allay concerns about the impact of the *Contracts Review Act* on purely commercial contracts.<sup>100</sup> The exclusion of this provision from the Consumer Credit Code is understandable given the Consumer Credit Code's restriction to consumer transactions. However, the broader reach of our recommendations, which now include guarantees that relate to small business transactions, justifies the inclusion of such a provision in the Model Law.

*Relevant industry codes*

11.67 The fair trading and financial services statutes state that the courts may have regard to the provisions of any applicable industry code or any other industry code where a person reasonably believed the other party would comply with them.<sup>101</sup> The House of Representatives Standing Committee on Industry, Science and Technology proposed

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97. J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980 (NSW)* (Butterworths, Sydney, 1982) at 131.

98. *Contracts Review Act 1980 (NSW)* s 9(2)(l).

99. J R Peden, *Harsh and Unconscionable Contracts* (Report to the Minister for Consumer Affairs and Co-operative Societies and the Attorney-General for New South Wales, 1976) at 31.

100. See NSW, *Parliamentary Debates (Hansard)* Legislative Assembly, 19 March 1980 at 5536. See also J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980 (NSW)* (Butterworths, Sydney, 1982) at 139.

101. *Australian Securities and Investments Commission Act 2001 (Cth)* s 12CC(2)(h) and (i). See also *Trade Practices Act 1974 (Cth)* s 51AC(3)(g) and (h).

these provisions in 1997.<sup>102</sup> The aim was to provide a limited legislative backing to industry codes. The provisions were introduced at the same time as amendments that sought to give legislative underpinning to ensure the effective operation of codes of practice and to achieve desired behavioural change in some industries.<sup>103</sup>

11.68 Such a provision would prove useful in cases where an industry code, such as the Banking Code of Practice, may be applicable. It should be included in the Model Law, with relevant adjustments so that it applies only to such codes as may have an impact on the relationship between the guarantor and the lender.

*Compliance with terms of the Model provisions*

11.69 Neither the Consumer Credit Code nor the *Contracts Review Act* expressly provides that the court may have regard to any contravention of their provisions.

11.70 In 1991, Victoria amended the provisions of its *Credit Act 1984* (Vic) to state that in determining whether a contract was unjust, the Victorian Civil and Administrative Tribunal is “not excluded from considering any conduct relating to the contract or mortgage by reason only that the conduct constitutes or may constitute a contravention of this or any other Act”.<sup>104</sup> This was, however, a response to a judgment which suggested “that a breach of the Act which results in a civil penalty may not be able to be considered by the tribunal in determining whether a contract should be reopened”.<sup>105</sup> The amendment was made to overcome an interpretation that was never intended and that would “severely limit the operation of the provision and result in major unfairness to consumers”.<sup>106</sup> Commentators have suggested that, notwithstanding the absence of such a provision in the Consumer Credit Code, conduct in contravention of the Act may still be considered a relevant circumstance if it is productive of injustice.<sup>107</sup> The courts have supported this position, noting that “there must have been relevant and actual injustice, not merely a failure to comply with provisions of the *Credit Act*, before a contract can be held to be unjust”.<sup>108</sup>

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102. Australia, House of Representatives Standing Committee on Industry, Science and Technology, *Finding a Balance: Towards Fair Trading in Australia* (Report, 1997) at 182-183.

103. Australia, *Parliamentary Debates (Hansard)* House of Representatives, 30 September 1997 at 8801.

104. *Credit Act 1984* (Vic) s 147(4)(b), inserted by *Credit (Further Amendment) Act 1991* (Vic) s 10.

105. Victoria, *Parliamentary Debates (Hansard)* Legislative Assembly, 6 June 1991 at 3117. It was suggested that the view appeared to be “based on the premise that as a civil penalty applies in that case, to also allow the contract to be reopened would involve a doubling-up of remedies”.

106. Victoria, *Parliamentary Debates (Hansard)* Legislative Assembly, 6 June 1991 at 3117.

107. D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 451, 465.

108. *Custom Credit Corporation Ltd v Gray* [1992] 1 VR 540 at 561. See also *Custom Credit Corporation Ltd v Lynch* [1993] 2 VR 469 at 481; *Morlend Finance Corporation (Vic) Pty Ltd v Westendorp* [1993] 2 VR 284 at 309.

11.71 One commentator has noted that the Victorian provision is redundant, but adds that the Consumer Credit Code's (implied) position is that "proof that the credit provider has contravened the statute may be relevant in determining whether a contract is unjust, but by itself cannot be decisive".<sup>109</sup> This is the same position with respect to the other criteria outlined above in so far as no one criterion, by itself, is decisive.

11.72 Ensuring compliance with the prescriptive provisions proposed elsewhere in this report is, at least in part, about avoiding unjust outcomes. Contravention of any of the prescriptive provisions could, conceivably, be relevant to determining whether a guarantee or a particular term is unjust. In addition, there would appear to be no reason why compliance with similar provisions in other statutes should not also be considered. The Commission, therefore, recommends that compliance, or otherwise, with the provisions of the Model Law or any other applicable statute should be included as one of the criteria that the courts may consider in deciding whether a guarantee or a provision of a guarantee is unjust.

## RECOMMENDATION 11.6

In determining whether a guarantee or a provision of a guarantee is unjust in the circumstances relating to it at the time it was entered into or changed, the court should have regard to the public interest and to all the circumstances of the case, including such of the following as it considers relevant:

- (a) the consequences of compliance, or noncompliance, with all or any of the provisions of the guarantee;
- (b) the relative bargaining power of the parties;
- (c) whether or not, prior to, or at the time the guarantee was entered into or changed, its provisions were the subject of negotiation;
- (d) whether or not it was reasonably practicable for the guarantor to negotiate for the alteration of, or to reject, any of the provisions of the guarantee or the change, including the extent to which the lender was willing to negotiate the relevant terms and conditions;
- (e) whether or not any of the provisions of the guarantee or change impose conditions that are unreasonably difficult to comply with, or not reasonably necessary for the protection of the legitimate interests of the lender;
- (f) whether or not the guarantor, or a person who represented the guarantor, was reasonably able to protect the interests of the guarantor because of his or her age or physical or mental condition; (A person is taken to have represented a guarantor if the person represented the guarantor, or assisted the guarantor to a significant degree, in the negotiation process prior to, or at, the time the guarantee was entered into or changed.)
- (g) the relative economic circumstances, educational background and literacy of the parties to the guarantee, and of any person who represented any of the parties to the guarantee;
- (h) the form of the guarantee and the intelligibility of the language in which it is expressed;

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109. A J Duggan and E V Lanyon, *Consumer Credit Law* (Butterworths, Sydney, 1999) at 360.

- (i) whether or not, and under what circumstances, the guarantor was given the opportunity to seek legal or other expert advice;
- (j) whether or not, and if so when, the guarantor obtained independent legal or other expert advice;
- (k) the extent to which any person accurately explained the provisions of the guarantee or change, and their legal and practical effect, to the guarantor and whether or not the guarantor understood those provisions and their effect;
- (l) whether the lender or any other person exerted or used unfair pressure, undue influence or unfair tactics on the guarantor and, if so, the nature and extent of that unfair pressure, undue influence or unfair tactics;
- (m) whether the lender took measures to ensure that the guarantor understood the nature and implications of the guarantee and, if so, the adequacy of those measures;
- (n) whether at the time the guarantee was entered into or changed, the lender knew, or could have ascertained by reasonable inquiry of the borrower at the time, that the borrower could not pay in accordance with the terms of the guaranteed loan or could only do so with substantial hardship;
- (o) whether the terms of the guarantee or the conduct of the lender are justified in the light of the risks undertaken by the lender;
- (p) the terms of other comparable guarantees involving other lenders and, if the injustice is alleged to result from excessive interest rates or other charges, the annual percentage rate or rates or other charges for which guarantors might become liable in comparable cases;
- (q) the requirements of (i) any applicable industry code, or (ii) any other industry code with which the guarantor reasonably believed the lender would comply;
- (r) whether, in entering the guarantee, the parties complied with the provisions of the Model Law or any other relevant statute;
- (r) the conduct of the parties to the proceedings in relation to similar contracts or courses of dealing to which any of them has been a party; and
- (s) any other relevant factor.

## GRANTING RELIEF

11.73 Under the Consumer Credit Code and *Contracts Review Act*, once the court has found that a contract or any of its provisions is unjust, it must decide whether or not to grant relief. In doing so, the court may refer to post-contract conduct.<sup>110</sup>

### Justification for a statutory regime

11.74 The Commission's recommendations ensure that a flexible range of remedies is available to the courts in granting relief in the case of guarantees or provisions of guarantees that are found to be unjust. In equity, the remedies available to the court include setting aside the contract completely or rescinding the contract in whole or in part. There is no jurisdiction in equity to remodel the agreement. It has been observed that remedies available in particular cases might well have been "less ample" had it not been

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110. See para 11.84-11.85.

for the availability of the statutory remedies such as those under the *Contracts Review Act*.<sup>111</sup>

11.75 The *Contracts Review Act* provides for a wider and more flexible range of remedies in a number of ways. First, it provides more options than setting aside the contract. Secondly, the relief it offers need not be constrained by equity. At general law, relief for unconscionable dealing is equitable, therefore, the court can look to the conduct of the guarantor and decline relief in some cases where it might otherwise be warranted. The *Contracts Review Act* also allows some measure of relief where courts may otherwise have been unwilling to grant it because of the consequences of setting aside a contract in its entirety. This was because the injustice to the lender in setting aside the contract was often seen as outweighing the injustice to the guarantor in enforcing it.<sup>112</sup>

11.76 The relief available under the *Contracts Review Act* is divided into principal and ancillary relief.

## Principal relief

11.77 The Consumer Credit Code makes provision for orders that may be made on the reopening of a transaction:

*The Court may, if it reopens a transaction under this Division, do any one or more of the following, despite any settlement of accounts or any agreement purporting to close previous dealings and create a new obligation—*

- (a) *reopen an account already taken between the parties;*
- (b) *relieve the debtor and any guarantor from payment of any amount in excess of such amount as the Court, having regard to the risk involved and all other circumstances, considers to be reasonably payable;*
- (c) *set aside either wholly or in part or revise or alter an agreement made or mortgage given in connection with the transaction;*
- (d) *order that the mortgagee takes such steps as are necessary to discharge the mortgage;*
- (e) *give judgment for or make an order in favour of a party of such amount as, having regard to the relief (if any) which the Court thinks fit to grant, is justly due to that party under the contract, mortgage or guarantee;*

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111. *Peters v Commonwealth Bank of Australia* (1992) ASC ¶56-135 at ¶57,366.

112. D Harland, "Unconscionable and Unfair Contracts: An Australian Perspective" in R Brownsword, N Hird and G Howells (ed), *Good Faith in Contract: Concept and Context* (Dartmouth Publishing Company, 1998) at 262.

- (f) *give judgment or make an order against a person for delivery of goods to which the contract, mortgage or guarantee relates and which are in the possession of that person;*
- (g) *make ancillary or consequential orders.*<sup>113</sup>

11.78 The orders in the Consumer Credit Code are specifically aimed at consumer credit transactions and are mostly derived from provisions in the *Credit Act 1984* (NSW).<sup>114</sup> This coverage may be compared with the more comprehensive provisions of the *Contracts Review Act* which are intended to cover a broader range of dealings. The principal orders that a court may make under the *Contracts Review Act* are:

- (a) *it may decide to refuse to enforce any or all of the provisions of the contract,*
- (b) *it may make an order declaring the contract void, in whole or in part,*
- (c) *it may make an order varying, in whole or in part, any provision of the contract,*
- (d) *it may, in relation to a land instrument, make an order for or with respect to requiring the execution of an instrument that:*
  - (i) *varies, or has the effect of varying, the provisions of the land instrument, or*
  - (ii) *terminates or otherwise affects, or has the effect of terminating or otherwise affecting, the operation or effect of the land instrument.*<sup>115</sup>

11.79 The Consumer Credit Code provisions are not as comprehensive as the *Contracts Review Act* provisions, especially in light of the enumeration of ancillary powers in the *Contracts Review Act*.<sup>116</sup> The *Contracts Review Act* also includes a statement of the object of granting relief, namely to avoid “as far as practicable an unjust consequence or result”.<sup>117</sup> There is no comparable express provision in the Consumer Credit Code, although such terms may be considered to be implied.<sup>118</sup>

11.80 However, some specific provisions of the Consumer Credit Code may have some utility. For example, s 71(a) overcomes the ordinary rule that an account stated is binding on the parties unless there is fraud or some other ground that allows an agreement to be

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113. *Consumer Credit (New South Wales) Code* s 71.

114. *Credit Act 1984* (NSW) s 146(2).

115. *Contracts Review Act 1980* (NSW) s 7(1).

116. See para 11.82. See also D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 513-514.

117. *Contracts Review Act 1980* (NSW) s 7(1).

118. See D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 513.

set aside.<sup>119</sup> Section 71(b) is a useful statement phrased broadly enough to allow the court to relieve a guarantor from such additional amounts as deferral charges, default interest and enforcement expenses.<sup>120</sup>

11.81 The Commission, therefore, considers that the *Contracts Review Act* provisions, including the list of ancillary powers, should be adopted, taking into account any useful elaborations in the Consumer Credit Code. The provisions in relation to land instruments, in conjunction with s 19 of the *Contracts Review Act* and the ancillary powers to order the transfer of property, are intended to deal with the principle of indefeasibility under the Torrens system of land registration.<sup>121</sup>

## RECOMMENDATION 11.7

The Model Law should provide that, in reopening a guarantee, and in order to avoid as far as practicable an unjust consequence or result, the court may do any one or more of the following, despite any settlement of accounts or any agreement purporting to close previous dealings and create a new obligation—

- (a) reopen an account already taken between the parties;
- (b) refuse to enforce any or all of the provisions of the guarantee;
- (c) set aside any provision of the guarantee in whole or in part,
- (d) vary any provision of the guarantee in whole or in part;
- (e) relieve a guarantor from payment of any amount in excess of such amount as the court, having regard to the risk involved and all other circumstances, considers to be reasonably payable;
- (f) in relation to a land instrument given by the guarantor, make an order for or with respect to requiring the execution of an instrument that:
  - (i) varies, or has the effect of varying, the provisions of the land instrument, or
  - (ii) terminates or otherwise affects, or has the effect of terminating or otherwise affecting, the operation or effect of the land instrument.

## Ancillary or consequential relief

11.82 The ancillary relief provisions in the Consumer Credit Code<sup>122</sup> are not as expansive as the ancillary and consequential provisions under the *Contracts Review Act*. The *Contracts Review Act* provides that, in addition to any orders under s 7, the court “may also make such orders as may be just in the circumstances for or with respect to any consequential or related matter”. The orders may include any of the following:

- (a) *the making of any disposition of property,*

119. D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 518.

120. D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 518.

121. See J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980 (NSW)* (Butterworths, Sydney, 1982) at 118.

122. *Consumer Credit (New South Wales) Code* s 71(g).



- (b) *the payment of money (whether or not by way of compensation) to a party to the contract,*
- (c) *the compensation of a person who is not a party to the contract and whose interest might otherwise be prejudiced by a decision or order under this Act,*
- (d) *the supply or repair of goods,*
- (e) *the supply of services,*
- (f) *the sale or other realisation of property,*
- (g) *the disposal of the proceeds of sale or other realisation of property,*
- (h) *the creation of a charge on property in favour of any person,*
- (i) *the enforcement of a charge so created,*
- (j) *the appointment and regulation of the proceedings of a receiver of property, and*
- (k) *the rescission or variation of any order of the court under this clause, and such orders in connection with the proceedings as may be just in the circumstances.*

Some of these orders cover the same ground as the orders in the Consumer Credit Code. For example, paragraph (d) covers the ground in paragraph (f) of the Consumer Credit Code orders, and paragraphs (b) and (c) cover the ground in paragraph (e) of the Consumer Credit Code orders. Some other paragraphs clearly have no relevance to the granting of relief to guarantors, such as those that refer to the supply or repair of goods or the supply of services. These should not be included in the Model Law.

#### *Mediation*

11.83 Professor Peden, in his early commentary on the *Contracts Review Act*, suggested that a useful ancillary power might be for the court to order the parties to submit their dispute to arbitration. However, he also noted that even without an express power, “courts have always been able to suggest to the parties appropriate lines upon which a settlement may be negotiated which could then form the basis for a consent order”.<sup>123</sup> Since the *Contracts Review Act* was enacted in 1980, mediation has become an accepted part of the orders that courts may make in seeking to resolve a matter.<sup>124</sup> Indeed, many courts in New South Wales may now order mandatory mediations.<sup>125</sup> Nevertheless, the Commission considers that it would be useful to include a mediation provision in the list of possible ancillary orders.

123. J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980 (NSW)* (Butterworths, Sydney, 1982) at 119.

124. See, eg, NSWLRC, *Community Justice Centres* (Report 106, 2005) at para 1.13.

125. *Civil Procedure Act 2005* (NSW) Part 4; *Consumer, Trader and Tenancy Tribunal Act 2001* (NSW) Part 5 Div 2. See also para 12.24-12.33.

## RECOMMENDATION 11.8

The Model Law should provide that the court may also make such orders as may be just in the circumstances for or with respect to any consequential or related matter, including any of the following:

- (a) the making of any disposition of property,
  - (b) the payment of money (whether or not by way of compensation) to a party to the guarantee,
  - (c) the compensation of a person who is not a party to the guarantee and whose interest might otherwise be prejudiced by a decision or order under the Model Law,
  - (d) the sale or other realisation of property,
  - (e) the disposal of the proceeds of sale or other realisation of property,
  - (f) the creation of a charge on property in favour of any person,
  - (g) the enforcement of a charge so created,
  - (h) the appointment and regulation of the proceedings of a receiver of property,
  - (i) the rescission or variation of any order of the court under this clause, and
  - (j) the submission of any aspect of the matter in dispute to mediation,
- and such other orders or relief in connection with the proceedings as may be just in the circumstances.

### Relevance of parties' conduct after the contract was entered into

11.84 The Consumer Credit Code allows the court, in deciding whether to grant relief, to have regard to the "conduct of the parties to the proceedings in relation to the contract... since it was entered into".<sup>126</sup> The *Contracts Review Act* contains a provision to the same effect,<sup>127</sup> although, arguably, the Consumer Credit Code provision is broader than the *Contracts Review Act* because the *Contracts Review Act* refers to conduct "in relation to the performance of the contract".<sup>128</sup>

11.85 This allows the court to consider post-contract conduct of the parties, such as breach, repudiation and election to rescind. It was envisaged that such a provision would "enable the court to examine conduct which is not itself an actual breach of contract but which may reflect upon the effect of the contract in practice and assist the court to fashion an appropriate form of relief".<sup>129</sup> For example, the court could take into account a lender's

126. *Consumer Credit (New South Wales) Code* s 70(5)

127. *Contracts Review Act 1980* (NSW) s 9(5).

128. See D McGill and L Willmott, *Annotated Consumer Credit Code* (LBC Information Services, Sydney, 1999) at 509; and *Antonovic v Volker* (1986) 7 NSWLR 151 at 157.

129. J R Peden, *The Law of Unjust Contracts including the Contracts Review Act 1980* (NSW) (Butterworths, Sydney, 1982) at 142. It should be noted that the provision, as originally proposed, was intended as one of the criteria for determining whether a contract or a provision of a contract is unjust: J R Peden, *Harsh and Unconscionable Contracts* (Report to the Minister for Consumer Affairs and Co-operative Societies and the Attorney-General for New South Wales, 1976) at 26.

lenient application of an otherwise harsh repayment clause.<sup>130</sup> A similar capacity to refer to such conduct should be included in the Model Law.

## RECOMMENDATION 11.9

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The Model Law should provide that, in deciding whether to grant relief, the court may have regard to the conduct of the parties to the proceedings in relation to the guarantee since it was entered into.

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130. See, eg, *Gibson v Finance Corporation of Aust Ltd* (1980) ASC ¶155-066 at 56,143.

## 12. Dispute resolution

- Introduction
- Empirical background
- Negotiation
- Tribunal proceedings
- Mediation
- Industry-based dispute resolution schemes

## INTRODUCTION

12.1 In this chapter, the Commission examines ways of resolving disputes between lenders and guarantors other than through court proceedings, in particular:

- by postponement of court proceedings to facilitate the negotiation of settlement;
- in proceedings before the Consumer, Trader and Tenancy Tribunal of New South Wales;
- by mediation; and
- through industry-based dispute resolution schemes.

## EMPIRICAL BACKGROUND

12.2 It appears that many guarantors simply pay the debts of others rather than dispute a transaction.<sup>1</sup> Given the high cost and low success rate of disputing debts, this is perhaps unsurprising. Where guarantors dispute the transaction, the empirical study conducted by the Commission and the University of Sydney ("Lovric and Millbank") found that litigation remains central to resolving disputes.<sup>2</sup> The data from the research clearly shows that the litigation process is a less than a satisfactory way to seek redress. Legal costs are quite high, which impacts disproportionately on guarantors as they have fewer financial resources and less experience in court processes compared with lenders. Lovric and Millbank were unable to determine clearly how many guarantors were proceeding to litigation without legal representation, although several judges who participated in the research stated that they saw a significant portion of unrepresented litigants.<sup>3</sup> In this context, the observations made by Justice Heydon in a case between a bank and an unrepresented litigant are telling:

*The court room contest revealed a gross disparity in power between the plaintiff bank and the defendant. The plaintiff bank was legally represented, was very experienced in this type of litigation, and was prepared to make full use of the opportunities which the rules of evidence and procedure afford a party not bearing the burden of proof in an adversary system. The defendant was not represented, was wholly inexperienced and was evidently almost wholly unable to do his cause any justice. The disparity in forensic power was akin to their disparity in economic power.*<sup>4</sup>

12.3 In addition to high costs, litigation in this area is often technical, lengthy and complex. It is marked by a complex maze of claims and cross claims on a variety of

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1. J Lovric and J Millbank, *Darling, please sign this form: a report on the practice of third party guarantees in New South Wales* (NSW Law Reform Commission and the University of Sydney, Research Report 11, 2003) at para 6.16. Almost a third of respondents to the study's survey of guarantors reported that they had paid the loan back in part or full.
  2. See Lovric and Millbank ch 7.
  3. Lovric and Millbank at para 7.82.
  4. *Conley v Commonwealth Bank of Australia* [2000] NSWCA 101 at para 102.

common law and statutory bases. Lovric and Millbank found that it was common for three or more grounds of defence to be relied upon in any single matter and late amendments to pleadings were a regular event.<sup>5</sup> Interlocutory applications are common, with many matters being subject to strike out or summary judgment applications by lenders or stay applications by guarantors. These applications can substantially increase the costs of litigation, and may serve as a serious impediment for those impecunious guarantors seeking access to the courts for redress.<sup>6</sup>

12.4 Many participants to the research expressed the view that litigation was expensive, complex and inefficient for the resolution of guarantee disputes, and expressed a preference for more accessible dispute resolution mechanisms, such as negotiation, mediation, tribunal processes or industry resolution.<sup>7</sup>

## NEGOTIATION

12.5 Negotiation, a process in which parties in dispute attempt to reach a resolution through discussion, persuasion, bargaining, compromise and settlement, is one of the most common and cost-effective means of resolving commercial disputes.<sup>8</sup> However, at the stage where a lender is entitled to enforce a guarantee, in particular where it has already taken the steps required for the initiation of legal proceedings, negotiating a settlement becomes more difficult for the borrower and guarantor because of the impending court proceedings. For consumer transactions, Part 5 Division 3 of the *Consumer Credit (New South Wales) Code* ("Consumer Credit Code"), consisting of s 86-89, gives assistance in this situation by allowing the postponement of court proceedings.

### Postponement by parties

12.6 Section 86(1) provides:

*A debtor, mortgagor or guarantor who has received a default notice under Part 5, Division 2, or a demand for payment under section 82, may, before the end of the period specified in the notice or demand, negotiate with the credit provider in respect of the postponement of the enforcement proceedings or any action taken under such proceedings or in respect of the operation of an acceleration clause.*

12.7 This provision specifies who may negotiate for a postponement of enforcement proceedings, the circumstances in which postponement may be sought, and the proceedings in respect of which postponement may be sought. It is, on its own, not very significant, since the parties can always negotiate if they want to. The section could not

5. Lovric and Millbank at para 7.8-7.10, 7.81.

6. Lovric and Millbank at para 7.11.

7. Lovric and Millbank at para 6.52.

8. See H Astor and C M Chinkin, *Dispute Resolution in Australia* (Butterworths, Sydney, 1992) ch 4.

have been intended as an implied prohibition on negotiations outside the section. Its real purpose is to lay the foundation for the subsequent provisions.<sup>9</sup>

12.8 Section 87 provides that, where a postponement is negotiated, “the default notice... is taken, for the purposes of the Code, not to have been given”. In other words, the credit provider is not entitled to take enforcement proceedings in the meantime. The default notice referred to is that which the credit provider must give to the debtor, mortgagor or guarantor under s 80. Under that section, the credit provider cannot initiate enforcement proceedings against the debtor or mortgagor until after 30 days from the date of the notice of default. This default notice is, however, not a requirement for the commencement of court proceedings against a guarantor.<sup>10</sup> The effect of s 87 on guarantees could therefore be called into question. However, this issue would not arise under our proposed legislation because of Recommendation 10.2 that the notice of default that needs to be given to the guarantor should be a pre-requisite to the commencement of enforcement proceedings by the lender against the guarantor.

12.9 Section 87 further provides that it is a condition of any negotiated postponement with the credit provider after the credit provider has taken possession of property subject of a mortgage that the mortgagor pay the reasonable costs of the credit provider in taking possession of the property. Moreover, the credit provider has an obligation to give a written notice to the relevant parties, not later than 30 days after the agreement was reached, setting out the conditions of the postponement and the consequences of non-compliance, which is that no further notice is required before the commencement of enforcement proceedings. If the credit provider fails to give the required notice, it commits a criminal offence that attracts a penalty of 100 penalty units.<sup>11</sup> Such failure does not, however, affect the effectiveness of the negotiated postponement.

## Court-ordered postponement

12.10 Where guarantors are unable to negotiate a postponement of the enforcement proceedings with the credit provider, s 88 of the Consumer Credit Code grants them a right to apply to the court for a postponement. The court may order or refuse to order the postponement and may make such other orders as it thinks fit. The Code gives no guidance as to the considerations to be taken into account by the court in determining what to order. If it considers it appropriate, the court may stay any enforcement proceedings under the credit contract or mortgage until the application has been determined. Where a court makes an order under s 88, the credit provider is entitled to apply for a variation of that order.<sup>12</sup>

12.11 The relief available under s 88 and the matters to be considered by the court when determining an application were considered by the Commercial Tribunal of Western Australia in *George v Bank of Western Australia Ltd*,<sup>13</sup> which involved a debtor but is

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9. D McGill and L Willmont, *Annotated Consumer Credit Code* (LBC Information Services, Pyrmont NSW, 1999) at 607.

10. See para 10.15-10.17.

11. *Consumer Credit (New South Wales) Code* s 87(2), (3) and (5).

12. *Consumer Credit (New South Wales) Code* s 89.

13. (1998) ASC ¶155-022.

nevertheless instructive in cases concerning guarantors. In this case, the applicant, who had borrowed money from the respondent bank which he was unable to repay, telephoned the bank and requested a three-week postponement of enforcement action. After some discussion, the bank postponed enforcement action for 25 days. After this period had expired, the applicant sought a postponement under s 88. The bank argued that the 25-day postponement was a negotiated postponement within the meaning of the section and, as a result, the Tribunal had no jurisdiction to hear the application. The Tribunal held that the 25-day postponement was not a negotiated postponement, as the applicant had not agreed to it. All the applicant had done was acknowledge that the 25 days was all that the respondent would allow. The applicant was granted a postponement after the Tribunal found that the bank would not suffer any real prejudice as a result of a postponement, that the reason for default was outside the direct control of the applicant, and that the applicant had attempted to remedy the default.

12.12 A condition precedent to the court granting a postponement under s 88 is the fact that the guarantor has been unable to negotiate a postponement pursuant to s 86. This section requires these negotiations to commence within the period specified in the default notice, which is 30 days from the date of the notice of the debtor's default. In *Anseline v General Motors Acceptance Corporation*,<sup>14</sup> the Credit Tribunal of Victoria held that an application could not be made to the court for a postponement if the unsuccessful negotiations were commenced after the specified period. There is, however, nothing in s 86 to indicate whether or not negotiations need to be completed within the specified period. The Tribunal in the *Anseline* case proceeded on the basis that it is sufficient, to comply with s 86, to commence negotiations within the period.

## The Commission's conclusions

12.13 The Model Law should contain provisions similar to s 86-89 (Part 5 Division 3) of the Consumer Credit Code, which authorise the postponement of court proceedings to allow the parties to negotiate a settlement. The proposed legislation may, however, need to specify a different monetary limit to that contained in the Code. Under the Consumer Credit Code, the right to negotiate the postponement of proceedings only applies to credit contracts in respect of which the maximum amount of credit that is or may be provided is \$125,000 or less.<sup>15</sup> The Consumer Credit Code allows the regulations to alter this amount but to date no such alteration has been made. It may be argued that the monetary limit in the Code is not appropriate for guarantees that relate to small business loans, which generally involve larger sums of money than consumer loans.

12.14 In the research conducted by Lovric and Millbank, 48% of the guarantors surveyed were involved with loans of less than \$50,000, while 26% were involved with loans of between \$50,000 and \$200,000, and 24% were involved with loans of over \$200,000.<sup>16</sup> The solicitors and barristers reported significantly larger amounts at stake in the transactions they last dealt with:

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14. (1998) ASC ¶155-020.

15. *Consumer Credit (New South Wales) Code* s 86(2).

16. Lovric and Millbank at para 2.20.



- 38% of barristers and 31% of solicitors reported that in the last guarantee matter on which they acted, the loan was valued at between \$50,000 and \$250,000,
- 18% of barristers and 25% of solicitors reported loans between \$250,000 and \$500,000 in their last matter,
- 38% of barristers and 22% of solicitors reported loans over \$500,000.<sup>17</sup>

12.15 The reported cases canvassed by Lovric and Millbank also revealed far higher amounts than those reported by guarantors:

- only 2% of matters involved a loan of less than \$50,000;
- 38% concerned a loan between \$50,000 and \$250,000;
- 25% were between \$250,000 and \$500,000; and
- 35% were over \$500,000.<sup>18</sup>

12.16 The involvement of lawyers and the use of litigation correlated with high value transactions in the reported cases. The smaller value of loans in the guarantors survey correlated with the proportion of guarantees that were for non-business purposes (such as loans to purchase cars for individual use). Although the amounts involved differed depending on the source of the data, the fact remains that the setting of an upper limit of \$125,000 for the operation of provisions on the negotiation of postponement of court proceedings would exclude a substantial number of guarantees. The Model Law should increase the monetary limitation on the right to negotiate the postponement of proceedings to \$500,000.

## RECOMMENDATION 12.1

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The Model Law should contain provisions similar to s 86-89 of the *Consumer Credit Code*, which provide for the postponement of court proceedings to allow the parties to negotiate a settlement. It should, however, additionally provide that the right to negotiate a postponement of proceedings only applies to credit contracts in respect of which the maximum amount of credit that is or may be provided is \$500,000 or less, or such other amount as may be prescribed by the regulations.

## TRIBUNAL PROCEEDINGS

12.17 Some tribunals may be seen as providing a more accessible dispute resolution forum than courts. Among such tribunals is the Consumer, Trader and Tenancy Tribunal of New South Wales ("CTTT"), which in February 2002 replaced the Fair Trading Tribunal and the Residential Tribunal.<sup>19</sup>

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17. Lovric and Millbank at para 2.20 note 28.

18. Lovric and Millbank at para 2.20 note 29.

19. It was established pursuant to the *Consumer, Trader and Tenancy Tribunal Act 2001* (NSW).

12.18 The Consumer Credit Code is one of the statutes that confer jurisdiction on the CTTT.<sup>20</sup> Hence, the CTTT has jurisdiction over guarantees that are within the ambit of the Consumer Credit Code. It can, for example, make a determination that a guarantee is unjust and relieve the guarantor from paying any amount in excess of the amount that it considers reasonable under the circumstances.<sup>21</sup> It can also review unconscionable interest rates and other fees and charges.<sup>22</sup> The jurisdiction of the CTTT is, as a general rule, not exclusive.<sup>23</sup> Hence, parties to a dispute may choose to go to a court that has jurisdiction over the matter.<sup>24</sup>

12.19 Proceedings conducted by the CTTT may be seen as having some advantages over court proceedings, especially where the litigant does not have legal representation. First, the CTTT is not bound by the rules of evidence and is required to act with as little formality as the circumstances of the case permit, and according to equity, good conscience and the substantial merits of the case without regard to technicalities or legal forms.<sup>25</sup> The freedom from technicality allows parties to understand and participate in the process in a meaningful way. Secondly, the CTTT, unlike courts, can engage in independent fact finding by requesting additional information be provided by the parties or seeking that information itself by, for example, calling witnesses on its own motion.<sup>26</sup> The CTTT's ability to take an active investigative approach means the outcome of a dispute would be less reliant on the resources and advocacy skills of the parties and/or their representatives. Thirdly, the law has put in place mechanisms to minimise costs for the parties: for example, parties in CTTT proceedings are required to pay their own costs, as a general rule.<sup>27</sup> A final advantage of the CTTT is the specialised nature of the matters that it can handle. This enables the CTTT to develop expert knowledge of the law and practice in a particular area, which may reduce the time needed to resolve the dispute and thus the costs incurred both by the parties and the system.

12.20 Lovric and Millbank found that very few third party guarantee disputes are being resolved by the CTTT (or its predecessor the Fair Trading Tribunal).<sup>28</sup> This under-usage is likely to be caused by the consumer/business distinction drawn in the Consumer Credit Code. Small business transactions are excluded from the Consumer Credit Code; so where the purpose of the loan is commercial rather than personal, the CTTT has no

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20. *Consumer Credit (New South Wales) Act 1995* s 8.

21. *Consumer Credit (New South Wales) Code* s 70, 71.

22. *Consumer Credit (New South Wales) Code* s 72.

23. The *Consumer Credit (New South Wales) Code* s 8(1)(a) confers exclusive jurisdiction on the Tribunal in the case of any jurisdiction prescribed by the regulations for the purposes of this paragraph. The jurisdiction prescribed by the regulations for the purposes of section 8 (1)(a) of the Act is: (a) any jurisdiction under section 69, 83 (1), 89, 100–114 or 162 of the Code, and (b) any jurisdiction under section 36 (6) of the Code in relation to an application made by a credit provider: *Consumer Credit (New South Wales) Special Provisions Regulation 2002* (NSW) cl 5.

24. *Consumer Credit (New South Wales) Act 1995* s 8. See also *Consumer, Trader and Tenancy Tribunal Act 2001*(NSW) s 23.

25. *Consumer, Trader and Tenancy Tribunal Act 2001* (NSW) s 28.

26. *Consumer, Trader and Tenancy Tribunal Act 2001* (NSW) s 28, 39.

27. *Consumer, Trader and Tenancy Tribunal Act 2001* (NSW) s 53.

28. Lovric and Millbank at para 6.43.

jurisdiction to hear the matter. Applications brought by guarantors to the CTTT have been dismissed on this basis.<sup>29</sup>

12.21 A 2001 decision of the New South Wales Supreme Court significantly restricted the possible operation of the Consumer Credit Code in this area. In *Boon v Park Avenue Nominees*,<sup>30</sup> credit was provided to the plaintiff to refinance an earlier loan made to the plaintiff and his son to finance the purchase of stock and improvements to the son's cattle stud. The plaintiff was not involved in the cattle stud business and the credit was secured by mortgages over property owned by the plaintiff. The Fair Trading Tribunal of New South Wales held that the predominant purpose of the plaintiff in obtaining the loan was to repay his son's debt. The tribunal characterised the loan as personal in nature because it was the action of a father aiding a son, and consequently the Consumer Credit Code applied to the transaction. The Supreme Court overturned this decision and held that the lender established that the loan was not provided wholly or predominantly for personal, domestic or household purposes.<sup>31</sup>

12.22 This decision effectively narrows the operation of the Consumer Credit Code in the area of third party guarantees. Data from the Lovric and Millbank study indicates that the primary motivation for many third party guarantors is the provision of assistance to family members, and that most borrowers apply these funds to small business enterprises.<sup>32</sup> The implication of the decision in *Park Avenue* is that, where a relative is motivated to assist a borrower with a business loan because of factors arising out of their relationship, access to dispute resolution mechanisms under the Consumer Credit Code is not available.

12.23 Lovric and Millbank found strong support for increased involvement by lower cost tribunals, such as the CTTT, in cases involving third party guarantees.<sup>33</sup> This is not possible (in the case of business loans widely defined) under the current jurisdictional restrictions of the tribunal. To provide an accessible, fair, speedy and inexpensive system of dealing with disputes concerning guarantees, the Model Law should grant the CTTT jurisdiction to resolve issues arising out of its provisions. However, cases with complicated issues of fact and law may be better suited for courts to resolve. The jurisdiction of the CTTT should be limited to cases where the amount claimed does not exceed \$500,000 or other (higher) figure prescribed by the regulations.

## RECOMMENDATION 12.2

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29. Communication from Mr Graeme Durie, Senior Member of the CTTT, 22 August 2002.

30. (2001) ASC ¶155-045.

31. The Supreme Court held that the Consumer Credit Code did not apply because the purpose of the loan did not come within s 6(1)(b). Both the court and the tribunal referred to the Victorian Supreme Court decision in *Linkenholt Pty Ltd v Quirk* (2000) ASC ¶155-040. However while the tribunal distinguished that case, the Supreme Court relied upon it.

32. See generally Lovric and Millbank ch 2.

33. Lovric and Millbank at para 6.47.

The Model Law should grant jurisdiction to the Consumer, Trader and Tenancy Tribunal to resolve matters arising out of its provisions. Its jurisdiction should, however, be limited to cases where the amount claimed does not exceed \$500,000 or any other figure prescribed by the regulations.

## MEDIATION

12.24 Mediation has been defined as a process whereby a third party, from a position of apparent neutrality, assists disputants towards an outcome agreed between them.<sup>34</sup>

*Initially the mediator introduces her or himself to the parties and explains the nature of mediation, the procedure which will be followed and the ground rules. Generally there follows a period of information gathering in which the parties describe to the mediator the nature of the dispute and its context, including all the issues they consider important or relevant. They agree which issues will be dealt with in the mediation. Next, options for resolving those issues are considered and agreement on some or all of them may be reached. Methods of implementing the agreement are considered.*<sup>35</sup>

12.25 There is a vast range of means by which parties in dispute may avail themselves of mediation. For example, the *Farm Debt Mediation Act 1994* (NSW) prevents a creditor from taking enforcement action against a farmer in respect of a farm mortgage until at least 21 days have elapsed after the creditor has given written notice to the farmer.<sup>36</sup> Within 21 days after the notice is given, the farmer may request mediation concerning the farm debt.<sup>37</sup> Enforcement of the farm mortgage is then postponed until the Rural Assistance Authority has issued a certificate that it is satisfied that certain processes have been carried out.<sup>38</sup>

12.26 Mediation is also available through industry-based dispute resolution schemes, which are discussed below.

12.27 This section is, however, confined to mediation incorporated into the court and tribunal systems, particularly the concept of mandatory referral to mediation and its relevance to disputes involving guarantees.

12.28 Both the New South Wales Supreme and District Courts have for some time now had the power to refer matters to mediation. However, the Supreme Court in August 2000 was given the power to refer proceedings to mediation or neutral evaluation even without

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34. H Astor and C M Chinkin, *Dispute Resolution in Australia* (Butterworths, Sydney, 1992) at 60 citing J Folberg and A Taylor, *Mediation: A Comprehensive Guide to Resolving Conflict Without Litigation* (San Francisco, Jossey Bass, 1984) at 7.

35. H Astor and C M Chinkin, *Dispute Resolution in Australia* (Butterworths, Sydney, 1992) at 96.

36. *Farm Debt Mediation Act 1994* (NSW) s 11(1).

37. *Farm Debt Mediation Act 1994* (NSW) s 9(1).

38. *Farm Debt Mediation Act 1994* (NSW) s 11(1).

the consent of the parties.<sup>39</sup> The court will only refer parties to mediation where, in its opinion, mediation appears appropriate. The parties themselves may also, at any stage of the court proceedings, agree to mediation.<sup>40</sup>

12.29 One of the main aims underlying the introduction of mandatory mediation in the court system is the reduction of costs of resolving disputes,<sup>41</sup> an issue that Lovric and Millbank found to be of significant concern to parties in disputes involving guarantees.<sup>42</sup> However, some commentators advise caution on mediation's ability to reduce costs. Studies of court-annexed alternative dispute resolution schemes in the United States and United Kingdom have suggested that claims of reduced costs are not justified.<sup>43</sup> Some mediations require extensive preparation, the involvement of lawyers for legal advice, and the additional cost of the mediator's fees.<sup>44</sup> Any agreement reached usually needs to be looked at by lawyers and approved by the court. Consequently, legal costs and court processes are not totally avoided.<sup>45</sup>

12.30 There have been no studies on the cost implications of court-annexed mediation in New South Wales, including mandatory mediation. Hence, no conclusion can be made on whether or not this type of mediation has an impact on the costs of dispute resolution. Nevertheless, their potential for cost reduction may be surmised, especially where the disputing parties reach agreement relatively quickly, thus avoiding the cost of court proceedings. Moreover, since effective dispute resolution programs require adequate administrative support, it may be postulated that an increase in the caseload of these programs as a result of mandatory referral may allow the administration to be provided on a cost-effective basis.

12.31 Setting aside the issue of costs, court-annexed mandatory mediation may have several benefits. Because parties and their lawyers may be more accustomed to the litigation process, rates of voluntary usage are often low. Mandating the use of mediation may increase substantially the total number of cases settled through its use. The expanded use of mediation as a result of mandatory participation will serve to educate

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39. This was accomplished through section 110K of the *Supreme Court Act 1970* (NSW), which provided that, if it considers the circumstances appropriate, the court may, by order, refer any proceedings, or part of any proceedings, before it for mediation or neutral evaluation, and may do so either with or without the consent of the parties to the proceedings concerned. This rule is now contained in section 26 of the *Civil Procedure Act 2005* (NSW). For a commentary on the Supreme Court's power to order mandatory mediation, see P Venus, "Advantages in Mandatory Mediation" (2003) 41 *Law Society Journal* 46.

40. *Civil Procedure Act 2005* (NSW) s 34.

41. D Spencer, "Mandatory Mediation and Neutral Evaluation: A Reality in New South Wales" (2000) 11 *Australian Dispute Resolution Journal* 237 at 238-242 citing the Parliamentary debate on the amendment to the *Supreme Court Act 1970* (NSW).

42. Lovric and Millbank at para 7.22-7.30.

43. See H Astor and C M Chinkin, *Dispute Resolution in Australia* (Butterworths, Sydney, 1992) at 174.

44. L Boule, *Mediation: Principles, Process, Practice* (Butterworths, Sydney, 1992) at 53.

45. R Alexander, "Family Mediation Under the Microscope" (1999) 1 *Australian Dispute Resolution Journal* 18 at 21.

parties and their lawyers, which could result in an increased use of dispute resolution programs outside the court processes. In other words, it may encourage disputing parties and their lawyers to consider settlement even before litigation. Finally, court-annexed mandatory mediation institutionalises the many general advantages of alternative dispute resolution.<sup>46</sup>

12.32 Parties to consumer guarantees may also benefit from the referral to mediation and neutral evaluation by the CTTT. The *Consumer, Trader and Tenancy Tribunal Act 2001 (NSW)* empowers the CTTT to refer a matter arising in any proceedings for mediation or neutral evaluation if the Tribunal considers the circumstances appropriate.<sup>47</sup> It contains provisions that are intended to maximise the effectiveness of mediation and neutral evaluation:

- Section 60 provides that the costs of mediation or neutral evaluation, including the costs payable to the mediator or neutral evaluator, are payable by the CTTT. This provision addresses to some extent the criticism that mediation annexed to courts or tribunals may not reduce the parties' costs. However, the regulations provide that, if the parties elect to employ their own mediator or neutral evaluator rather than rely on one arranged by the CTTT, they must pay the costs of the mediation or neutral evaluation in such proportions as they may agree among themselves or, failing agreement, in such manner as may be ordered by the Tribunal.<sup>48</sup>
- Section 62 extends to mediation sessions and neutral evaluations the same privilege with regard to defamation as exists in relation to legal proceedings. It is aimed at encouraging a person who is taking part in mediation to speak freely so that the true facts may be ascertained.
- Section 63 prohibits a mediator or neutral evaluator from disclosing information obtained in connection with mediation or neutral evaluation except in very specific circumstances.<sup>49</sup> The assurance of secrecy is essential in establishing trust between

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46. M Dawson, "Non-Consensual Alternative Dispute Resolution: Pros and Cons" (1993) 4 *Australian Dispute Resolution Journal* 173 at 175.

47. *Consumer, Trader and Tenancy Tribunal Act 2001 (NSW)* s 59. The Act defines mediation as a structured negotiation process in which the mediator, as a neutral and independent party, assists the parties to a dispute to achieve their own resolution of the dispute. Neutral evaluation means a process of evaluation of a dispute in which the neutral evaluator seeks to identify and reduce the issues of fact and law that are in dispute. The neutral evaluator's role includes assessing the relative strengths and weaknesses of each party's case and offering an opinion as to the likely outcome of the proceedings: *Consumer, Trader and Tenancy Tribunal Act 2001 (NSW)* s 57.

48. *Consumer, Trader and Tenancy Tribunal Regulation 2002 (NSW)* s 21.

49. These are: (a) with the consent of the person to whom the information relates, (b) in connection with the administration or execution of this Division, (c) if there are reasonable grounds to believe that the disclosure is necessary to prevent or minimise the danger of injury to any person or damage to any property, (d) if the disclosure is reasonably required for the purpose of referring any party or parties in a mediation session or neutral evaluation session to any person, agency, organisation or other body and the disclosure is made with the consent of the parties in the mediation session or neutral evaluation session for the purpose of aiding in the resolution of a dispute between those parties or assisting the parties in any other

the mediator and the parties. Otherwise, parties may refuse to reveal certain information that could be prejudicial in a subsequent trial.

12.33 In Recommendation 12.2, we said that the Model Law should grant jurisdiction to the CTTT to resolve matters arising out of its provisions. Should this recommendation be implemented, parties to disputes concerning small business guarantees would be able to benefit from the provisions of the *Consumer, Trader and Tenancy Tribunal Act 2001* (NSW) on alternative dispute resolution.

## INDUSTRY-BASED DISPUTE RESOLUTION SCHEMES

12.34 Banks, credit unions, building societies and other entities that are required to have a financial services licence and that provide financial services to retail clients are required by law to have a dispute resolution system in place to deal with complaints by their customers.<sup>50</sup> The required dispute resolution system must consist of two components: internal dispute resolution procedures that meet standards set by the Australian Securities and Investment Commission ("ASIC"); and membership in an external dispute resolution scheme approved by ASIC.<sup>51</sup> As a consequence, most financial institutions have internal complaints mechanisms, which are governed by the relevant codes of practice.<sup>52</sup> In addition, there has been a growth in industry-funded alternative dispute resolution and Ombudsman schemes. These systems now represent a significant part of the consumer protection regulatory framework and are intended to secure accessible justice for consumers. ASIC has, to date, approved several external dispute resolution schemes. The following are the most relevant to third party guarantees.

### Banks

12.35 All banks that have adopted the Code of Banking Practice ("Banking Code") use the Banking and Financial Services Ombudsman ("BFSO"), formerly called the Australian Banking Industry Ombudsman, to meet their obligations to provide an external dispute resolution process to their customers.<sup>53</sup> The BFSO has, according to its terms of reference, jurisdiction to consider disputes brought by an individual or a small business that either has received a financial service (for example, a loan) that is the subject of the complaint or has provided security, such as a guarantee, over the financial service. Its terms of reference expressly give it authority to resolve disputes concerning guarantees.<sup>54</sup> However, if the guarantee were given to secure moneys owing a business, the BFSO can only consider the dispute if the business satisfies its definition of small business, which is

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manner, (e) in accordance with a requirement imposed by or under a law of the State (other than a requirement imposed by a subpoena or other compulsory process) or the Commonwealth: *Consumer, Trader and Tenancy Tribunal Act 2001* (NSW) s 63.

50. *Corporations Act 2001* (Cth) s 912A(1)(g).

51. *Corporations Act 2001* (Cth) s 912A(2).

52. Code of Banking Practice (2004) cl 35; Credit Union Code of Practice (1994) cl 20.1-20.3.

53. Lovric and Millbank at para 6.29.

54. *Terms of Reference of the Banking and Financial Services Ombudsman Limited* s 2.5.

one having less than 100 full time equivalent employees, if a manufacturing business, or 20 full time equivalent employees if the business is of another nature.<sup>55</sup> The main limits on the types of disputes the BFSO can deal with are indicated by the following disqualifying matters:

- The dispute relates solely to a financial services provider's commercial judgment in decisions about lending or security;
- The dispute relates to a practice or policy of the financial services provider, for example its general interest rate or fees and charges policy (however, the BFSO may consider a dispute regarding a fee or charge being incorrectly applied);
- The amount claimed exceeds \$250,000;
- The subject matter of the dispute is, was or becomes the subject of proceedings in any court, tribunal, arbitrator or conciliation body or statutory Ombudsman, or is more appropriately dealt with by a court or other forum;
- The event to which the dispute relates occurred more than six years after the financial services provider was first notified of the matter;
- The subject matter of the dispute has been previously considered by the BFSO, unless there is new information; or
- The dispute is vexatious or frivolous.<sup>56</sup>

12.36 The BFSO has recognised the "relationship debt" phenomenon, which it defined in a 1999 report it published as "the transfer of responsibility for a debt incurred by a party to his/her partner in circumstances in which the fact of the relationship, as distinct from an appreciation of the reality of the responsibility for the debt, is the predominant factor in the partner accepting liability".<sup>57</sup> The report was aimed at providing information on resolving relationship debt complaints under the BFSO scheme, and identifying issues that may arise in such cases. According to the report, the number of complaints received concerning guarantees is relatively small and the proportion of guarantee complaints has been decreasing relative to the overall number of complaints. For example, the report said that, while in 1991 guarantee complaints represented 5% of all closed complaints, they represented a mere 0.4% in 1998.<sup>58</sup>

12.37 More recent figures from the BFSO indicate that the number of cases relating to guarantees it handles is on the decline. The BFSO expects to see a further decline in disputes relating to guarantees because the amended Banking Code more thoroughly regulates guarantor transactions prior to the execution of the contract of guarantee.<sup>59</sup>

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55. *Terms of Reference of the Banking and Financial Services Ombudsman Limited* s 15.1

56. *Terms of Reference of the Banking and Financial Services Ombudsman Limited* s 5.

57. Australian Banking Industry Ombudsman, *Report on Relationship Debt*, Bulletin No 22, September 1999 at 1.

58. Australian Banking Industry Ombudsman, *Report on Relationship Debt*, Bulletin No 22, September 1999 at 3.

59. See Lovric and Millbank at para 6.36-6.37.



## Credit Unions and Building Societies

12.38 The Credit Union Dispute Resolution Centre (“CUDRC”) is a free and independent dispute resolution body set up by the Credit Union Services Corporation (Australia) Ltd (CUSCAL) in 1996 to assist participating credit unions and their members resolve disputes in a fair, timely and cost-effective manner. It is funded by participating credit unions, which currently number more than 150 or more than 80% of credit unions in Australia.

12.39 A significant number of credit unions have signed up to the Financial Cooperative Dispute Resolution Scheme (“FCDRS”). The FCDRS is intended to be the external dispute resolution scheme of all building societies and also replaces the Credit Union Ombudsman scheme. This scheme officially commenced operation on 1 April 2003, although many of the participating building societies and credit unions did not sign up until the early part of 2004.

12.40 The scope of and limitations on the jurisdictions of the CUDRC and the *FCDRS* are similar to those that apply to the *BFSO*.<sup>60</sup> Their *terms of reference specifically cover guarantees made by an individual or a small business to secure money owed by an individual or a small business*.<sup>61</sup> *In other words, like the BFSO, the CUDRC and FCDRS are authorised to deal with disputes concerning guarantees that relate to loans taken out for consumer or small business purposes. Their terms of reference define small business as one with fewer than 100 full-time (or equivalent) employees if it is engaged in the manufacture of goods, or one with fewer than 20 full-time (or equivalent), if engaged in any other type of business*.<sup>62</sup> *The jurisdictions of the CUDRC and FCDRS have at least one significant difference from that of the BFSO: their monetary limit is lower at \$100,000*.<sup>63</sup>

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60. See Credit Union Dispute Resolution Centre Pty Limited, *Terms of Reference for the Credit Union Dispute Manager Under the Dispute Resolution Scheme* (2003) s 4; *Financial Co-operative Dispute Resolution Scheme Terms of Reference* at 3-5.

61. Credit Union Dispute Resolution Centre Pty Limited, *Terms of Reference for the Credit Union Dispute Manager Under the Dispute Resolution Scheme* (2003) s 2.1 (definition of “member”); *Financial Co-operative Dispute Resolution Scheme Terms of Reference* at 2-3; *Financial Co-operative Dispute Resolution Scheme Terms of Reference* at 9-10 (definition of “financial service”).

62. Credit Union Dispute Resolution Centre Pty Limited, *Terms of Reference for the Credit Union Dispute Manager Under the Dispute Resolution Scheme* (2003) s 2.1; *Financial Co-operative Dispute Resolution Scheme Terms of Reference* at 3; *Financial Co-operative Dispute Resolution Scheme Terms of Reference* at 11.

63. Credit Union Dispute Resolution Centre Pty Limited, *Terms of Reference for the Credit Union Dispute Manager Under the Dispute Resolution Scheme* (2003) s 4; *Financial Co-operative Dispute Resolution Scheme Terms of Reference* at 4-5.

## The Commission's conclusions

12.41 Industry-based alternative dispute resolution schemes play a vital role in the broader financial regulatory system. They give financial services providers opportunity to improve their standards of conduct and cultivate good relations with their clients. For consumers, they provide a forum to resolve complaints that is quicker and more flexible than the formal, adversarial court system. The services provided by these schemes are free and therefore have the capacity of reducing the costs incurred by consumers in getting their complaints and disputes resolved. Consumer advocates generally agree that using these schemes is a good option. Yet very few matters relating to third party guarantees go to these schemes. For example, only 7% of guarantor survey respondents to the Lovric and Millbank study reported using the BFSO to assist them with their problems.<sup>64</sup>

12.42 If these schemes are to be successful, there is a need to raise their profile in the public mind, make the potential users aware of them, and build a demand for their services. A publicity strategy could include an enduring multi-media campaign aimed at the general public. In addition, sustained educational initiatives targeting consumers, such as those that have obtained or guaranteed loans from financial institutions, should be undertaken. The financial institutions themselves could be used to publicise the schemes. Banks, for example, should be encouraged to inform their clients about the BFSO services during the course of a transaction, but particularly when a dispute arises. Equally important, officers and employees of financial institutions should be educated about the effectiveness of these schemes in resolving disputes with their clients.

12.43 One problem with these three schemes in relation to third party guarantees is the low financial jurisdiction. The maximum amount in dispute that the ABIO can hear is \$250,000<sup>65</sup> while the jurisdictional limitations of the CUDRC and FCDRS are even lower at \$100,000. As a large portion of guarantees are secured by residential properties and are undertaken to support small business borrowing, these jurisdictional limits would exclude many third party guarantee matters. In addition, the fact that the commencement of litigation ousts the jurisdiction of these dispute resolution schemes means that even a higher monetary limit would not necessarily enhance its coverage of the field if lenders were unwilling to use it. There may be a need to encourage expansion of the jurisdictions of the BFSO, CUDRC and *FCDRS* to ensure that they do not result in the exclusion of a substantial number of disputes relating to third party guarantees.

*12.44 The Commission's concerns regarding publicity and jurisdictional limitations of the various industry-based dispute resolution schemes are matters the financial industry ought to examine in the course of the regular review of these schemes.*

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64. Lovric and Millbank at para 6.33-6.34.

65. Prior to 1 December 2004, the monetary limit on the BFSO's jurisdiction was only \$150,000.

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# Appendix

- List of submissions

## SUBMISSIONS

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Australian Bankers' Association (9 August 2004)

Australian Credit Forum (30 August 2001)

Australian Finance Conference *Submission 1* (30 October 2000)

Centre for Elder Law, University of Western Sydney (3 December 2001)

Commonwealth Bank of Australia *Submission 1* (18 December 2000) *Submission 2* (17 September 2001).

Confidential Submission (18 August 2000)

Country Women's Association of NSW (1 September 2000)

Drummond, M E (29 May 2000)

Financial Counsellors' Association of NSW (29 August 2000)

Goldring, Jack L (1 June 2000)

King On Tang (25 May 2000)

Legal Aid Commission of NSW (24 October 2000)

NSW Department of Fair Trading (29 September 2000)

NSW Department for Women (18 October 2000)

NSW Young Lawyers (11 September 2000)

O'Donnell, Carol (29 August 2000)

Office of the Federal Privacy Commissioner (30 August 2000)

Ryde-Eastwood Financial Counselling Service (18 July 2000)

Salmon, John A (11 March 2001)

St George Bank Ltd (30 January 2001)

Suncorp Metway Ltd (7 September 2001)

Women Lawyers Association of NSW (6 October 2000)

Women's Legal Resources Centre (14 September 2000)

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# Tables

- Table of legislation
- Table of cases

## TABLE OF LEGISLATION

---

### Commonwealth

#### *Australian Securities and Investments Commission*

<i>Act 2001</i> .....	2.18, 2.19, 8.34
s 12BAA(7)(k) .....	2.18
s 12BC(2) .....	5.18
s 12CA 2.18	
s 12CA-12CC .....	2.29
s 12CB .....	2.18, 2.19
s 12CB(1) .....	11.20
s 12CB(2) .....	2.22, 7.13, 11.21, 11.31, 11.37, 11.44, 11.47, 11.56, 11.60
s 12CB(5) .....	2.32
s 12CC .....	2.18, 2.19, 5.15
s 12CC(2) .....	2.22, 7.13, 11.31, 11.37, 11.44, 11.47, 11.56, 11.57, 11.60, 11.67
s 12CC(3) .....	2.22, 7.13
s 12CC(6)-(9) .....	2.32
s 12DA .....	2.18, 2.24
s 12DJ .....	2.18
s 12GD .....	2.24, 2.29
s 12GF .....	2.24
s 12GH(4) .....	2.24
s 12GM .....	2.24, 2.29
<i>Australian Securities and Investments Commission Regulations 2001</i>	
reg 2B(1) .....	2.18
<i>Bankruptcy Act 1924</i> .....	3.49

<i>Corporations Act 2001</i>	
s 761G(12).....	5.18
s 912A .....	12.34
<i>Family Law Act 1975</i> .....	6.23
s 112AD.....	6.23
<i>Financial Services Reform Act 2001</i> .....	5.17-5.19, 5.25, 5.27
<i>First Corporate Law Simplification Act 1995</i> .....	5.20
<i>Income Tax Assessment Act 1997</i>	
s 960-335.....	5.20
<i>Privacy Act 1988</i> .....	6.20, 6.24, 6.25, 6.27, 6.45
s 6C .....	6.16
s 6D(1).....	5.20
s 11B(1).....	6.18
s 18N .....	6.14, 6.19, 6.29, 9.30
s 18N(1).....	6.14, 6.15, 6.17, 6.18, 6.20-6.22, 6.24, 6.25, 6.27, 6.28, 6.45, 9.30, 9.31, 10.7
s 18N(2).....	6.14
s 18N(9).....	6.19, 9.30
Sch 3 .....	6.28
<i>Privacy Amendment (Private Sector) Act 2000</i> .....	6.16, 6.24, 6.27
<i>Trade Practices Act 1974</i> .....	5.12, 5.15, 5.16, 7.5, 11.6
s 4B .....	5.13
s 51AA-51AC.....	2.18, 2.19
s 51AA.....	2.21
s 51AAB(2) .....	2.18
s 51AB(1).....	11.20

s 51AB(2).....	11.21, 11.31, 11.37, 11.44, 11.56, 11.60
s 51AC.....	2.18, 4.55, 5.15
s 51AC(3) .....	11.21, 11.31, 11.36, 11.37, 11.44, 11.56, 11.57, 11.60, 11.67
s 52.....	2.18
s 60.....	2.18
s 68.....	5.53
s 75B .....	2.24
s 80.....	2.18
s 82.....	2.18, 2.29
s 87.....	2.18, 2.29
<i>Trade Practices Amendment Act (No. 1) 2001</i> .....	5.15

## New South Wales

<i>Anti-Discrimination Act 1977</i> .....	2.36, 2.49
s 39.....	2.36
s 47.....	2.36
s 89-113.....	2.37
s 108(2) .....	2.37
<i>Bills of Sale Act 1898</i>	
s 5.....	3.49
<i>Civil Procedure Act 2005</i>	
Part 4.....	11.83
s 26.....	12.28
s 34.....	12.28
<i>Consumer Credit (New South Wales) Act 1995</i>	
s 8.....	10.42, 12.18



<i>Consumer Credit (New South Wales) Code 1995</i> .....	1.11, 2.18, 4.15, 4.23, 4.26, 4.48-4.56, 4.58, 4.59 4.62, 5.3-5.5, 5.7, 5.8, 5.42, 6.20, 6.25, 6.37, 6.47, 6.52, 6.68, 6.99, 7.6, 7.14, 7.17, 7.21, 7.31, 8.2, 8.36, 8.49, 9.3, 11.3, 11.7, 11.10, 11.14, 11.15, 11.18, 11.22, 11.29, 11.32, 11.34, 11.36, 11.46, 11.47, 11.55, 11.58, 11.62, 11.64, 11.66, 11.69-11.71, 11.73, 11.78, 11.79, 11.82, 11.84, 12.5, 12.13, 12.18, 12.20-12.22
s 4(1) .....	5.3
s 5.....	5.3, 5.8
s 6.....	2.34, 4.23, 4.54, 5.5, 5.7, 5.8, 5.30, 10.25, 11.3, 12.21
s 8(1) .....	12.18
s 9.....	7.15
s 9(1) .....	2.34, 5.30
s 21.....	6.53
s 34.....	2.35, 8.38, 9.21-9.23, 9.26, 9.28, 10.5
s 35.....	9.24
s 43.....	8.9, 8.20
s 44.....	5.50-5.51
s 45(1) .....	10.48
s 50.....	2.35, 6.6, 6.7, 7.11, 7.15,
s 50(1) .....	7.8
s 50(4) .....	7.16
s 51.....	2.35, 6.5, 6.7, 6.17, 6.19-6.21, 6.53, 6.101
s 52.....	9.17, 9.18
s 53.....	6.78, 9.48
s 53(1) .....	2.35, 9.3, 9.4
s 54.....	8.10, 8.12, 8.30, 8.31, 8.35, 8.38
s 55.....	8.42, 8.49, 8.52, 8.53
s 55(1) .....	5.42, 5.43, 8.42, 8.43, 8.50, 10.48

s 55(2) .....	5.54, 8.50
s 56.....	8.10, 9.36, 9.37, 9.39, 9.44
s 56(1) .....	9.35
s 56(2) .....	9.36
s 57.....	6.7
s 58(2) .....	9.36
s 59-61.....	9.36
s 63.....	9.46, 9.48
s 63(3) .....	9.47
s 65.....	9.41, 9.45
s 65(1) .....	9.41, 9.44, 9.45
s 65(2) .....	9.43
s 65(3) .....	9.45
s 68.....	10.43
s 70.....	2.18, 2.35, 6.101, 7.32, 11.1, 12.18
s 70(1) .....	11.9, 11.14
s 70(2) .....	2.22, 6.52, 7.13, 11.18, 11.20, 11.28, 11.29, 11.37, 11.49
s 70(3) .....	11.39
s 70(4) .....	11.16
s 70(5) .....	11.84
s 70(7) .....	11.9
s 71.....	2.28, 7.32, 11.77, 11.80, 11.82, 12.18
s 72.....	12.18
s 75.....	10.9
s 75(1) .....	10.3, 10.6
s 75(2) .....	10.4-10.6

s 76.....	10.6
s 77.....	10.8
s 78(8) .....	10.48
s 80.....	10.11, 10.21, 12.8
s 80(1) .....	10.11, 10.15-10.17
s 81.....	10.20, 10.21
s 82.....	1.8, 10.17, 10.24-10.26, 10.32, 10.34, 10.36
s 86.....	12.12
s 86(1) .....	12.6
s 86(2) .....	12.13
s 87.....	12.8, 12.9
s 88.....	12.10-12.12
s 89.....	12.10
s 99.....	10.41, 10.44, 10.48, 10.52
s 99(1) .....	10.45, 10.47
s 99(2) .....	10.49-10.51
s 162.....	7.32
s 162(1) .....	2.35, 7.16
s 162(1A).....	7.16
s 162(2) .....	7.17
s 163.....	9.19
s 164A(1).....	7.15
s 169.....	5.53, 5.55, 8.49, 8.52, 10.3
s 169(1) .....	5.55, 5.56, 8.49
s 169(2) .....	5.54-5.56
s 169(3) .....	5.54

s 169A .....	5.54
Sch 1 cl 1 .....	5.42, 6.5, 10.5, 10.42
<i>Consumer Credit (New South Wales)</i>	
<i>Regulations 1995</i> .....	2.34, 6.11, 6.107, 6.113, 7.6, 7.31, 8.36
s 20 .....	2.35, 6.6, 6.107
s 21 .....	6.5
s 39 .....	7.16, 7.32
s 39A .....	7.32
<i>Consumer Credit (New South Wales) Special Provisions</i>	
<i>Regulation 2002</i>	
cl 5 .....	12.18
<i>Consumer, Trader and Tenancy Tribunal Act 2001</i> .....	
Part 5 Div 2 .....	11.83
s 23 .....	12.18
s 28, s 39, s 53 .....	12.19
s 57, s 59, s 60, s 62, s 63 .....	12.32
<i>Consumer, Trader and Tenancy Tribunal Regulation 2002</i>	
s 21 .....	12.32
<i>Contracts Review Act 1980</i> .....	
2.18, 2.19, 2.21, 2.22, 2.26, 2.27, 2.39, 4.18-4.20, 6.51, 7.5, 7.12, 7.18, 8.63, 8.65, 11.2, 11.3, 11.7, 11.9, 11.10, 11.12, 11.14, 11.18, 11.22, 11.29, 11.31, 11.32, 11.46, 11.55, 11.56, 11.58, 11.62, 11.65, 11.66, 11.69, 11.73-11.76, 11.78-11.79, 11.82- 11.84	
s 4 .....	2.19, 11.9, 11.14
s 6 .....	2.31
s 7 .....	2.18, 2.19, 2.26, 7.18, 11.78, 11.79, 11.82
s 7(1) .....	11.78-11.79
s 8 .....	2.26
s 9 .....	2.22
s 9(1) .....	2.22, 11.20, 11.30

s 9(2) .....	2.22, 7.13, 11.31, 11.34, 11.36-11.38, 11.40, 11.41, 11.44, 11.47, 11.52, 11.55, 11.57, 11.60, 11.63, 11.65
s 9(4) .....	11.16
s 9(5) .....	11.84
s 10.....	2.40
s 15.....	11.18
s 19.....	11.81
s 70.....	2.19
<i>Conveyancing Act 1919</i>	
s 66S .....	6.99
s 66W .....	6.99
<i>Credit Act 1984</i> .....	11.3, 11.9
s 76(1) .....	10.47
s 138.....	10.33, 10.35, 10.36
s 146(2) .....	11.78
<i>Credit Regulation 1984</i>	
Sch 1 cl 16.....	10.36
<i>Crown Lands Act 1895</i>	
s 23.....	3.49
<i>Crown Lands Act 1989</i> .....	3.49
<i>Crown Lands Consolidation Act 1913</i> .....	3.49, 3.51
<i>Crown Lands Consolidation Regulations 1914</i>	
reg 208 .....	3.51
<i>Crown Lands Regulations 1914</i>	
reg 207-209 .....	3.51

<i>Fair Trading Act 1987</i> .....	2.18-2.19,
s 42.....	2.18, 2.24, 2.29,
s 43.....	2.18, 2.19, 2.29, 2.33
s 43(1).....	11.20
s 43(2).....	2.22, 7.13, 11.21, 11.31, 11.37, 11.44, 11.47, 11.56
s 55.....	2.18, 2.29
s 61.....	2.24
s 65.....	2.29
s 65(1).....	2.24, 2.29
s 68.....	2.29
s 70(4).....	2.24
s 72.....	2.29

*Fair Trading Amendment Act 2003*

Sch 1[18]-[20].....	2.33
---------------------	------

*Farm Debt Mediation Act 1994*.....

s 4(1).....	2.38
s 7(1).....	2.39
s 8(1).....	2.38
s 9(1), s 11(1).....	2.38, 12.25

*Supreme Court Act 1970*.....

12.28

*Uniform Civil Procedure Rules 2005*

r 5(b).....	10.47
-------------	-------

**Queensland**

*Consumer Credit (Queensland) Act 1994*.....

2.18, 7.15

Part 4.....	2.34
-------------	------

*Property Law Act 1974*

s 57.....	8.61
<b>South Australia</b>	
<i>Consumer Credit (South Australia) Act 1995</i> .....	2.18
<b>Tasmania</b>	
<i>Consumer Credit (Tasmania) Act 1996</i> .....	2.18
<b>Victoria</b>	
<i>Consumer Credit (Victoria) Act 1995</i> .....	2.18
<i>Credit Act 1984</i> .....	11.70
s 147(4).....	11.70
<i>Credit (Further Amendment) Act 1991</i>	
s 10.....	11.70
<i>Money Lenders Act 1958</i> .....	5.6
<b>Western Australia</b>	
<i>Consumer Credit (Western Australia) Act 1996</i> .....	2.18
<b>Australian Capital Territory</b>	
<i>Consumer Credit Act 1995</i> .....	2.18
<b>Northern Territory</b>	
<i>Consumer Credit (Northern Territory) Act 1995</i> .....	2.18
<b>Canada</b>	
<i>Alberta</i>	
<i>Dower Act RSA 2000 c D-15</i>	
s 4.....	3.41
s 5.....	3.79
s 25 (2).....	3.42

*Saskatchewan*

<i>Homesteads Act 1989, SS 1989-90, c H-5.1</i> .....	3.41
s 5(1) .....	3.41
s 5(2) .....	3.42
s 7 .....	3.77

**Europe***Directive for the Protection of Consumers in Respect of Contracts*

<i>Negotiated away from Business Premises 85/577/EEC</i> .....	3.55
art 1, art 2 .....	3.69, 3.70
art 4, art 5 .....	3.71

*Directive on Consumer Credit 87/102/EEC* .....

art 1(2), art 2(1) .....	3.65
art 4(3), art 15, Annex I item 1 (vii) .....	3.66

*Directive on Unfair Terms in Consumer*

<i>Contracts 93/13/EEC</i> .....	3.55
art 1(1) .....	3.57
art 3 .....	3.61
art 3(1) .....	3.57
art 3(2) .....	3.58
art 4(1) .....	3.59
art 5 .....	3.58-3.59
art 6(1), s 7 .....	3.56



## Germany

### *Bürgerliches Gesetzbuch (BGB)*

§ 138.....	3.10-3.13
§ 307 (1) .....	3.61
§ 312.....	3.72
§765-778 .....	3.10

<i>Grundgesetz</i> .....	3.9, 3.11
--------------------------	-----------

## New Zealand

<i>Joint Family Home Act 1964</i> .....	3.44, 3.47
s 9(1) .....	3.44
s 9(2) .....	3.46
s 16.....	3.45

## South Africa

<i>Suretyship Amendment Act 1971</i> .....	3.8
--	-----

## United Kingdom

### *Consumer Protection (Contracts Concluded Away from Business Premises) Regulations 1987*

reg 4 .....	3.73
-------------	------

<i>Fines and Recoveries Abolition Act of 1833</i> .....	3.78
---	------

<i>Money Lenders Act 1927</i> .....	8.45
-------------------------------------	------

### *Unfair Terms in Consumer Contracts Regulation 1999*

reg 5(1) .....	3.63
----------------	------

reg 8(1) .....	3.64
----------------	------

### *Unfair Terms in Consumer Contracts Regulations 1994*

reg 5(1) .....	3.64
----------------	------



## United States

### *United States Code, Title 15*

§ 45 (a) .....	3.74, 3.76
§ 57 a(a) .....	3.74
§ 1691-1691f .....	2.36, 3.9, 3.14, 3.15
§ 1691.....	3.15
§1691a (b) .....	3.18
§ 1691b (a) .....	3.16, 3.17
§ 1691b (1).....	3.16
§1691d (a).....	3.16
§ 1691e.....	3.17
§ 1691e (c).....	3.22

### *Code of Federal Regulations, Title 12*

Pt 202 .....	2.36
§ 202.2.....	3.17
§ 202.5.....	3.16
§ 202.6.....	3.16
§ 202.7(d)(1).....	3.17-3.18

### *Code of Federal Regulations, Title 16*

§ Pt 444 .....	3.74
§ 444.1.....	3.74
§ 444.3.....	3.74-3.75
§ 444.5.....	3.75

### *Kansas*

<i>Constitution of the State of Kansas</i> §15-9.....	3.34
<i>Kansas Statutes</i> §60-2301.....	3.34

*Massachusetts*

*General Laws of Massachusetts*

§188.....3.39

*Texas*

*Texas Constitution*

Art 16 §50 and §51 .....3.36

*Texas Property Code*

§41.001.....3.36

§41.002.....3.36

## TABLE OF CASES

<i>AD &amp; JA Wright Pty Ltd v Custom Credit Corp Ltd</i> (1992)	
108 FLR 45 .....	9.20
<i>AGC (Advances) Ltd v West</i> (1984) 5 NSWLR 590 .....	5.44, 11.2
<i>Akron Securities v Iliffe</i> (1997) 41 NSWLR 353 .....	2.23
<i>Alderton v Prudential Assurance Company Ltd</i> (1993)	
41 FCR 435 .....	2.10
<i>Ankar Pty Ltd v National Westminster Finance</i> <i>(Australia) Pty Ltd</i> (1987) 162 CLR 549 .....	2.3, 5.38, 9.32
<i>Anseline v General Motors Acceptance Corporation</i> (1998) ASC ¶155-020 .....	12.12
<i>ANZ Banking Group Ltd v Alirezai</i> [2004] QCA 6 .....	2.15
<i>Australian and New Zealand Banking Group Ltd v Capper</i> [2001] NSWSC 946 .....	7.2, 8.32
<i>Australian and New Zealand Banking Group Ltd v Dunosa Pty Ltd</i> [1995] ANZ Conv R 86 .....	6.112
<i>Australian and New Zealand Banking Group Ltd v Volmensky</i> (NSW, Supreme Court, No 15542/1992, Spender AJ, 14 December 1994, unreported) .....	7.1, 7.2, 7.18-7.20, 8.7
<i>Australian Bank Ltd v Stokes</i> (1985) 3 NSWLR 174 .....	2.31
<i>Australian Competition and Consumer Commission v C G Berbatis Holdings Pty Ltd</i> (2003) 214 CLR 51 .....	2.5, 2.19, 2.21, 4.16
<i>Australian Competition and Consumer Commission v CG Berbatis</i> <i>Holdings Pty Ltd (No 2)</i> (2000) 96 FCR 491 .....	4.16
<i>Australian Competition and Consumer Commission v Maritime</i> <i>Union of Australia</i> (2001) 114 FCR 472 .....	2.18
<i>Australian Competition and Consumer Commission v McCaskey</i> (2000) 104 FCR 8 .....	2.18
<i>Australian Societies Group Financial Services (NSW) Ltd v Bogan</i> (1989) ASC ¶155-938 .....	11.52
<i>Bache &amp; Co (London) Ltd v Banque Vernes et Commerciale De Paris</i> SA [1973] 2 Lloyd's Rep 437 .....	8.54, 8.55, 8.58, 8.61

<i>Baltic Shipping Co v Dillon (The Mikhail Lermantov)</i> (1991) 22 NSWLR 1 .....	2.21, 11.21
<i>Bank of Credit and Commerce International SA v Aboody</i> [1990] 1 QB 923 .....	2.9
<i>Bank of New South Wales Ltd v Rogers</i> (1941) 65 CLR 42.....	2.9, 2.10
<i>Barclays Bank plc v O'Brien</i> [1994] 1 AC 180 .....	1.15, 2.14
<i>Baum v Great Western Cities Inc</i> 703 F2d 1197 (1983) .....	3.76
<i>Bayerische Hypotheken- und Wechselbank AG v Dietzinger</i> (European Court of Justice, C-45/96, Judgment of the Court (5th Chamber), 17 March 1998) .....	3.72
<i>Berliner Kindle Brauerei AG v Siepert</i> (European Court of Justice (5th Chamber), C-208/98, Judgment of the Court, 23 March 2000) .....	3.67, 3.72
<i>Berliner Kindle Brauerei AG v Siepert</i> (European Court of Justice (5th Chamber), C-208/98, Opinion of Advocate General Léger, 28 October 1999) .....	3.67, 3.72
BGH NJW 2002, 2228 .....	3.13
BGH NJW 47 1994 .....	3.12, 3.13
<i>Blomley v Ryan</i> (1956) 99 CLR 362.....	2.5, 2.19, 2.21, 7.12, 11.38
<i>Bond v Hongkong Bank of Australia Ltd</i> (1991) 25 NSWLR 286 .....	9.32
<i>Boon v Park Avenue Nominees</i> (2001) ASC ¶155-045. ....	12.20, 12.22
<i>Bradley v Pacific Southwest Bank</i> 960 F2d 502 (1992) .....	3.37
<i>Brick and Pipe Industries Ltd v Occidental Life Nominees Pty Ltd</i> [1992] 2 VR 279 .....	8.55
<i>Bridge Wholesale Acceptance (Australia) Ltd v GVS Associates Pty Ltd</i> (1991) ASC ¶156-105 .....	2.27
<i>Bridgewater v Leahy</i> (1998) 194 CLR 457 .....	2.5
<i>British Motor Trust Ltd v Hyams</i> (1934) 50 TLR 230.....	9.33
<i>Broadcast Australia Pty Ltd v Minister Assisting the Minister for Natural Resources (Lands)</i> (2004) 204 ALR46 .....	3.49
<i>Brown's Estate, Brown v Brown</i> [1893] 2 Ch 300.....	10.22

<i>Browning v Morris</i> (1778) 98 ER 1364 .....	10.50
<i>Burke v State Bank of NSW Ltd</i> (1994) 37 NSWLR 53 .....	2.27, 8.8
<i>Burrawong Investments v Lindsay</i> [2002] QSC 082 .....	6.81
BVG NJW 1993, 36 .....	3.11
<i>Campbell v Metway Leasing Ltd</i> (1998) ATPR 41-630 .....	2.18
<i>Carlson v Coca-Cola Co</i> 483 F2d 279 (1973) .....	3.76
<i>Carter v White</i> (1884) 25 Ch D 666 .....	8.44
<i>Cassidy v NRMA Health Pty Ltd</i> (2002) ATPR 41-891 .....	2.24
<i>Cassidy v Saatchi and Saatchi Australia Pty Ltd</i> (2004) ATPR 41-980 .....	2.24
<i>Cellulose Products Pty Ltd v Truda</i> (1970) 92 WN (NSW) 561 .....	10.35
<i>Challenger Management Investment Ltd v Davey</i> [2002] NSWSC 430 .....	7.5
<i>Charles v Parkinson</i> [2000] FCA 1467 .....	9.14
<i>Child v Commonwealth Development Bank of Australia Ltd</i> [2000] NSWCA 256 .....	2.16
<i>CIT Credit Pty Ltd v Keable</i> [2006] NSWCA 130 .....	2.21
<i>Citadel General Assurance Co v Johns-Manville Canada Inc</i> (1983) DLR (3d) 593 .....	2.3, 5.2
<i>Citicorp Pty Ltd v Hendry</i> (1985) 4 NSWLR 1 .....	5.40
<i>CMF Virginia Land LP v Brinson</i> 806 F Supp 90 (1992) .....	3.23
<i>Coffey v DFC Financial Services Ltd</i> (New Zealand Court of Appeal, No 255/89, 2 October 1991, unreported) .....	10.11
<i>Cole v Challenge Bank Ltd</i> [2001] FCA 1425 .....	2.18
<i>Commercial Bank of Australia Ltd v Amadio</i> (1983) 151 CLR 447 .....	2.5-2.8, 2.10- 2.12, 2.16, 2.19, 2.21, 4.16, 4.19, 6.3, 7.12, 11.38
<i>Commercial Bank of Australia Ltd v Colonial Finance, Mortgage, Investment &amp; Guarantee Corp Ltd</i> (1906) 4 CLR 57 .....	10.11
<i>Commercial Banking Co of Sydney Ltd v Patrick Intermediate Acceptances Ltd (in liq)</i> (1978) 52 ALJR 404 .....	1.7

<i>Commonwealth Bank of Australia v Gough</i> (1993) ASC ¶56-247 .....	7.3
<i>Conley v Commonwealth Bank of Australia</i> [2000] NSWCA 101 .....	12.2
<i>Cook v Bank of New South Wales</i> (1982) ASC ¶55-223 .....	8.62-8.64
<i>Corser v Commonwealth General Assurance Co Ltd</i> [1963] NSWR 225 .....	5.38
<i>Covino v Bandag Manufacturing Pty</i> [1983] 1 NSWLR 237 .....	10.35
<i>Custom Credit Corporation Ltd v Lupi</i> [1992] 1 VR 99 .....	11.9, 11.21, 11.70
<i>Custom Credit Corporation Ltd v Lynch</i> [1993] 2 VR 469 .....	11.70
<i>David Securities Pty Ltd v Commonwealth Bank of Australia</i> (1992) 175 CLR 353 .....	5.58
<i>Davies v London &amp; Provincial Marine Insurance Co</i> (1878) 8 Ch D 469 .....	9.20
<i>Diamond v Union Bank and Trust of Bartlesville</i> 776 F Supp 542 (1991) .....	3.23
<i>Direct Acceptance Finance Ltd v Cumberland Furnishing Pty Ltd</i> [1965] NSWR 1504 .....	1.3, 5.39
<i>Dobbs v National Bank of Australasia Ltd</i> (1935) 53 CLR 643 .....	8.55-8.57, 8.62, 8.63
<i>Edgelow v MacElwee</i> [1918] 1 KB 205 .....	5.6
<i>Eldridge v Taylor</i> [1931] 2 KB 416 .....	8.44, 8.45
<i>Elkofairi v Permanent Trustee Co Ltd</i> [2002] NSWCA 413 .....	2.31
<i>Esanda Finance Corp Ltd v Tong</i> (1997) 41 NSWLR 482 .....	2.31, 6.81
<i>Esanda Finance Corporation Ltd v Murphy</i> (1989) ASC ¶55-703 .....	11.23
<i>Eshelby v Federated European Bank Ltd</i> [1932] 1 KB 423 .....	10.11
<i>Federal Deposit Insurance Corporation v 32 Edwardsville Inc</i> 873 F Supp 1474 (1995) .....	3.23
<i>Federal Deposit Insurance Corporation v Medmark Inc</i> 897 F Supp 511 (1995) .....	3.23
<i>Forster v Jododex Australia Pty Ltd</i> (1972) 127 CLR 421 .....	9.42
<i>Fraser v NRMA Holdings Ltd</i> (1995) 55 FCR 452 .....	2.24



<i>Fulton v Hecht</i> 580 F2d 1243 (1978) .....	3.76
<i>Garcia v National Australia Bank Ltd</i> (1998) 194 CLR 395 .....	1.15, 2.3, 2.12-2.15, 2.47, 4.18, 4.19, 6.51, 6.54, 6.88
<i>Gattellaro v Westpac Banking Corporation</i> [2001] NSWCA 76 .....	8.32
<i>Gattellaro v Westpac Banking Corporation</i> [2004] HCA 6 .....	8.32
<i>George v Bank of Western Australia Ltd</i> (1998) ASC ¶155-022 .....	12.11
<i>George v Paul George Pty Ltd</i> (NSW, Supreme Court, 2575/1993, Santow J, 29 February 1996, unreported) .....	2.9
<i>Gibson v Finance Corporation of Aust Ltd</i> (1980) ASC ¶55-066 .....	11.85
<i>Grant v Mossman</i> 384 F2d 496 (1967) .....	3.34
<i>Gregg v Tasmanian Trustees Ltd</i> (1997) 73 FCR 91 .....	2.29
<i>Guild and Co v Conrad</i> [1894] 2 QB 885 .....	1.7
<i>Hall v Hadley</i> (1828) 5 Bing 54, 130 ER 980 .....	10.23
<i>Hancock v Williams</i> (1942) 42 SR (NSW) 252 .....	5.38, 9.32
<i>Hayward v Nichols</i> (1996) NSW Conv R 55-763 .....	2.27
<i>Hillston v Bar-Mordecai</i> [2003] NSWSC 89 .....	2.9
<i>Holloway v Bristol-Myers Corp</i> 485 F2d 986 (1973) .....	3.76
<i>Hornsby Building Information Centre Pty Ltd v Sydney Building Information Centre</i> (1978) 140 CLR 216 .....	2.24
<i>Huguenin v Baseley</i> (1807) 14 Ves 273 .....	2.9
<i>Hungier v Grace</i> (1972) 127 CLR 210 .....	5.6
<i>Hyde Management Services Pty Ltd v FAI Insurance Ltd</i> (1979) 144 CLR 541 .....	10.2
<i>Hyundai Heavy Industries Co Ltd v Papadopoulos</i> [1980] 1 WLR 1129 .....	8.43
<i>Hyundai Shipbuilding and Heavy Industries Co Ltd v Pournarus</i> [1978] 2 Lloyd's Rep 502 .....	8.43
<i>I &amp; L Securities Pty Ltd v HTW Valuers (Brisbane) Pty Ltd</i> (2002) 210 CLR 109 .....	2.29

<i>Integra Bank v Freeman</i> 839 F Supp 326 (1993).....	3.23
<i>Jackson v Digby</i> (1854) 2 WR 540.....	1.8, 10.22
<i>Janesland Holdings Pty Ltd v Simon</i> [2000] ANZ Conv R 112.....	6.81
<i>Je Maintiendrai Pty Ltd v ANZ Banking Group Ltd</i> (1985) 38 SASR 70 .....	8.55
<i>Jenyys v Public Curator</i> (1953) 90 CLR 113 .....	2.9
<i>Johncorp Industries v Sussman</i> [2001] NSWSC 519.....	8.33
<i>Johnson v Buttress</i> (1936) 56 CLR 113 .....	2.9
<i>Jonsson v Arkway Pty Ltd</i> (2003) ASC ¶155-060 .....	2.34
<i>Jowitt v Callaghan</i> (1938) 38 SR (NSW) 512.....	5.44
<i>Karam v ANZ Banking Group Ltd</i> [2001] NSWSC 709 .....	7.4
<i>Knightsbridge Estates Trust Ltd v Byrne</i> [1938] Ch 741 .....	10.2
<i>Kranz v National Australia Bank</i> (2003) 8 VR 310 .....	2.15
<i>Lakeman v Mountstephen</i> (1874) LR 7 HL 17 .....	1.7
<i>Lang v Licciardello</i> [1999] NSWSC 93.....	6.81
<i>LaRue v Gilbert</i> 18 Kan 220 (1877) .....	3.35
<i>Linkenholt Pty Ltd v Quirk</i> (2000) ASC ¶155-040 .....	12.21
<i>Liu v Adamson</i> [2003] NSWSC 74.....	2.15
<i>Long Leys Co Pty Ltd v Silkdale Pty Ltd</i> (1991) [1992] NSW Conv R ¶59,476 .....	8.62
<i>Louth v Diprose</i> (1992) 175 CLR 621 .....	2.5, 2.8, 2.9
<i>Manso v David</i> [2003] NSWSC 905.....	2.18
<i>McDonald v Dennys Lascelles Ltd</i> (1933) 48 CLR 457.....	1.7, 8.39
<i>McNally v Australia and New Zealand Banking Group</i> (2001) ASC ¶155-047 .....	10.43
<i>Melverton v Commonwealth Development Bank of Australia</i> (1989) ASC ¶55-921 .....	2.27
<i>Micarone v Perpetual Trustees Ltd</i> (1999) 75 SASR 1 .....	6.81, 6.84

<i>Minister of Consumer Affairs v W W Vallack Real Estate Pty Ltd</i> (1986) ASC ¶55-478 .....	2.40
<i>Morlend Finance Corporation (Vic) Pty Ltd v Westendorp</i> [1993] 2 VR 284 .....	11.70
<i>Morrison v Back Yard Burgers Inc</i> 91 F3d 1184 (1996).....	3.76
<i>Morton v Hampson</i> [1962] VR 364.....	9.42
<i>Moschi v Lep Air Services Ltd</i> [1973] AC 331.....	1.8, 10.22
<i>Multi-Span v Portland</i> [2001] NSWSC 696 .....	2.31
<i>Mutual Finance Co v Wetton</i> [1937] 2 KB 389 .....	2.16
<i>National Australia Bank Ltd v Hall</i> (1993) ASC ¶56-234 .....	2.27
<i>National Australia Bank Ltd v Sampson (No 2)</i> (NSW, Supreme Court, 4434/1991, Young J, 9 September 1991, unreported).....	8.62, 8.64
<i>Naylor v Case and McGrath Inc</i> 585 F2d 557 (1978).....	3.76
<i>Northern Territory v GPAO</i> (1999) 196 CLR 553 .....	6.23
<i>Official Assignee v Lawford</i> [1984] 2 NZLR 257.....	3.45, 3.48
<i>Parkdale Custom Built Furniture Pty Ltd v Puxu Pty Ltd</i> (1982) 149 CLR 191 .....	2.24
<i>Parkinson v College of Ambulance Ltd</i> [1925] 2 KB 1.....	10.50
<i>Pasternacki v Correy</i> [2001] ANZ Conv R 240.....	6.81
<i>Permanent Mortgages Pty Ltd v Cook</i> [2006] NSWSC 1104 .....	4.23, 11.21
<i>Perpetual Trustees Co Ltd v Khashoba</i> [2006] NSWCA 41 .....	11.21, 11.23
<i>Petelin v Cullen</i> (1975) 132 CLR 355.....	2.16
<i>Peters v Commonwealth Bank of Australia</i> (1992) ASC ¶56-13 .....	11.74
<i>Price v Parsons</i> (1936) 54 CLR 332 .....	3.49
<i>Re Conley</i> [1938] 2 All ER 127 .....	5.44
<i>Re Howe; Ex parte Brett</i> (1871) LR 6 Ch App 838.....	10.22
<i>Ring Tread Systems Australasia Pty Ltd v Tubb</i> (NSW, Court of Appeal, 40830/1996, 30 October 1998, unreported) .....	2.31

<i>Ristic v Greater Building Society Ltd</i> [2002] NSWCA 266.....	10.37
<i>Robinson v Watts</i> [2000] NSWSC 584.....	9.7
<i>Ross v Bank of New South Wales</i> (1928) SR (NSW) 539 .....	9.20
<i>Royal Bank of Scotland plc v Etridge (No 2)</i> [2002] 2 AC 773 .....	4.18
<i>RT Vanderbilt Co v OSHRC</i> 708 F2d 570 (1983) .....	3.76
<i>Sampson v Burton</i> (1820) 129 ER 891 .....	1.7
<i>Sandtara Pty Ltd v Australian European Finance Corporation Ltd</i> (1990) 20 NSWLR 82.....	10.44
<i>Sapuppo v Ribchenkov</i> [2002] ANZ Conv R 164.....	6.81
<i>Shergold v Tanner</i> (2000) 62 ALD 584 .....	8.55
<i>Shomat v Rubinstein</i> (1995) 124 FLR 284.....	8.62
<i>Silverman v Eastrich Multiple Investor Fund LP</i> 51 F 3d 28 (1995).....	3.17, 3.23
<i>Small v Currie</i> (1854) 2 Drew 102; 61 ER 657 .....	9.20
<i>Smith v Australia and New Zealand Banking Group Ltd</i> (1996) NSW Conv R 55-774.....	8.8
<i>Sorrell v National Australia Bank</i> [1998] WASCA 69.....	5.44
<i>Southwestern Pennsylvania Regional Council Inc v Gentile</i> 776 A 2d 276 (2001).....	3.23
<i>St George Bank Ltd v Trimarchi</i> [2004] NSWCA 120.....	2.31
<i>State Bank of New South Wales v Hibbert</i> [2000] NSWSC 628.....	2.15
<i>Stern v Espirito Santo Bank of Florida</i> 791 F Supp 865 (1992) .....	3.18
<i>Sunbird Plaza Pty Ltd v Maloney</i> (1988) 166 CLR 245.....	1.3, 1.8, 5.37, 10.31
<i>Taylor v Johnson</i> (1983) 151 CLR 422 .....	2.16
<i>Temperance Loan Fund Ltd v Rose</i> [1932] 2 KB 522.....	5.38, 8.45
<i>The Queen v Credit Tribunal; Ex parte General Motors Acceptance Corporation</i> (1977) 137 CLR 545.....	6.25
<i>Thomas Fuller Construction Co (1958) Ltd v Continental</i> <i>Insurance</i> (1970) 36 DLR (3d) 336.....	10.11

<i>Tong v Esanda Finance</i> (NSW Supreme Court, No 20449/94, Grove J, 17 April 1996, unreported) .....	6.81
<i>Toscano v Holland Securities Pty Ltd</i> (1985) 1 NSWLR 145 .....	2.31
<i>Total Oil Products (Aust) Pty Ltd v Robinson</i> [1970] 1 NSW 701 .....	1.3
<i>Truth About Motorways Pty Ltd v Macquarie Infrastructure Investment Management Ltd</i> (2000) 200 CLR591 .....	2.40
<i>Union Bank of Australia Ltd v Barry</i> (1897) 23 VLR 505 .....	10.23
<i>Van Rensburg v Minnie</i> 1942 OPD 257 .....	3.8
<i>Watt v State Bank of New South Wales</i> [2003] ACTCA 7 .....	1.17, 2.15
<i>West v AGC (Advances) Ltd</i> (1986) 5 NSWLR 610 .....	7.18, 11.23, 11.60
<i>Western Credit Ltd v Alberry</i> [1964] 2 All ER 938 .....	5.39
<i>Westpac Banking Corporation v Mitros</i> [2000] VSC 465 .....	9.7
<i>Westpac Banking Corporation v Sugden</i> (1988) NSW Conv R ¶55-377 .....	8.65
<i>Wilks v Heely</i> (1832) 1 Cr & M 249, 149 ER 393 .....	10.22
<i>Wilton v Farnworth</i> (1948) 76 CLR 646 .....	11.38
<i>Winstone Ltd v Bourne</i> [1978] 1 NZLR 94 .....	9.34
<i>Yeoman Credit Ltd v Latter</i> [1961] 1 WLR 828 .....	1.8, 5.38
<i>Yerkey v Jones</i> (1939) 63 CLR 649 .....	2.3, 2.9, 2.12-2.15, 2.21, 4.19

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# Index

## INDEX

---

### *All moneys clauses*

codes of practice .....	8.11-8.13
Commission's recommendation .....	8.32-8.38, R 8.1
common law .....	8.7, 8.8
Consumer Credit Code.....	8.9
definition .....	8.4-8.6

### *Alternative dispute resolution*

empirical background .....	12.2-12.4
industry-based dispute resolution schemes .....	12.34
Banking and Financial Services Ombudsman .....	12.35-12.37
Commission's conclusions .....	12.41-12.44
Credit Union Dispute Resolution Centre .....	12.38-12.40
mediation .....	12.24-12.32
Commission's conclusion .....	12.33
negotiation .....	12.5
Commission's recommendation .....	12.13-12.16, R 12.1
court-ordered postponement .....	12.10-12.12
postponement by parties .....	12.6-12.9
tribunal proceedings .....	12.17-12.22
Commission's recommendation .....	12.23, R 12.2

### *Changes to guarantee obligations*

by agreement between lender and borrower.....	9.41-9.45, R 9.6
common law .....	9.30, 9.31
increase in liabilities .....	9.35-9.40, R 9.5

unilateral action by lender .....	9.46-9.48, R 9.7
<b><i>Characteristics of guarantors</i></b>	
age .....	4.9
family relationships .....	4.7
gender .....	4.8
lack of information .....	4.25
language background .....	4.10
literacy .....	4.11
<b><i>Co-extensiveness principle</i></b>	
Commission's recommendation .....	8.53, R 8.2
common law .....	8.39-8.43, 8.50-8.52
Consumer Credit Code .....	8.42
<b><i>Comparative law</i></b>	
Canada .....	3.41-3.43, 3.74-3.76
European Union .....	3.53-3.73
Germany .....	3.10-3.13
New Zealand .....	3.44-3.48, 3.77-3.79
Roman law .....	3.3-3.8
United States .....	3.14-3.40
<b><i>Conclusive evidence clauses</i></b>	
Commission's recommendation .....	8.66, 8.67, R 8.3
current law .....	8.54-8.65
<b><i>Contracting out</i></b> .....	5.53-5.58, R 5.7
<b><i>Cooling off</i></b>	
post-contract .....	9.2-9.12, R 9.1
pre-contract .....	6.104, 6.106, R 6.6, R 6.7
<b><i>Corporate guarantors</i></b>	
corporations and other artificial persons .....	5.30, R 5.4



directors..... 5.31-5.36, R 5.5

**Costs**

See Enforcement expenses

**Credit contract defined**..... 5.2-5.4, R 5.1

**Default by borrower**

notice to guarantor

Commission's recommendation .....10.15, R 10.2

common law ..... 10.11, 10.13, 10.14

industry codes of practice ..... 10.12

pursuing the borrower before the guarantor

Commission's recommendation ..... 10.27-10.36, R 10.4

common law ..... 10.22, 10.23

Consumer Credit Code ..... 10.23-10.25

industry codes of practice ..... 10.26

remedy by guarantor .....10.20, R 10.3

**Definitions**

credit contract..... 5.2-5.4, R 5.1

guarantee ..... 1.3-1.6

indemnity ..... 5.37

small business

see Small business

third party mortgage ..... 5.44

**Disclosure of information**

post-contract

borrower's default ..... 9.29

empirical background ..... 9.13-9.15

obligations and liabilities .....9.16-9.19, R 9.2, R 9.3

Privacy Act 1988 (Cth) .....	9.30, 9.31
status of the guaranteed loan.....	9.20-9.28, R 9.4
pre-contract	
Code of Banking Practice.....	6.88-6.11
Commission's recommendation .....	6.40-6.47, R 6.1-6.3
common law .....	6.3, 6.4
Consumer Credit Code .....	6.5, 6.6
Privacy Act 1988 (Cth) .....	6.14-6.29
<b><i>Disputing guarantee contracts</i></b>	
grounds	
duress .....	2.16
misrepresentation.....	2.16
mistake.....	2.16
non est factum.....	2.16
special equity for wives .....	2.12-2.15
statutes.....	2.19-2.34
unconscionability.....	2.5-2.7
remedies.....	2.25-2.29
see also Alternative dispute resolutions and Unjust contracts	
<b><i>Enforcement</i></b>	
default	
see Default by borrower	
expenses	
Commission's recommendation .....	10.51, R 10.5
empirical background .....	10.37
excessive .....	10.49, 10.50

lender's internal costs .....	10.44-10.46
meaning .....	10.42, 10.43
reasonably incurred and reasonable amount.....	10.47, 10.48
<b><i>Family home</i></b>	
restriction on use .....	4.37-4.41
homestead laws .....	3.28-3.51
<b><i>Form of guarantee contract</i></b>	
legibility and plain English .....	7.13-7.32, R 7.2
written .....	7.8-7.11, R.7.1
<b><i>Incidence of use of guarantees</i></b> .....	1.11, 1.12
<b><i>Indemnity</i></b> .....	5.37-5.43, R 5.6
<b><i>Independent advice</i></b>	
Code of Banking Practice .....	6.54, 6.55
Commission's recommendations.....	6.100-6.103, R 6.4, R 6.7
Consumer Credit Code.....	6.52, 6.53
empirical background .....	6.79-6.93
functions .....	6.48
Solicitors Practice Rules.....	6.56, 6.57, 6.87, 6.88
<b><i>Interpretation</i></b>	
all moneys clauses .....	8.8
guarantees in general.....	2.3
<b><i>Secondary liability of guarantors</i></b> .....	1.7, 1.8
<b><i>Signing of guarantee documents</i></b>	
empirical background .....	6.109, 6.110
Commission's recommendation .....	6.11, 6.13, R 6.8
<b><i>Small business</i></b>	
definition	
Australian Bureau of Statistics .....	5.21-5.21

Code of Banking Practice.....	5.19
Commission's recommendation .....	5.27, R 5.3
<i>Special equity for wives</i> .....	2.12-2.15
<b><i>Termination by early repayment</i></b>	
Commission's recommendation .....	10.10, R 10.1
common law .....	10.2
Consumer Credit Code.....	10.3-10.8
industry code of practice .....	10.3-10.8
<i>Third party mortgage</i> .....	5.44-5.52
<i>Unconscionability</i> .....	2.5-2.7
<b><i>Unjust contacts</i></b>	
common law	
see Disputing guarantee contracts	
Model Law provisions	
factors to be considered by the court	
age, physical or mental condition .....	11.38, 11.39, R 11.6
all the circumstances of the case .....	11.23, 11.24, R 11.5
capacity to satisfy the debt .....	11.52-11.54, R 11.6
comparable guarantee transactions .....	11.56-11.59, R 11.6
compliance with Model Law provisions .....	11.69-11.72, R 11.6
consequence of compliance or non-compliance .....	11.30, R 11.6
economic, educational, etc background .....	11.63, 11.64, R 11.6
explanation and understanding .....	11.44-11.46, R 11.6
form and intelligibility of contract .....	11.40, R 11.6
guarantor's capacity to negotiate.....	11.36, R 11.6
independent advice .....	11.41-11.43, R 11.6

interrelated arrangements .....	11.8, 11.9, R 11.4
justification of contractual terms .....	11.55, R 11.6
other relevant factors.....	11.60, 11.61, R 11.6
post-contract conduct .....	11.84, 11.85, R 11.9
prior negotiations of contractual terms .....	11.31, 11.32, R 11.6
public interest .....	11.21, 11.22, R 11.5
reasonably foreseeable circumstances .....	11.16, 11.17, R 11.3
relative bargaining power .....	11.31, 11.32, R 11.6
relevant industry codes.....	11.67, 11.68, R 11.6
setting, purpose and effect of guarantee .....	11.65, 11.66, R 11.6
understanding implications of guarantee .....	11.49-11.51, R 11.6
unfair pressure or tactics, undue influence.....	11.47, 11.48, R 11.6
unreasonable or unnecessary contractual provisions	11.37, R 11.6
reliefs.....	11.73-11.83, R 11.7, R 11.8
timeframe of unjustness .....	11.14-11.15, R 11.2
unjust defined.....	11.1-11.13, R 11.1
statutes.....	2.19-2.34
<i>Uses of guarantees</i> .....	<i>1.9</i>