

## Case Note

### Perpetual Trustees Australia Limited v Schmidt & Anor [2010] VSC 67

by



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**Unconscionability and Asset Lending** – Forrest J, Supreme Court of Victoria, determines that the equitable principle of unconscionability can apply to a lender seeking to enforce a security in circumstances where they have failed to properly assess the risk of failure of the borrower to perform under the terms or repayment thereby giving rise to “situational special disadvantage”.

In *Perpetual Trustees Australia Limited v Manfred Peter Schmidt & Anor* [2010] VSC 67 (**Perpetual v Schmidt**), Justice J Forrest examined whether the misconduct of an originator/adviser could be shot home to a lender that had lent on the strength of the security offered alone, and otherwise “*had nothing to do with the loan other than providing the funds*”<sup>1</sup>.

Although the case traversed a number of areas of law relevant to those practising in the banking & finance field<sup>2</sup>, Forrest J’s decision is perhaps most noteworthy for the suggestion that the developing concept of ‘situational’ special disadvantage may more readily extend the reach of unconscionability to instances involving the practice of asset lending<sup>3</sup>. This was particularly interesting given the relevance afforded a series of NSW decisions considering asset lending, partly in the context of the NSW *Contract Review Act* 1980.

#### *Background*

The first defendant (**Schmidt**) was a retiree who grew up in Austria. Schmidt was duped into investing in a disastrously unsuccessful property syndicate by a conman who was eventually gaoled for his conduct (**Maddocks**). Maddocks was a self-styled financial adviser, and as part of his job on Schmidt he ‘arranged’ a loan financed by the plaintiff (**Perpetual**). The other players with roles in between Schmidt and Perpetual were: Medallion Finance Concepts Pty Ltd (**Medallion**), a finance broker with whom Maddocks dealt to source the loan; Violet Home Loans

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<sup>1</sup> [2010] VSC 67 at [3].

<sup>2</sup> Including, for instance, how principles of agency apply to the loan broker/originator/mortgage manager/lender roles; whether lenders owe borrowers a tortious duty of care; and whether an unconscionability claim can be apportioned or defeated on the basis of contributory negligence under the *Wrongs Act* (1958).

<sup>3</sup> Asset lending is the practice of lending money without regard to the ability of the borrower to repay by instalments under the contract, in the knowledge that adequate security is available in the event of default.

Australia Pty Ltd (**VHLA**) the 'mortgage manager' of Schmidt's loan; and Macquarie Securitisation Limited (**MSL**), the program manager of the particular fund, financed by Perpetual, out of which Schmidt's loan was drawn.

### *The relationships*

Put briefly, the arrangement was that Perpetual, as the trustee and custodian of a fund, would release monies to finance loans following an application by MSL, who was the programme manager of the fund. MSL would itself be acting upon applications made to it by VHLA, as mortgage manager. VHLA did not conduct retail operations itself, rather it relied upon brokers to attract would be borrowers. Medallion was one of a number of such brokers. After sourcing the customers, brokers such as Medallion would then submit applications on the customer's behalf to VHLA. As programme manager, MSL was in charge of the relationship with mortgage managers such as VHLA, and had ultimately approved Schmidt's loan – on the basis of the application provided to it by VHLA.

### *The loan*

The loan taken out by Schmidt with Perpetual was what is commonly known as a low doc loan, and was secured by way of mortgage over Schmidt's residential property. It was provided upon the basis of the contents of an application submitted by Maddocks to the broker Medallion. The loan application had been filled out by Maddocks with multiple misstatements about Schmidt's assets, income and circumstances generally. It was then forwarded up the chain to VHLA and, following some "massaging" (and re-submission) by Maddocks/Medallion upon VHLA's insistence, eventually MSL. It was found that VHLA had at least been aware of inconsistencies in the documentation provided to it by Medallion on behalf of Schmidt, and had available to it information to suggest that Schmidt would be unable to service the loan repayments – i.e. prior loan statements suggesting interest repayments were coming out of capital rather than wages or other income<sup>4</sup>.

Upon the investments being confirmed as sour and Schmidt's unsurprising default under the loan, Perpetual instituted enforcement proceedings for judgment and possession of the mortgaged property. Schmidt resisted the enforcement action, and by way of counterclaim alleged that VHLA (either itself or through its agent) had acted unconscionably in procuring and submitting the loan, and whilst doing so was acting as Perpetual's agent, who was therefore liable for such unconscionable conduct<sup>5</sup>.

### *Agency*

Central to Schmidt's counterclaim was the allegation of the existence of agency relationships – either between VHLA and Perpetual and/or, more elaborately, between Medallion and Perpetual, through VHLA. Justice Forrest determined that, although Medallion was merely the initiator and not an agent of VHLA, VHLA itself was acting as agent of Perpetual. Consequently, Perpetual was liable for VHLA's conduct.

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<sup>4</sup> At [198].

<sup>5</sup> He also alleged that VHLA had breached the duty of care it owed to him and that it had engaged in misleading and deceptive conduct.

In support of the first determination, Forrest J referred to the decision of *Moreland Finance Corporation (VIC) Pty Ltd v Westerncorp* [1993] 2 VR 284, which broadly stands for the proposition that where a broker facilitates the provision of a loan through a financier then, notwithstanding the payment of a commission, they are not regarded as the agent of the financier<sup>6</sup>. By contrast, it was considered that the VHLA/Perpetual arrangement was “*a long way (measured I think in kilometres rather than meters)*” from the *Moreland* scenario since, unlike in *Moreland* where the broker had played a role as manager on behalf of the borrower, VHLA had done so on behalf of Perpetual.

### *Unconscionable conduct*

Justice Forrest’s consideration of the principles of unconscionable conduct, under the various statutory regimes and the common law, was extensive. His Honour highlighted the tension between the drift away from simple ‘constitutional’ concepts of special disadvantage (e.g. age, illness, poverty etc.) towards more ‘situational’ special disadvantage<sup>7</sup>, and the need to avoid such descriptions taking on a life of their own by supplanting the principle<sup>8</sup>.

Although his Honour stated that he was conscious of the “*wise cautionary words*” warning against unprincipled or inconsistent identification of the “*vulnerability which equity is prepared to protect*”<sup>9</sup>, his belief that, “*equity will protect individuals in an unequal bargaining position who are the subject of behaviour which can reasonably be regarded as morally repugnant*”, appears a nod in the direction of the situational disadvantage school. Relevantly, his Honour also perceived some role for this developing concept in the treatment of the practice of asset lending, noting that:

“Acceptance of the concept of situational disadvantage extends the reach of the doctrine to cases involving asset lending where there is intentional moral obloquy, contrary to good conscience on the part of the financier or the procurer of the loan in relation to its dealings (including the processing of the application) with the borrower. It is not limited to knowledge of linguistic, educational or intellectual difficulties, but, I think, extends to a situation where the loan documentation alerts the financier or its representative to real issues...concerning the borrower’s ability to repay the loan, particularly where the security, in the form of the borrower’s family home, is his or her only asset.” [emphasis added]<sup>10</sup>

In reaching this conclusion concerning the possible extension of the scope of unconscionability to cover asset lending, albeit in circumstances of “*intentional moral obloquy*”, Forrest J pointed in particular to three decisions from New South Wales: *Elkofairi v Perpetual Trustee Co Ltd* [2002] NSWCA 413; *Small v Gray* [2004] NSWSC 97 and *Kowalczyk v Accom Finance Pty Ltd* [2008] NSWCA 343.

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<sup>6</sup> In that case a finance broker who had prepared an application for finance to Moreland was found to be the agent of the borrower (and possibly the guarantors), notwithstanding the fact that he had received a commission and prepared documentation for the lender (see p. 308).

<sup>7</sup> At [193] – [196].

<sup>8</sup> As considered by Gleeson CJ in *ACCC v CG Berbatis Holdings Pty Ltd* (2003) 214 CLR 51 [8] – [10].

<sup>9</sup> At [208]. Quoting Harper J in *Kakavas v Crown International Limited* [2009] VSC 559 at [426]. The quote of Harper J ended with “*The seeds of tyranny are to be found in the footsteps of those who profess to know more about what is good for the subject of their attention than do the subjects themselves*”.

<sup>10</sup> At [207].

Each of these NSW decisions involved asset lending type transactions being set aside<sup>11</sup>.

His Honour did, however, go at least some way towards framing his approach upon the more traditional notion of special disadvantage, finding that Schmidt was “*an unsophisticated and naïve man who had little financial nous...and... only a rudimentary knowledge of the English language*”<sup>12</sup>.

In that context, it was determined that VHLA’s actions in processing the loan in the knowledge of the various factors concerning Schmidt’s financial position and likely inability to repay the loan, “*were deliberate and attended by moral fault and lack of moral responsibility...[and] [b]y turning a blind eye to the irregularities in the loan application and the income declaration and ensuring that the supplementary information was massaged, VHLA did not act in good faith*”<sup>13</sup>. As such, Forrest J was satisfied that VHLA acted unconscionably and, given that VHLA was acting as Perpetual’s agent, Perpetual was liable for VHLA’s unconscionable conduct.

### *Asset lending*

Lenders might be forgiven for being confused about how far the current law extends their investigative obligations when dealing with borrowers whose primary support for a loan is their interest in a property they are prepared to offer as security. Although both the Victorian and NSW Courts have stopped short of simply proscribing the practice of asset lending as unconscionable per se, at the very least, the approach seems to be to treat lenders who transact with such borrowers as being ‘on-notice’ of potential unconscionability. Given the relatively slight “*other matters*” which appear to have the effect of tipping an asset lending arrangement over the threshold into the realms of unconscionability (slight in the context of the asset lending itself), some lenders might feel that there is minimal practical difference.

### *Appeal*

Justice Forrest’s decision in *Perpetual v Schmidt* has been appealed by the corporate reincarnation of VHLA. The Grounds of Appeal focus upon the findings of unconscionability, and specifically contend that his Honour erred in relying upon NSW authorities determined under the *Contracts Review Act (NSW) 1980*.

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<sup>11</sup> Interestingly, these findings were interrelated with findings concerning the ‘unjust’ nature of the relevant contracts and relief that flowed under the NSW *Contracts Review Act*, although the boundaries between the two grounds of relief were demarked by the NSW Courts in each case.

<sup>12</sup> At [211].

<sup>13</sup> At [212].