HOW EFFECTIVE IS YOUR SECURITY — THE IMPACT OF RECENT CASES

QUESTIONS AND ANSWERS

Question - Linda Donohue (Challenge Bank):

I just want to direct a question on the **Linter** case to the panel which was to ask how they believe the principles in the **Linter** case apply to a more everyday practical example of lending by a bank? And the scenario I have in mind is the customer comes in wanting to borrow $100,000 to purchase property say of $125,000 and is intending to give the bank security over the property. What duty does the bank have and how far does the bank have to go in inquiring where he is getting the other $25,000 from? And if it transpires that he is getting it from, for example, his mother, how far you have to go in finding out if there is a written loan agreement between the mother and son, and if you have to speak to the mother and find out if she knows what he is doing with the money? I mean it sounds absurd, but if you follow back the **Linter** case to basic principle, it does seem to have an impact on that sort of condition and that can arise every day of the week in front line banking.

Response - David Wetherell (Speaker):

I think the first comment I would make is that **Linter** concerned a company and the interest arose as a result of breach of directors' duties. In the example put forward, I have difficulty perceiving (unless perhaps undue influence or something like that existed), how an interest could arise in favour of the mother even should the bank have notice of it. Obviously it depends on the circumstances, but in terms of the example put forward, I do not believe that the bank would need to conduct due diligence on the mother. However, in a typical transaction where a corporate is borrowing and a corporate is granting security and the other funds are being made available by a related company then I think even perhaps in transactions of the size discussed, it is an issue which you should probably require your solicitors to address in terms of whatever sign off they give you. The solicitor should go so far as getting evidence of the nature of that funding, appropriate resolutions, that sort of thing, without going too far in terms of frustration and cost. It is a difficult balance.

Comment - David Clifford (Allen Allen & Hemsley):

Just one comment. Philip Wood made the point that bankers are ordinary people, not detectives. I think it is worth pointing out and maybe in relation to the last question that the loan made by Linter in that case was its entire shareholders' funds of some $200 million. The loan made by CIBC was some $150 million. And I recall in another context the High Court in the **Northside Developments** case in relation to authority to enter into a mortgage has said that where the entire wealth of a company is at stake, the duty of inquiry that is imposed is much higher than in other circumstances.

Response - David Wetherell (Speaker):

That is a fair comment. However, the only response that I would make is it was 77% of Linter's shareholders funds. The concern I have with that analysis is that Linter was acting as a treasury vehicle for the group although admittedly I think as Stephen said, because it represented a cash cow. But where

you have an investment group then I personally have difficulty with that aspect of the judge's finding on the breach of duties and therefore the requirements on CIBC that, merely because it represented 77% of Linter's funds, it should have made more inquiries. It was an investment group. Linter was a treasury vehicle.

Comment - Robert Baxt (Arthur Robinson & Hedderwicks):

David, regrettably the decision in Australia on duties to groups is not a High Court decision, it is only a dictum of Rolfe J in the New South Wales Supreme Court and I would be interested to see whether other people have some observations on that. But I just wanted to pick up the point that you and Stephen mentioned in relation to ratification. There is a general belief that **Duomatic** applies and that you can get shareholder approval in relation to things that might gone beyond the powers of directors. Now as a result of **Kinsela's** case and the interests of creditors being at risk, I just wonder how far shareholder ratification can go. And in any event both the Court of Appeal in New South Wales and the Full Court of the Western Australian Supreme Court in **Poliwka**, a recent decision that queried the application of **Duomatic**, I just wondered whether anyone else might have some views on that because I think that there may be a danger in assuming that shareholder ratification can cure some of those difficulties that arise where the directors have gone beyond power.

Response - Stephen Sawer (Commentator):

Well certainly, Bob, you are right in that if the creditors have an interest then obviously shareholder ratification is not to the point, or is not to the whole point. It is really an issue of seeking to do the best you can to protect yourself as a banker, and you take the obvious steps as best you can. You also have to think, if you are getting to the stage where this company may be insolvent or you have some concern that it may be insolvent, to really think through whether the loan and the security is really one that you should be involved in. But I concede that **Duomatic** may well not provide that shareholder ratification is a copper-bottomed solution to your problem. You need to do much more than that. But you obviously take that one as it is easily obtainable.

Question - Chris Wilson (National Australia Bank):

I have a question on the first paper. Taking up on the point where you said you had heard someone comment that the decision was in fact a bit off the wall, I wonder if that is in fact the case or do you see the remedial constructive trust in fact moving further and further into the commercial world? If so, are we looking at registering a lot more equitable interests than we presently do and get a legal interest to property?

Response - David Wetherell (Speaker):

In my paper I said that the concern I have with **Linter** is that I think it represents the advancement of the constructive trust into commercial areas without it having been thought through. But in response to your second issue, I think moving to registration is obviously one answer. It does not solve all the problems because you still have the bona fide purchaser issue, but it will give you priority over an equitable interest. But the constructive notice point remains. I think in all cases, if you can get a legal interest as against an equitable interest, then it is worth pursuing - depending on the circumstances.

Question - Ian Davidson (Barrister):

A question for David Wetherell. This might be dealt with in the paper, but it was not clear to me if you were saying that because a tracing interest was involved or could be involved, that it was really inappropriate to be looking at constructive trust or whether you were saying that if a tracing interest was involved you really could not be looking at the constructive trust, where I would have thought that the availability of one equitable remedy is not going to stop the other one being looked at. So is the focus really just to say that it is inappropriate here to have used, rather than it is not possible.

Response - David Wetherell (Speaker):

Yes. You are exactly right. The focus was to say that a constructive trust was not required in this instance because there already existed, as you say, an equitable manner of recovering the property which was tracing. And the problem that a constructive trust gives rise to is a timing issue of when the interest arises.