EQUITY'S ROLE IN FINANCIAL RISK ALLOCATION:

Satisfying or defying commercial expectations?*

WORKING PAPER

1. Introduction

It has been common in discussing equity's role in the commercial field to think of that role in terms of a dichotomy; on the one hand, equity imposing liability and, on the other, equity providing relief from liability. Equity might impose liability through, for example, recognising a fiduciary relationship or a constructive trust. It might provide relief by setting aside a contract on account of a counterparty's unconscionable conduct or undue influence or by giving relief against forfeiture or penalties. In such situations, equity has focused on the position between particular parties dealing with each other. Its role may, in commercial terms, be viewed as allocating risk as between the two specific counterparties. Generally, it is the conduct of one party to the commercial transaction which causes equity to intervene in the transaction[1] and often there is some disparity between the parties, in terms for example of knowledge or experience. Emphasis is laid on the concept of 'conscience', which the Chief Justice of the Federal Court has described as being of 'central importance to [equity's] mission'.[2]

This paper[3] contends however that there is a further role which equity appears to play in commercial, and in particular financing, transactions, which is quite distinct from that more commonly acknowledged role. In certain, at times seemingly ill-defined, circumstances, equity may intervene to 'adjust' a person's legal position. It adjusts it in the sense of first recognising the actual legal position - for example, a legal liability of a party to a transaction or, in more general terms, some form of exposure to financial risk - and then reducing the practical impact of that liability or exposure without necessarily altering the original liability or exposure. Perhaps the clearest example is provided by the position of a guarantor (G1) who has paid out under a guarantee. G1 may be able under equitable principles to call on another guarantor of the same debt (G2) to make a payment to G1, thereby reducing G1's overall exposure. Assume that G1 has a legal liability to pay $100. If equity intervenes, G1 may call successfully on G2 for $50. G1's overall exposure is therefore only $50, although G1's admitted legal liability was $100.

It can be argued that there are a number of equitable doctrines capable of being loosely grouped around a concept of 'adjustment' and that, taken together, they offer a useful insight

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[1] Hence Sir Anthony Mason's extra-curial observation that Equity's intervention in commerce has 'subjected the participants in commercial transactions, where appropriate, to the higher standards of conduct for which it is noted and....exposed the participants to the advantages and detriments of relief in rem': Mason, 'The place of equity and equitable remedies in the contemporary common law world' in Lindell (ed) **The Mason Papers** Federation Press Sydney 2007 at p 309. See also (1994) 110 LQR 238.

[2] Keane, 'The 2009 WA Lee Lecture in Equity: The conscience of equity' (2010) 84 ALJ 92 at 94.

[3] This working paper is part of a larger research project into the role of equity in financial risk allocation. It is also informed by courses developed and taught on 'Equity and Financial Risk Allocation' in conjunction with my colleague, Professor John Stumbles, at Sydney Law School in 2010-2011.

from a banking and finance lawyer's perspective into how equity may allocate financial risk. This paper commences by briefly identifying possible doctrines. While the grouping may be academically controversial, the paper assumes its utility in order to focus on a practical issue potentially of interest to an audience of transactional lawyers; namely, the extent to which such doctrines may be said to satisfy commercial expectations. It is not uncommon to find views expressed that some, if not all, of these doctrines, which tend to be rooted in 17th and 18th century English case law, either have no place in the modern Australian commercial legal landscape or at least need to be significantly modified if they are to survive and flourish. In his dissenting judgment in *Burke v LFOT Pty Ltd*[4] in 2002, Kirby J called, for example, for a re-evaluation of contribution and other equitable remedies and advocated their development to meet what he described as 'new and modern needs'. He observed:

> In developing equitable principles to fit the modern world, courts, including this Court, should look beyond the exposition of the principles in old cases or texts that necessarily reflect the often rigid legal environment and judicial disposition of past times. Instead, they should search for the underlying purpose of the old rule: concepts, not detail... Equitable remedies need to be fashioned to meet new and changing circumstances. Contribution is one such remedy. Our admiration of equity's past is best expressed by being alert to assure its present operation and future relevance.

This paper explores what commercial expectations banking and finance lawyers may have in relation to these doctrines and the extent to which those expectations might reasonably be considered satisfied. Given time constraints, it focuses by way of example on simply one of these doctrines - the doctrine of marshalling, which was recently described in a somewhat understated fashion by the English High Court as 'a doctrine with its own peculiar and distinct characteristics'.[5] The doctrine is of particular interest for several reasons and not only because it is often viewed as impenetrable, with many lawyers typically recalling that it has 'something to do with Whiteacre and Blackacre'[6] but struggling nonetheless to articulate what that something might be. Two rather more serious reasons are:

- an increasing likelihood that the issue will be encountered in practice. It has been suggested, for example, that more claims to marshall than would customarily arise may emerge in the near future, given the proliferation of credit in the period immediately prior to the global financial crisis. The hypothesis is that ready availability of credit would have led to property being used to support more than one mortgage, thereby establishing factual circumstances potentially triggering the operation of the doctrine;[7] and

- unresolved issues emerging from relatively recent academic commentary and judicial obiter dicta which potentially push the boundaries of the doctrine further than perhaps generally appreciated in practice.[8]

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[4] (2002) 209 CLR 282 at 326.

[5] *The Serious Organised Crime Agency v Szepietowski* [2010] EWHC 2570 (Ch).

[6] This recollection is seemingly often based on an oft-cited dictum from *Webb v Smith* (1885) 30 Ch D 192 at 200 per Cotton LJ.

[7] Chippindall , 'A blast from the past: marshalling of later mortgagee's securities and apportionment of proceeds of sale of securities in the current economic climate', (2009) 25(3) BLB 53 at 53.

[8] Interestingly, a ''pushing of the boundaries'' is not confined to marshalling. Recent litigation suggests that other doctrines within this grouping are susceptible to having their scope of operation tested. See for example *Burke v LFOT Pty Ltd* (2002) 209 CLRL 282 and *Friend v Brooker* (2009) 239 CLR 129 on the limits of

An additional, and indeed compelling, reason which should cause banking and finance lawyers at the moment to pause and further reflect on the doctrine is the much heralded advent of the *Personal Property Securities Act* 2009 (Cth),[9] which not only expands the notion of what constitutes a security interest in relation to personal property but also significantly changes the traditional common law rules for creating and ranking such interests. Academic debate in other jurisdictions which have introduced equivalent legislation has raised the question whether the doctrine should continue to be available. In 1994, for example, Professor MacDougall analysed Canadian case law and concluded:[10]

> Marshalling is one old piece of the law that deserves a place in modern secured transactions law.

However, some 10 years later Professor Gedye, reviewing the position in New Zealand, described himself as 'ambivalent' on the issue, pointing to a number of local circumstances which he suggested would make the doctrine more frequently applicable than in Canada.[11] He identified as a matter of particular concern the potential number of suppliers holding unperfected purchase money security interests, for whom marshalling might provide the 'only prospect of payment', bearing in mind that unperfected security interests are not invalidated in an insolvency under the New Zealand legislation.[12] Certainly, it would appear that the statutory recognition of such functionally equivalent transactions, not to mention flawed asset arrangements, as 'in substance' security interests[13] and indeed of other arrangements as 'deemed' security interests[14] has the potential to significantly widen the scope for marshalling. Such issues are, however, beyond the scope of this paper.

2. Identifying possible equitable doctrines which allocate risk through 'adjustment'

The doctrines of contribution and marshalling offer a useful starting point for the analysis of risk allocation. Explanations of their operation based on a notion of 'adjustment' can be found in case law dating back to at least the mid-19th century.[15] While contribution is reasonably readily outlined as noted in the Introduction, marshalling affords a rather more complicated illustration. Marshalling may be said to adjust the position of a second ranking secured creditor (the second creditor), the value of whose security over a particular piece of property has been diminished because a prior ranking secured creditor who also has security over other property (the first creditor), decides to enforce its security over the property over which the second creditor is secured. The second creditor may enforce its security over what remains of the property after the first creditor has enforced. To the extent, however, that there

contribution; *Bofinger v Kingsway Group Ltd* (2009) 239 CLR 269 in relation to the doctrinal basis of subrogation.

[9] Enacted in 2009, the legislation is expected to become operative in October 2011: see www.ag.gov.au.

[10] MacDougall, 'Marshalling and the Personal Property Security Acts: Doing Unto Others...' (1994) 28 UBC Law Review 91 at 122.

[11] Gedye, 'What's Yours is Mine: Attachment of Security Interests to Third Party Assets' (2004) 10 NZBLQ 203 at 217. See generally ibid at 216-220. See also Gedye, Cuming & Wood, *Personal Property Securities in New Zealand*, Thomson Brookers Wellington 2002 p 17.

[12] Gedye, 'What's Yours is Mine: Attachment of Security Interests to Third Party Assets' (2004) 10 NZBLQ 203 at 218. Compare *Personal Property Securities Act* 2009 (Cth) s 267 under which an unperfected security interest may vest in the grantor on the occurrence of a prescribed insolvency event.

[13] See *Personal Property Securities Act* 2009 (Cth) s 12(1), (2).

[14] *Personal Property Securities Act* 2009 (Cth) s 12(3).

[15] See eg *Tombs v Roch* (1846) 2 Coll 490 at 499, 500; 63 ER 828 at 832.

is a shortfall which would not have arisen if the first creditor had enforced over the other property, the second creditor may be able through marshalling to obtain the benefit of that first creditor's security over that other property. The shortfall will be treated as if were secured by the first creditor's security. Hence the extent of the exposure that the second creditor faces at law is reduced.

Interestingly, in the case of the doctrine of contribution and the example given of the guarantor seeking contribution from another guarantor, the adjustment is not as between the parties to the actual transaction – the guarantor and the creditor. Rather, it is between the two guarantors. The first guarantor may not even be aware of the existence of that second guarantor. [16] In the case of the second creditor seeking to marshall, the person against whom the adjustment is made seems to be more controversial. Depending on how the doctrine of marshalling is understood to operate,[17] the adjustment is likely under modern Australian case law to be made not as against the first creditor but rather as against the debtor, albeit by reference to the position of the first creditor. Once again, however, the second creditor seeking the adjustment will not necessarily know of the existence of the first creditor, unless both securities are registrable securities.

Marshalling and contribution are not, however, the only possible examples of an adjustment taking place in equity. In 1983 the High Court of Australia in *Hewett v Court*,[18] drawing on the judgment of Isaacs J in *Davies v Littlejohn*,[19] observed for example in relation to the doctrine of equitable lien:

> Equitable lien does not depend either upon contract or upon possession. It arises by operation of law, under a doctrine of equity 'as part of a scheme of equitable adjustment of mutual rights and obligations'.

Other doctrines also seem capable of potentially being understood in terms of adjustment, although operating somewhat differently to contribution and marshalling. Equitable set-off, for example, which enables debtors to claim that they are not required to pay the full amount of a demand to the extent of money owing to them by their creditor could be described in terms of 'adjustment' – in the sense that there is an adjustment to the amount of the claim initially owing.[20] Subrogation may also fall within the group to the extent that it enables a person to stand in the shoes of another to gain protection in some form against an exposure that arises. A bank faced with a defaulting corporate borrower who turns out to hold all its assets on trust has an exposure for the outstanding contractual amount of the loan, but may be able to recover an equivalent amount through subrogation to the trustee's indemnity, assuming such an indemnity is available on the facts.[21]

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[16] *Dering v Earl of Winchelsea* (1787) 1 Cox 318; 29 ER 1184.
[17] See discussion below.
[18] (1983) 149 CLR 639 at 645.
[19] (1923) 34 CLR 174 at 185.
[20] Whether an actual discharge takes place prior to a court order is currently controversial: see *Fearns v Anglo-Dutch Paint & Chemical Co Ltd* [2011] 1 WLR 366.
[21] See *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319 at 335-356; *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 367; *Lerinda Pty Ltd v Laertes Investments Pty Ltd* (2009) 74 ACSR 65 at 67.

What is striking about these doctrines as a group is that they are long established[22] and that their role of adjusting risk has historically been largely uncontroversial, even though the scope and application of the principles may have at times proved contentious.

It is admittedly not common practice for these equitable doctrines to be grouped together (except perhaps rather frivolously – by academics and practitioners alike- on the basis of a common perception that they are somewhat obscure). Textbook writers vary in their treatment. *Meagher, Gummow & Lehane's Equity Doctrines and Remedies* classifies subrogation, contribution and marshalling under 'Assurances and Assignments' and set-off under 'Equitable Defences'.[23] Parkinson, *Principles of Equity* adopts the same classification for subrogation, contribution and marshalling, and places set-off in a part headed 'Defences and Set-Off'.[24] Heydon and Leeming, *Cases and Materials on Equity and Trusts*, groups marshalling, contribution and subrogation under the general heading of 'Grounds for Relief. [25] Young, Croft & Smith, *On Equity*, treats subrogation, contribution and marshalling under 'Miscellaneous Equities'[26] and Evans, *Equity and Trusts* includes subrogation and contribution as separate chapters under the heading of Equity (as distinct from Trusts), but incorporates marshalling within a chapter entitled Minor Doctrines .[27]

Yet it is contended that a loose grouping of these doctrines, particularly when fashioned around a common concept of 'adjustment,'can offer to a transactional banking and finance lawyer a useful insight into how financial risk may be allocated in equity. It is the potential for an adjustment in the wake of the action of a creditor which makes the doctrines relevant to those involved in structuring security arrangements. Anecdotal evidence suggests, however, that little attention is often paid to the doctrines. Documentation in fact tends to be structured on the basis that such doctrines will potentially operate and should be excluded in the particular situation. From a financial institution's perspective as creditor, there is clearly an advantage to restricting claims for contribution as between co-sureties. While guarantors and indemnifiers may be keen to rely on contribution and may draft their documentation accordingly, a financial institution as creditor may fear interference with its ability either to recover repayment of the principal debt or to enforce the guarantee and indemnity. The financial institution will often seek agreement by sureties to suspend their claims for contribution while moneys are outstanding.[28] Whether, however, it is appropriate to exclude marshalling is not so clear, for reasons explored below. Much depends on what commercial expectations actually are.

[22] See eg *Webb v Smith* (1885) 30 Ch D 192 in the case of marshalling securities. Other well-known earlier cases such as *Lanoy v Duke of Atholl* (1742) 2 Atk 44; 26 ER 668 and *Alrich v Cooper* (1803) 8 Ves Jun 381; 32 ER 402 arose in the context of marshalling of assets but share their principles. See *Rawson v Samuel* (1841) Cr & Ph 161; 41 ER 451 in respect of set-off ; *Duncan-Fox & Co v North & South Wales Bank* (1880) 6 App Cas 12 in respect of subrogation.

[23] Meagher, Hedyon & Leeming, *Meagher Gummow & Lehane's Equity Doctrines & Remedies,* LexisNexis Butterworths Austalia (4th ed) 2002. Equitable lien does not appear to have a separate heading and appears primarily in the context of discussion of subrogation to a vendor's lien under the chapter on subrogation (pp 355-356).

[24] Parkinson (ed), *The Principles of Equity*, Law BookCo Sydney (2nd ed) 2003.

[25] Heydon & Leeming, *Cases & Materials on Equity and Trusts,* LexisNexis Australia 2011.

[26] Young, Croft & Smith, *On Equity*, Law Book Co Thomson Reuters, Australia 2009.

[27] Evans, *Equity and Trusts*, LexisNexis Australia (2nd ed) 2008.

[28] See eg *Hong Kong Bank of Australia Ltd v Larobi Pty Ltd* (1991) 23 NSWLR 593 at 596.

3. **Identifying commercial expectations**

The phrase ‘commercial expectations’ is rather nebulous and may, in one sense, appear meaningless. Short of empirical research, expectations cannot be readily determined. Furthermore, any expectations ascertained are likely to disclose a wide range of opinions, depending on many factors, not least of which is whether the person surveyed is a lawyer or a banker. The phrase is used in this paper simply as a means to reflect on whether banking and finance lawyers might consider a doctrine to operate in a manner that adequately reflects the demands of commercial practice. The discussion takes as a given that there is a role for the operation of equity. Not only, as Lord Millett pointed out, can equity’s place in commercial transactions ‘no longer be denied’,[29] but the case law makes clear that marshalling of securities has long been used in commercial circumstances. Take, for example, one of the ‘classic’ cases, *Webb v Smith,*[30] which was a decision of the English Court of Appeal in 1882 and from which the description of the doctrine of marshalling is frequently extracted.[31] The issue was whether funds held by an auctioneer of a brewery were subject to marshalling. On the facts, the relevant funds were not available as they were not regarded as being on the same footing. There was no doubt however of the potential availability of a claim where the established criteria could on the facts be satisfied.

Sometimes litigation can offer some clues, if not a comprehensive guide, as to commercial expectations, reflecting commercial understanding of how a particular doctrine is expected to operate. In that regard, it is interesting to note the stark observation by Lord Hoffmann in *Re Bank of Credit and Commerce International SA* (No 8)[32] that he was at a ‘loss to understand’ how a marshalling claim had been brought by a bank depositor seeking to require the bank to take the deposit prior to demanding repayment of an outstanding loan. He pointed out:[33]

> There is only one debt and this is owed to [the bank] by the principal borrower. [The bank] has security to which it can resort as it chooses.... there is no basis upon which the depositors can assert an equity to require [the bank] to proceed against their deposits before claiming against the principal debtors.

The very bringing of the claim in such circumstances suggested that the legal foundation for the claim of marshalling was not well understood. Rose LJ in the Court of Appeal had actually described the claim as ‘completely misconceived’.[34]

There has been relatively little litigation in Australia, with the High Court of Australia having only considered the doctrine twice: in 1912 in *Ramsay v Lowther*[35] and in 1963 in *Miles v Official Receiver in Bankruptcy.*[36] Only the latter case involved marshalling of securities (as distinct from marshalling of assets) and there too the action appeared misconceived. Had the fund holder not taken the particular action in relation to the fund of which the claimant complained on the ground that it precluded marshalling, the holder would have been in

[29] Millett, ‘Equity’s place in the law of commerce’ (1998) 114 LQR 214 at 214.
[30] (1885) 30 Ch D 192.
[31] ‘..if two estates, *Whiteacre* and *Blackacre*, are mortgaged to one person, and subsequently one of them, *Blackacre*, is mortgaged to another person, unless *Blackacre* is sufficient to pay both charges, the first mortgagee will be compelled to take satisfaction out of *Whiteacre*, in order to leave to the second mortgagee *Blackacre*, upon which alone he can go’: *Webb v Smith* (1885) 30 Ch D 192 at 200 per Cotton LJ.
[32] [1998] AC 214 at 231.
[33] [1998] AC 214 at 231.
[34] [1996] Ch 245 at 271.
[35] (1912) 16 CLR 1.
[36] (1963) 109 CLR 501.

breach of its obligations to the claimant.[37] In applying the fund as it did, it acted 'strictly in accordance with its obligations'.[38] Interestingly, in that case the High Court affirmed general principles laid down by English courts as far back as 1803,[39] indicating that those principles remained equally applicable over 150 years later. Overseas criticism of the operation of marshalling in more modern times has been that it remains too rooted in its original form when commercial practices have changed[40] – criticism not dissimilar of course to that made by Kirby J in his call, noted previously,[41] for a focus on 'concepts; not detail'. An Australian commentator has observed:[42]

> The history of marshalling of securities in the twentieth century is characterised by a mood of consolidation or affirmation, rather than one of innovation.

It is noticeable, nonetheless, that cases in lower courts since the 1970s in Australia have addressed arguments testing the established limits of the doctrine. Courts have been required to consider, for example, whether the doctrine could make the first creditor a trustee of the other property or could confer an equitable interest in the other property in favour of the second creditor;[43] whether the doctrine restricted the first creditor from choosing which fund to go against;[44] whether there are circumstances in which it is not necessary to have a common debtor;[45] and whether the first creditor might in some circumstances have a liability to account.[46] In the most recent reported Australian case,[47] a decision of the New South Wales Supreme Court in 2008, the court was quick to note on the particular facts an absence of complicating factors such as claims that the first creditor had acted deliberately to the prejudice of the other creditor or had inappropriately released security or should account for moneys received through enforcement action. The raising and discussion of these issues in litigation might be interpreted as indicative of increasing expectations on the part of litigants of the doctrine's possible reach.

Some support for such a suggestion might, at least initially, be argued to be found in provisions typically now encountered in Australian security documentation. Anecdotal evidence indicates that first ranking secured parties commonly attempt to exclude the operation of marshalling. This could be interpreted, for example, as suggesting that those creditors perceive the operation of the doctrine as burdensome. Such an interpretation, however, is based on several assumptions – firstly, an assumption that the inclusion of the relevant negative covenant has been a considered action rather than simply reliance on a well used standard precedent; and, secondly, an assumption that the clause achieves what it sets out to do. While negative covenants may take various forms, it is not uncommon to find that the clause has been drafted in a manner that purports to relieve a first ranking secured creditor from being obliged to marshall. Such a clause clearly assumes that that secured party is

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[37] (1963)109 CLR 501 at 509.

[38] (1963) 109 CLR 501 at 510.

[39] (1963) 109 CLR 501 at 510-511, citing in particular *Aldrich v Cooper* (1803) 8 Ves Jun 382, 32 ER 402; *Trimmer v Bayne* (1803) 9 Ves Jun 209; 32 ER 582.

[40] See eg Averch & Prostock, 'The Doctrine of Marshalling: An Anachronistic Concept under the Bankruptcy Code' (1990) UCC LJ 224, cited and discussed by MacDougall, 'Marshalling and the Personal Property Security Acts: Doing Unto Others...' (1994) 28 UBC Law Rev 91 at 97-98.

[41] See above.

[42] Ali, *Marshalling of Securities*, Clarendon Press Oxford 1999 at p 32.

[43] *Commonwealth Trading Bank v Colonial Mutual Life Assurance Society Ltd* (1970) 26 FLR 338.

[44] *Mir Bros Projects Pty Ltd v Lyons* [1977] 2 NSWLR 192.

[45] *Sarge Pty Ltd v Cazihaven Homes Pty Ltd* (1994) 34 NSWLR 658.

[46] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 14 ACSR 586.

[47] *Accross Australia Finance Pty Ltd v Kalls* (2008) 14 BPR 26,265.

actually under any such obligation and that it is therefore important to preclude an obligation from arising. That clause is problematic, for several reasons.

While it is true that some judicial descriptions in cases regarded as 'classic' authorities do indeed refer to a creditor being, in the phrase used by Cotton LJ in *Webb v Smith* 'compelled to take satisfaction' out of the less encumbered property,[48] it is nonetheless clear that the current legal position under Australian common law, in marked contrast to the US position, regards the first creditor as free to choose against which property or fund it will proceed. This was made clear by the New South Wales Supreme Court in *Mir Bros Projects Pty Ltd v Lyons*[49] in 1977 when Wadell J observed:

> It is, in my opinion...well established that the doctrine does not prevent an earlier mortgagee satisfying his charge against whichever fund or security he thinks fit.

The court described[50] the above dictum of Cotton LJ not only as obiter but also 'contrary to the great weight of authority'. While Lord Hoffmann in *Re Bank of Credit and Commerce International SA (No 8)*[51] also appeared to countenance an action against the first creditor when he referred to the second creditor having 'an equity to require that the first creditor satisfy himself' out of the relevant fund, he immediately qualified that phrase by adding parenthetically '(or be treated as having satisfied himself)'.

More fundamentally, the clause seems to reflect a misunderstanding of how marshalling operates. The security documentation in which the clause is typically located is executed as between the debtor and the first creditor. The person who actually makes the claim to marshall is the second creditor and that creditor marshalls not as against the first creditor but as against the debtor. Not only therefore does the first creditor have a choice as to which property or fund it goes against, but if any restriction is to be placed on making a claim to marshall, that restriction must be a restriction on the second creditor. It is of course possible for the first creditor to preclude the operation of marshalling by agreeing with the debtor that the securities are to be enforced in a particular manner. In circumstances where there is no genuine choice as to which fund to go against, marshalling cannot operate. [52] The clause under discussion however does not purport to narrow the choice of funds.

The use of such a clause raises a further broader question as to why the first creditor should be concerned to exclude marshalling, given that the marshalling is against the debtor. It is possible that those drafting the clause have in mind a possible claim by a second creditor for the first creditor to account, an argument that will be examined below. Yet that is not the situation which the current drafting addresses.

These questions that arise from the current use of marshalling clauses in documentation, coupled with the pushing of the boundaries emerging from the admittedly rather scant case law in Australia, indicate some doubt over the operation of the doctrine and suggest that in practice commercial expectations of the doctrine may be at best rather optimistic, and at worst rather confused.

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[48] *Webb v Smith* (1885) 30 Ch D 192 at 200 per Cotton LJ, noted above. See also *Aldrich v Cooper* (1803) 8 Ves Jun 382 at 388-389, 32 ER 402 at 405, cited with approval by the High Court of Australia in *Miles v Official Receiver in Bankruptcy* (1963) 109 CLR 501 at 510.

[49] [1977] 2 NSWLR 192 at 196.

[50] [1977] 2 NSWLR 192 at 196.

[51] [1998] AC 214 at 231. This description in its entirety was recently cited without comment by the English High Court in *The Serious Organised Crime Agency v Szepietowski* [2010] EWHC 2570 (Ch).

[52] *Miles v Official Receiver in Bankruptcy* (1963) 109 CLR 501.

There is another perhaps more academic aspect to this question of commercial expectations. For the purposes of further assessing the utility of the doctrine, it is worth exploring at a more abstract level what commercial expectations might demand of an equitable doctrine and whether those are currently satisfied. From a transactional banking and finance lawyer's perspective, there seem to be at least three fundamental expectations:

- That the rationale for the doctrine is clear, enabling lawyers not only to understand how the doctrine may apply in particular factual circumstances but to anticipate how the doctrine may develop in the future ;

- That the criteria are readily identifiable and capable of application, enabling lawyers to apply the doctrine in the specific circumstances and guarding against accusations of 'palm-tree justice' while still preserving flexibility; and

- That the interests of the parties to a transaction and those of third parties are balanced appropriately and that equity does not impede the prized and oft-cited 'flow of commerce'.

Each merits attention, but given the constraints of time, the first is dealt with at more length as the most fundamental expectation.

4. Assessing commercial expectations

- ***Expectation that the rationale for a doctrine is clear***

So often concerns over the operation of equitable doctrines lie in the fact that the doctrines are expressed to be based on the broad concept of 'justice'. Reference was made previously to the 19th century case of *Tombs v Roch*[53] where the court spoke of a claim affecting properties which was:

> ...enforced in a manner not unjust, as far as the person is concerned by whom it was or may be enforced, but not just as between the...... properties liable....

Yet, although the notion of 'justice' clearly underlies equity's intervention, the driving factor has often been articulated in terms other than conscience. Furthermore, the meaning of 'justice' under such a formulation has actually been quite limited.

In *Miles v Official Receiver in Bankruptcy* the High Court of Australia approved and adopted the view expressed by Lord Eldon in *Aldrich v Cooper*[54]in 1803. Lord Eldon observed:[55]

> The principle in some degree is that it shall not depend upon the will of one creditor to disappoint another.

Interestingly, the qualification of 'some degree' was missing in the formulation adopted by Sir William Grant MR in *Trimmer v Bayne*,[56] a case decided in the same year as *Aldrich v*

[53] (1846) 2 Coll 490 at 499,500; 63 ER 828 at 832. See above.
[54] (1803) 8 Ves Jun 382, 32 ER 402.
[55] (1803) 8 Ves Jun 382 at 388, 32 ER 402 at 405.
[56] (1803) 9 Ves Jun 209 at 211; 32 ER 582 at 583.

Cooper, and explicitly approved by Lindley LJ in *Web v Smith*[57] and, as noted previously, cited by the High Court of Australia in *Miles v Official Receiver in Bankruptcy*:

> ... a person having resort to two funds shall not by his choice disappoint another, having one only.

In these descriptions of marshalling, the notion of disappointment which the courts appeared concerned to remedy flowed from the deliberate action of the first creditor. In *Across Australia Finance Pty Ltd v Kalls*[58] in 2008 the New South Wales Supreme Court had, however, to consider whether the doctrine might still operate where it was not the first creditor who made the choice but a lower ranking secured party. The court opined:[59]

> ...it is not correct in principle to treat the will or election of a prior mortgagee as a significant ground for a claim for marshalling.

The court focused its intention on the impact on the person seeking to marshall. It did not matter who initiated the action if the impact was that the securities were enforced in a manner which reduced the value of the second creditor's security and left the first creditor's other security untouched. The court regarded references by Lord Eldon to caprice and election in *Aldrich v Cooper* as simply illustrating circumstances in which marshalling was available rather than as 'delimit[ing] the availability of marshalling.'

Even with that possible widening of the notion, this focus on the impact on the second creditor is clear. The accidental action of a creditor as a ground for equitable intervention has certainly been emphasised in two recent decisions of the High Court in 2009 in relation to the doctrine of contribution. In *Friend v Brooker*[60] the court described equity as offering protection against the 'accident or chance' of an action of a creditor. [61] In *Bofinger v Kingsway Group Ltd* a unanimous High Court observed:[62]

> ..equity is moved by concern that the common exposure of the contributors to the creditor and the equality of burden not be defeated by the accident or chance that the creditor select for recovery one or some rather than all of the contributors.

However, uncertainty has crept into the operation of marshalling with explicit references to 'conscience'. In *Sarge v Cazihaven Homes Pty Ltd*[63] in 1994 Young J, referring to Waldock's explanation of the motivation for permitting marshalling as:[64]

> a court cannot countenance an election in the first mortgagee to satisfy or disappoint the second by his choice in realising his securities,

observed:[65]

> ...the probabilities are that the doctrine rests on a principle of conscience....

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[57] (1885) 30 ChD 192 at 202.
[58] (2008) 14BPR 26,265.
[59] (2008) 14 BPR 26,265 at [30].
[60] (2009) 239 CLR 129.
[61] *Friend v Brooker* (2009) 239 CLR 129 at 148.
[62] (2009) 239 CLR 269 at 299.
[63] (1994) 34 NSWLR 658.
[64] Waldock, *The Law of Mortgages* 2nd ed (1950) at 299-300. Waldock dismissed two other bases: namely, specific performance and consolidation.
[65] (1994) 34 NSWLR 658 at 665.

Reference to conscience had also appeared in the judgment of the Supreme Court of Tasmania in the 1970 decision of *Commonwealth Trading Bank v Colonial Mutual Life Assurance Society Ltd*[66] where Neasey J cited a passage from the third English edition of *Story on Equity* explaining the basis of the doctrine of marshalling of assets but which was said also to apply in relation to marshalling of mortgages.[67] There *Story* had laid emphasis on an 'unreasonable power' of the first creditor to defeat the claimants and said that the courts of equity would:[68]

> ...treat such an exercise of power as wholly unjust and unconscientious; and therefore will interfere, not, indeed, to modify or absolutely to destroy the power but to prevent it from being made an instrument of caprice, injustice, or imposition.

It should be recalled however (as was subsequently discussed in the Supreme Court of New South Wales)[69] that in the US the first creditor may be restrained from taking action to enforce his security. In jurisdictions where the first creditor cannot be restrained, the impact of the marshalling order is on the debtor. Nonetheless, in *Re Bank of Credit and Commerce International SA (No 8)* Lord Hoffmann had clearly referred to marshalling as:

> ..a principle for doing equity between two or more creditors...[70]

The current state of thinking was described[71] rather robustly by the New South Wales Supreme Court in 2008 in *Across Australia Finance Pty Ltd v Kalls*. In response to the observation by the plaintiff's counsel that the grounds for equity's action were uncertain, the court remarked:

> This is quite correct; courts of equity have marshalled funds and claims, in the absence of an altogether satisfactory exposition of the juridical basis for doing so, for about three centuries at least.

The court identified what it described as 'several strands of grounds upon which equity has traditionally acted'.[72] These were 5 in number:[73]

> The accidental nature of the impact of the actions of the prior creditor, a wish to avoid the defeat of a later claim by the decision or caprice of a prior creditor, a close but not altogether satisfactory analogy with subrogation, the court's concern to deal justly when establishing entitlements to funds under its control, and the maxim that Equity is equality, leading to decisions which gave similar treatments to persons with closely similar interests.

The court concluded however:[74]

> It is enough….that courts of equity have for a very long time applied principles of marshalling, themselves not highly defined, to problems of this kind.

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[66] (1970) 26 FLR 338.
[67] (1970) 26 FLR 338 at 344.
[68] *Story on Equity*, 3rd English edition p 239.
[69] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 14 ACSR 586.
[70] [1998] AC 214 at 230.
[71] (2008) 14 BPR26,265 at [10].
[72] (2008) 14 BPR26,265 at [10].
[73] (2008) 14 BPR26,265 at [10].
[74] (2008) 14 BPR26,265 at [10].

A lack of clarity over the rationale for the doctrine is of concern, particularly when it is noted that broader notions of justice have crept into other equitable doctrines and in particular in recent years into the doctrine of contribution, often (albeit controversially) said to be linked to marshalling. In the classic 19th century case of *Dering v Earl of Winchelsea*[75] contribution was famously described as 'bottomed and fixed on general principles of justice'. That justice was generally understood, however, as based on the notion of equity being equality – the sureties having a common burden and a common interest. Underlying that was arguably the further notion that it was the accidental nature of the creditor selecting one surety that triggered the claim. [76]

The previously noted observations made by the High Court in *Friend v Brooker*[77] and *Bofinger v Kingsway Group Ltd*[78]in support of 'accident' as a basis of intervention were of particular importance, given the earlier decision of a differently constituted High Court in *Burke v LFOT Pty Ltd*[79] in 2002 where several judges introduced the concept of unjust enrichment in their explanation of the operation of contribution. McHugh J had been very clear on the point:

> An order of contribution prevents the injustice that would otherwise flow to the plaintiff by the defendant being enriched at the plaintiff's expense in circumstances where they have a common obligation to meet the liability which the plaintiff has met or will have to meet. [80]

Professor Goode has explained marshalling in terms of the unjust enrichment of the debtor through the increase in the value of the debtor's equity. [81] In the wake of the High Court of Australia's explicit rejection in *Bofinger v Kingsway Group Ltd*[82] of the concept of unjust enrichment as 'a principle supplying a sufficient premise for direct application in a particular case', this line of argument may be unlikely to be further developed in Australia, at least at the moment.

It is submitted that commercial expectations in relation to marshalling may be better met by confining the notion of justice to the narrower view of a random action.

- ***Expectation that the principles (or criteria) are readily identifiable and capable of application***

In discussing the equitable doctrine of set-off, one of the other doctrines capable of inclusion within a general concept of adjustment, the Queensland Court of Appeal made the telling observation:[83]

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[75] (1787) 1 Cox 318 at 321, 29 ER 1184 at 1185.

[76] 'the one who is sued must pay it...but, as between themselves, there shall be a contribution for they are *in equali iure* : *Dering v Earl of Winchelsea* (1787) 1 Cox 318 at 322; 29 ER 1184 at 1186. See also *McLean v Discount and Finance Ltd* (1939) 64 CLR 312; *Mahoney v McManus* (1981) 180 CLR 370.

[77] (2009) 239 CLR 129.

[78] (2009) 239 CLR 269 at 299.

[79] (2002) 209 CLR 282.

[80] (2002) 209 CLR 282 at 299. See also at 300 and per Gaudron A-CJ and Hayne J at 294.

[81] Goode, *Commercial Law*, Penguin Books London (3rd ed) 2004 at p 645.

[82] (2009) 239 CLR 269 at 299.

[83] *Forsyth & Anor (as trustees for the C&S Forsyth Superannuation Fund) v Gibbs* [2008] QCA 103 at [9].

> Consistently with the technique of equity, which does not seek to define what an elephant is but knows one when it sees one, the principles governing the availability of equitable set-off of cross-claims are couched in open-textured terms, such as 'sufficient connection' and 'unfairness'.

The criteria for a marshalling claim, at least one articulated in orthodox terms and based on the narrower concept of justice, seem more readily identifiable and significantly less open-textured than those for equitable set-off. Although the law relating to marshalling has been described as 'not highly defined or clearly stated',[84] it nonetheless appears less open to the rather controversial charge laid by Kirby J in *Burke v LFOT Pty Ltd*[85] in relation to the doctrine of contribution that the relevant principles had become:

> ...needlessly encrusted with artificial rules and restrictions resulting in disputation, confusion and uncertainty....

The principal criteria emerged at an early stage of the doctrine's development. In summary form,[86] there are three principal criteria:[87]

- *Secured creditors and a common debtor*

  Generally, marshalling arises where a debtor owes a debt to each of two creditors who are secured over the debtor's property. The lack of two such debts was one reason for the dismissal of the marshalling claim in *Re Bank of Credit and Commerce International SA (No 8)*.[88]

- *Two existing funds of the common debtor on the same footing*

  Generally, it is said that there must be two existing funds which are on the same footing. This is neatly illustrated by the decision of the English Court of Appeal in *Webb v Smith*[89] in 1885. A brewer had instructed an auctioneer to sell a brewery and some furniture. Following the sale, the auctioneer held two funds: one representing sale proceeds of the brewery; the other, sale proceeds of the furniture. The proceeds of the brewery were subject to two securities; a lien in favour of the auctioneers and a charge in favour of another creditor. The chargee attempted to rely on marshalling by arguing that the auctioneers had a separate claim on the fund representing the proceeds of the sale of the furniture. However the Court of Appeal found that the auctioneers had only a set-off and that a claim based on set-off was 'inferior' to that based on lien, meaning that the auctioneers did not have the ability to resort to either of the two funds.

[84] *Accross Australia Finance Pty Ltd v Kalls* (2008) 14 BPR 26,265 at 26,270.
[85] (2002) 209 CLR 282 at 309.
[86] See more generally McDonald, 'Marshalling' in Parkinson (ed), *The Principles of Equity*, Law Book Co Sydney (2nd ed) 2003 pp 569-580.
[87] A further criterion of 'control' by the court has been rather liberally interpreted: see discussion in *Accross Australia Finance Pty Ltd v Kalls* (2008) 14 BPR 26,265 at 26,270-26,271 where reference on this point is made to *Commonwealth Trading Bank v Colonial Mutual Life Assurance Society Ltd* (1970) 26 FLR 338.
[88] See above.
[89] (1995) 30 ChD 192.

- *The first creditor has a genuine choice as to which fund it will enforce*

  If there is any restriction that requires a creditor to go first against one fund before the other, there can be no marshalling. If the rationale is that the doctrine protects against random choice, the existence of the agreement directs the action and thus precludes any need to rely on the doctrine.

In the future, the application of these criteria may prove more controversial, placing commercial expectations under some pressure. Traditionally, the funds available for marshalling appear to have been constituted by a mortgage or a charge or a lien over property.[90] With the imminent introduction of the personal property securities legislation,[91] the range of available funds may expand to include flawed asset arrangements as well as functionally equivalent security transactions in relation to personal property.[92] A further interesting question will be the extent to which marshalling would be available in respect of deemed security interests, such as certain operating leases.[93]

- ***Expectation that interests are balanced appropriately and that equity does not impede the prized, and oft-cited, 'flow of commerce'***

The balancing of interests as between parties to a transaction and third parties has long been a contentious issue in the commercial application of equitable doctrines. Tension between those twin competing goals of flexibility and certainty can be readily found. In *Hewett v Court*[94] the High Court of Australia was divided 3:2 as to whether to recognise an equitable lien to protect a purchaser under a contract for labour and materials. In refusing to recognise the lien, the minority judges were unwilling to extend principles which had led to recognition of an unpaid vendor's lien as well as a purchaser's lien under a contract for sale of land. The effect of recognition would, in their view, have been:[95]

> [to] introduce unnecessary complexity into the ascertainment of the rights of the parties and would be destructive of that certainty which is the basis of sound commercial practice.

Judicial criteria such as 'impeachment of title to the demand' under the doctrine of equitable set-off [96] and a requirement for co-ordinate liabilities under the doctrine of contribution[97] can be regarded as attempts by courts to set limits on the operation of equity. With marshalling, some limits have certainly been imposed through the development of the principle of 'marshalling by apportionment', said to be 'analogous' to marshalling. It arises when the debtor creates a further security over the single encumbered property in favour of a third

[90] Such property might take the form of land, a chose in possession or a chose in action such as an insurance policy or shares.

[91] *Personal Property Securities Act* 2009 (Cth), currently expected to be operative in October 2011. See above.

[92] *Personal Property Securities Act* 2009 (Cth) s 12(1),(2).

[93] See *Personal Property Securities Act* 2009 (Cth) s 12(3).

[94] (1983) 149 CLR 639.

[95] (1983) 149 CLR 639 at 659.

[96] See *Rawson v Samuel* (1841) Cr & Ph 161; 41 ER 451*; Re Just Juice Corporation Pty Ltd (recs & mgrs apptd)* (1992) 8 ACSR 444.

[97] *Albion Insurance Co Ltd v Government Insurance Office (NSW)* (1969) 121 CLR 342; *Friend v Brooker* (2009) 239 CLR 129. See also the very recent decision of the High Court of Australia, delivered on 22 August 2011, in *HIH Claims Support Ltd v Insurance Australia Ltd* [2011] HCA 31.

person. To allow marshalling in those circumstances would be to prejudice that third person. The court will thus deem the first creditor to have been paid rateably from both properties.[98] Such a limitation has been recognised since the 19th century.[99]

In the context of the debate as to whether marshalling should be available under personal property securities legislation, the view has been expressed[100] that marshalling impacts adversely on the unsecured creditors of the debtor by 'diverting to the junior secured creditor assets that would otherwise be shared pari passu'. However, a Canadian commentator takes the contrary view on the basis that the debtor, and hence 'in most cases' the debtor's unsecured creditors, have no legitimate expectation of property which has been given by way of security; they would otherwise receive a windfall. [101] This view is persuasive.

This expectation of an appropriate balancing of interests is certainly likely to be contentious in the future, with academic and judicial discussion of the potential imposition of a liability to account on a first creditor who has satisfied its debt out of the double encumbered property. This is the so called middle ground advanced by Meagher, Gummow & Lehane and referred to with apparent approval in the New South Wales Supreme Court- initially, in *Sarge Pty Ltd v Cazihaven Homes Pty Ltd*[102] in 1994 by Young J and later that same year in *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd*[103] by Cohen J. Accepting that the second creditor has no proprietary interest in the single encumbered property and hence that there is no relationship of trustee/beneficiary, the middle ground proposes rather:[104]

> .....attaching to the double claimant personal liability of a fiduciary character to account to the single claimant for the loss occasioned by release of the first charge or a proprietary interest in moneys received by the double claimant upon exercise of that charge...

In *Chase* Cohen J saw 'attraction' in the suggestion, but considered it could only apply in what he described initially in very broad terms as 'circumstances where it would be regarded as inequitable or unconscionable to release the security' but which he then immediately qualified by saying 'that is, with full knowledge of the right being asserted by the other mortgagee'.[105] However, in subsequently considering the facts,[106] he did appear to regard unconscionable conduct and knowledge as alternatives, again opening up the issue to further discussion.

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[98] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 35 NSWLR 1 at 18. See also *Across Australia Finance Pty Ltd v Kalls* (2008) 14 BPR 26,265.

[99] In *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 35 NSWLR 1 at 18 the court referred to *Barnes v Racster* (1842) 1 Y &C Ch Cas 401; 62 ER 944.

[100] Gedye, 'What's Yours is Mine: Attachment of Security Interests to Third Party Assets' (2004) 10 NZBLQ 203 at 217. He describes it as ''invariably'' harming those unsecured creditors and argues that it may in fact also provide a windfall for the junior creditor: see his argument in note 50 .

[101] McDougall, 'Marshalling and the Personal Property Security Acts: Doing unto Others....' (1994) 28 UBC Law Review 91 at 122.

[102] (1994) 34 NSWLR 658.

[103] (1994) 14 ACSR 586.

[104] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 14 ACSR 586 at 603.

[105] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 14 ACSR 586 at 603.

[106] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 14 ACSR 586 at 603: '....it does not seem that I could find that Norbrik or its directors acted unconscionably or that they released their security in the knowledge that Chase would, or even was likely to, seek to be subrogated'.

5. Conclusion

Assessing commercial expectations of equity's role in financial risk allocation is not an easy task, not least because of the difficulty which lies in attempting firstly to identify the range of equitable doctrines potentially capable of playing a part in any such risk allocation and secondly to articulate such expectations. As far as the first obstacle is concerned, it is submitted that a general concept of 'adjustment', whether of exposure or liability, may offer a useful basis for exploring the role of doctrines such as marshalling and contribution as well as those of subrogation, equitable set-off and perhaps equitable lien.

Selecting marshalling as one possible example of a doctrine through which equity allocates risk by adjusting financial exposure, this paper has sought to reach a preliminary assessment on the operation of that doctrine in the light of three general expectations which can be argued to reflect typical concerns of banking and finance transactional lawyers – clear rationale ; criteria that are readily identifiable and capable of application; and an appropriate balancing of interests of those impacted by the operation of the doctrine. The first and third of such expectations appear unsatisfied, with the brief overview of modern Australian case law revealing some lack of clarity on the reasons for equity's intervention and indeed some possible tension as between creditors. Whether such problems arise from uncertainty as to the original role of equity in this area or from attempts to shape equitable doctrine in particular directions reflecting policy goals different to those originally encompassed by the doctrine remains to be investigated and debated. By contrast, the second expectation of clear criteria appears initially to be met. Yet there is also some ground for concern under this heading, and not simply because of doubt as to the manner in which these criteria may operate under the new regime of security interests introduced by the *Personal Property Securities Act* 2009 (Cth). The terms in which marshalling is typically excluded in commercial documentation suggest that the principles which the criteria reflect are not necessarily fully appreciated.