Lender Liability in Australia and New Zealand -

CASE STUDY

Lendsafe Bank

v.

Prosciutto Packaging Pty Ltd and others

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Alberto and his friend Bruce emigrated to Australia from Italy in 1978. In 1982 Alberto and Bruce started a business together packaging prosciutto, which they have run ever since as partners. Alberto and Bruce each own half of the issued shares in, and are directors of, Prosciutto Packaging Pty Ltd (PP). PP owns the plant and equipment used by the business and employs several staff to operate packaging machinery, attend reception, manage deliveries and otherwise operate the business.

Alberto and Bruce have done all of their banking with Lendsafe Bank ("Lendsafe") ever since they moved to Australia. They hold a number of accounts with Lendsafe including an unsecured overdraft of $100,000. Alberto and Bruce have a good relationship with Lendsafe and in particular Lawrence, an employee of Lendsafe, who manages Alberto and Bruce's accounts. Lendsafe knows that, although Alberto and Bruce are business partners, Alberto has very little knowledge of financial matters and relies on Bruce to run the business and read any relevant documents. Bruce is experienced in the industry and is predominantly responsible for managing the business' finances.

Given the seasonal nature of the business, the debit balance in the overdraft fluctuated wildly and the approved limit was regularly exceeded. Lawrence complained about this practice but he continued to honour all essential cheques drawn on the account. As the overdraft spiralled over the limit Lawrence became concerned about the bank's position and he advised Bruce that he would selectively dishonour cheques in the interests of the bank. He said that unless the overdraft was cleared within two weeks he would be compelled to terminate the facility. Bruce informed Lawrence that it would be impossible to clear the debit within this period because the capital of the business was already committed elsewhere. Nevertheless, he made a strenuous effort to reduce the overdraft by $33,000 at the expense of other projects and to the overall detriment of the business.

A few weeks later Bruce decided to leverage his expertise in packaging prosciutto by expanding the business through the purchase of a larger factory and more equipment. As Bruce was wandering past his local branch of Lendsafe, he saw a poster advertising Lendsafe's new "BizBoost Loan." The advertisement stated that this was a small business expansion facility "with a low 3% p.a. interest rate readily available to approved customers."

Bruce subsequently inquired about borrowing $1m to finance their business expansion. Lawrence told Alberto and Bruce that they did not qualify for the lower rate because it was only available for a minimum loan of $2m and to customers who satisfied particular creditworthiness (which Alberto and Bruce did not meet). In fact, a number of Lendsafe's other customers also applied for a "BizBoost Loan" and were persuaded into borrowing money at a higher interest rate because they did not meet Lendsafe's creditworthiness requirements. Bruce agreed to a higher 4% p.a. variable interest rate after Lawrence led him to believe that the interest rate would not increase for a number of years.

Bruce negotiated the other terms of the financing with Lawrence. They agreed that Lendsafe would provide $1m to Alberto and Bruce jointly. Alberto and Bruce would use those funds to make an equity investment in PP which would issue shares on a one-for-one basis to Alberto and Bruce. PP would purchase the factory and equipment.

The loan facility was secured by a real property mortgage over the factory and a fixed and floating charge over the assets of PP. A meeting of PP's shareholders was held at which the shareholders approved the granting of these securities and the issue of shares. The security documents included provisions which entitled Lendsafe to appoint, as PP's agent, a receiver and manager to PP if the business suffered serious financial difficulties.The documents were prepared by Lendsafe and provided to Alberto and Bruce with a letter from Lawrence asking Alberto and Bruce to "read over them". The loan facility agreement provided that

Lendsafe could vary the interest rate simply by publishing a notice in *The Australian*. Alberto telephoned Lawrence and asked him about the documents generally. Alberto confided to Lawrence : "I don't really know why we need all of these documents, you'd be better off getting Bruce to sort it all out" and asked : "You've been helping us for years now, do you think the expansion is a good idea?" Lawrence advised Alberto that he thought the expansion was viable and that Alberto should talk further to Bruce about any concerns he had. Lawrence had recently declined to finance a similar meat processing venture because Lawrence was concerned that there was insufficient market demand for packaged meats.

Alberto and Bruce eventually agreed to the terms proposed by Lendsafe. The documents were then executed by Alberto, Bruce, Lendsafe and PP and the expansion of PP proceeded. Lendsafe provided $1m after it satisfied itself that, among other things, the property mortgage was registered. PP increased its output of packaged prosciutto in its new, larger, processing plant.

In December last year, Lendsafe notified Alberto and Bruce that it was varying the definition of "rate" to refer to a "base rate plus margin." The effect was that Alberto and Bruce's loan would, after 90 days, be subject to an interest rate 0.2% p.a. higher. The change took effect in March this year.

The expansion of PP was largely unsuccessful and, as a result of the higher rate of interest being charged by Lendsafe, Alberto and Bruce defaulted on their obligations under the loan facility in May 2003. This default resulted from Alberto and Bruce failing to make an interest payment when it fell due. PP's financial state progressively worsened, and Lawrence considered that it was unlikely to improve in the near future. Alberto and Bruce were also struggling to meet their interest repayment obligations.

For this reason, Lawrence decided to enforce the securities given by PP. Consequently Lendsafe appointed Roger as a receiver and manager of PP's assets. Under the terms of the mortgage debenture Roger was expressed to be the agent of PP. He attempted to run the packaging business in place of Alberto and Bruce for a period and sold some of the backlogged stock to try to pay some of the outstanding invoices. However, Roger sold the stock for half of its market value as he did not fully investigate how much it was worth. PP subsequently went into compulsory liquidation and Fred Ferret was appointed as liquidator. Nevertheless, Roger continued with his attempts to sell the company's assets. He failed to accept a generous offer to purchase PP's forklift and computer systems. At the same time, Roger took possession of PP's factory under the mortgage and is now seeking to exercise Lendsafe's power of sale of the factory property.

What problems might Lendsafe encounter in seeking to recover the funds it lent to Alberto and Bruce, including enforcing its rights under the mortgage and the company charge?