THE Financier

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THE FINANCIERS ASSOCIATION OF AUSTRALIA LIMITED NEWSLETTER
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Welcome to the Summer 2006/07 edition of The Financiers Association of Australia Limited newsletter. We trust you had a Very Merry Christmas and we wish you a Prosperous New Year .

As usual we try to keep up with any legislative changes in the credit code as well as inserting any interesting general business pieces gleaned from various sources.

A welcome is also extended to new members at this time.

NOTICE TO MEMBERS

The board are delighted to announce the Associations' new web site is now operational.

The address is
www.financiersassociation.com.au

Your comments, feedback and suggestions to enhance the site would be very much appreciated.

Would all members kindly forward their current e-mail address to
membership@financiersassociation.com.au

Regards
Lou Statos, Secretary

The following article shows the necessity for ensuring credit contracts conform to the credit code

Compensation credit company fined $45,000

A Brisbane-based finance company and its two directors have been fined $45,000 for serious breaches of the Consumer Credit Code.

Fair Trading Minister Margaret Keech said the Supreme Court consent order against Compensation Finance (Australia) Pty Ltd and its directors, Wayne Roberts and Neil Tierney, should serve as a warning to other lenders who flouted the law.

“The Consumer Credit Code is designed to ensure people are properly informed before taking on credit and to prevent organisations taking advantage of vulnerable Queenslanders,” Mrs Keech said.

“In the case of Compensation Finance, however, the 80 contracts their clients entered into between March 2002 and January 2003 failed to state the amount of credit, the annual interest rate, how interest was calculated and the total amount of interest."

“These are serious breaches of the Consumer Credit Code because these contracts denied customers the opportunity to make an informed choice by comparing costs between credit providers.”

Mrs Keech said Compensation Finance’s breaches prevented customers from receiving key information about their credit contract.

“Compensation Finance’s directors provided loans to Queenslanders expecting payouts from court-related proceedings,” she said.

“Borrowing money from finance companies always costs money, however Compensation Finance withheld this information from their customers, thereby denying them the information they needed to shop around for the best deal."

“The Consumer Credit Code states that regardless of their financial position, Queenslanders are entitled to know this information up front, before they sign.”

Mrs Keech said while the Consumer Credit Code provided for civil penalties of up to $500,000 for companies found omitting key information from credit contracts, the omissions from Compensation Finance (Australia)’s contracts were not

intentional and a $45,000 fine was appropriate.

"Until discovered by Fair Trading investigators, both directors failed to take steps to ensure the documentation they used in their business complied with the Consumer Credit Code," she said.

"This court action should send a clear warning to the finance industry that unless credit contracts and other documentation comply with the law, companies can expect to be penalised."

Low doc loan declared unjust

In Permanent Mortgages Pty Ltd v Michael Robert Cook and Karen Cook [2006] NSWSC 1104 the NSW Supreme Court declared a loan contract and mortgage unjust notwithstanding the judge's description of the borrowers as "foolish", following the decision in Khoshaba.

The borrowers (defendants) executed a mortgage over their home. They were substantially in arrears and the mortgagee (plaintiff) sought possession.
The borrower's expert described the loan's features:

78) The public interest is one of the matters that the court must have regard to under s70. On this issue over the objection of the Plaintiff, I admitted evidence by Dr Steve Keen, Associate Professor of Economics and Finance at the University of Western Sydney.

79) After reviewing the Defendants' borrowings, for reasons which he gave in a lengthy and detailed report, he categorised the subject mortgage as evidencing a "Ponzi" loan, namely one which "can only be repaid by either taking out a larger subsequent loan, or by selling the asset that was financed using the loan". He also described it as a "low doc" loan, that is one where borrowers self verify their income in the application process. He said that such loans are:
"designed mainly for the self-employed or those with irregular income who do not have the documentation required to obtain a conventional housing loan."

80) As to the public interest involved in "low doc" and "Ponzi" loans, Professor Keen said:

(a) Standard home loans are limited in size by the need for the borrower to establish that he/she can repay the loan out of income.

(b) Legitimate "Low "Doc Loans" are a necessary development of income-based loans

(c) Ponzi Loans are loans that can only be repaid by either taking out a larger subsequent loan, or by selling the asset that was financed using the loan.

(d) Ponzi Lending can occur in Low Doc Loans because the loosening of income-verification standards enables loans to substantially exceed the size that could be met out of borrower's actual income.

(e) The Subject Loan to the Cooks was a Ponzi Loan.

....

(g) Were the practice of Ponzi Lending to become widespread, it would substantially increase the tendency of the Australian financial system to asset bubbles and subsequent financial crises, by:
i - accelerating the accumulation of excessive debt during the up-swing to an asset bubble;
ii - accelerating the rate of decline during the bursting of the bubble; and
iii - causing the recovery to take much longer.

(h) Ponzi Loans thus have adverse economic consequences that extend well beyond the immediate parties to the loan agreement.
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85) Against any public interest in discouraging loans of the type identified by Professor Keen and Mr Carraill, there is, of course, a public interest in the enforcement of contractual obligations freely entered into. In the result, I do not regard the public interest as of much significance in resolving this case. Rather, I think the greater focus should be upon factors personal to the Defendants, or more directly concerned with the particular transaction...

88} Whether I should hold the mortgage unjust in this case involves a balancing exercise. On the one hand are the circumstances that the Defendants speak English as their first language; were experienced borrowers; had the services of a solicitor; were extremely anxious to obtain the loan; and were prepared to sign false statements and procure false certificates. On the other hand, the beneficial nature of the Code indicates that

it was intended to protect the unsophisticated and meagrely educated, such as the Defendants, from their own foolishness. Given the means of the Defendants and their credit history, the Plaintiff, in my view, was aware, or would have been aware, had it made the most perfunctory of enquiries, that the Defendants were not capable of servicing the loan even at the lower rate of interest and could only satisfy their obligations by selling the mortgaged property for a sum sufficient to cover the principal and interest. It was likely that they would thus become obligated to pay interest on the amount of the credit, not at 8.8% p.a., but at the much higher rate of 13.8%....

92 Undoubtedly, the Defendants were foolish but, in my opinion, the circumstances of this case constitute the "something more" contemplated by Basten JA [in Khoshaba], in that the Plaintiff or its agents who were, or should have been, aware of the foolishness had, in effect, encouraged it. I am of the opinion that the subject mortgage and the credit contract, pursuant to which it was given, should be held to be unjust within s70 of the Code."

Finance company directors sued for making bad loans

Gold Ribbon (Accountants) Pty Ltd (in liq) v. Sheers & Ors [2006] QCA 335 (5 September 2006)

Gold Ribbon (Accountants) Pty Ltd was set up in December 1997 and provided unsecured loans to accountants. The interest rate charged was almost twice the bank interest rate for comparable secured loans. Gold Ribbon was described as a "last resort lender". It lent up to 80% of the value of the accounting practice's aged receivables. Borrowers did not have to provide any security other than the personal guarantees of directors if the borrower was a company.
Terence Michael Dunn was a non-executive director of Gold Ribbon. In the early stages it was expected that the Dunn's company, Commercial Recovery Management Pty Ltd, would be responsible for administering the scheme and carrying out the due diligence. However, this role instead went to Austide Holdings Pty Ltd which was run by the de facto partner of Richard Sheers, one of the other directors.

Sheers, Stephen Romp, Garry Howes and Robert Taylor were also directors of Gold Ribbon for most or all of the time during which the scheme was set up and implemented. There was dissention on the board of directors over a number of matters. The judge in the subsequent case said, "[n]either [Sheers nor Howes] was inclined to compromise or conciliation and Howes exhibited a degree of aggression in his dealings with other directors which inhibited any calm exchange of views and dispassionate decision-making". These two apparently tried to exclude Dunn from the affairs of the business.

In 1999 and 2000, Gold Ribbon made a number of bad loans. Borrowers did not, it seems have to produce lists of debtors (even though the basis of the loan was their accounts receivable), or financial statements or tax returns for the previous years, or provide a charge over their debts.

On 8 August 2001, the Gold Ribbon went into liquidation. The directors were sued for breach of their duties of care as directors. Judgment by default was obtained against Howes in May 2003. The other directors are bankrupt and did not defend the claim. The case proceeded against Dunn, who denied liability.

It was not claimed that Dunn should have been checking the loans himself. Instead, it was argued that, as a director, he should have "ensured that the respondent's loan program was administered according to standards of prudence so basic as to be obvious to any lender." Specifically, the claim said that the lender should have confirmed that:

"A. the applicant was in fact a registered practising accountant;
B. the certified accounts receivable existed...and did not include work in progress;
C. ... the applicant was not currently experiencing and/or had not in the immediate past or repeatedly in the past experienced financial difficulty;
D. the applicant had the ... capacity to service the loan (in terms of making the required payments on the loan) plus repay the loan capital in terms of the loan arrangements, preferably from demonstrated ongoing cash flow, but, at the very least, from available assets of the applicant and/or the guarantors;

E. the terms and conditions of the loan application were otherwise satisfied by the applicant."

The liquidators of Gold Ribbon relied on evidence relating to the five loans in order to establish a case against Dunn. Any "borderline" applications for funding were to be discussed with a director prior to approval or rejection of the application, and this was done for the five loans concerned.

For example, a total of $842,000 was lent to Jumarsh Pty Ltd. The directors of Jumarsh at the time of these advances were Julian Norton-Smith and Sheers (who was a director of Gold Ribbon!) Michael Norton-Smith was a certified practising accountant and it was his professional membership which was relied on to obtain the loan. He was a bankrupt at the material time. It would seem that no credit check was done on him, or, if it was, it was not acted upon. The trial judge said that "Sheers was aware that Julian Norton-Smith's certification of receivables bore little, if any, relation to reality." The loan was guaranteed by Julian Norton-Smith and Michael Norton-Smith. Ultimately there was a loss of $692,000.

A total of $800,000 was lent to John McCouat, approved by Sheers. Austide carried out a search which showed that McCouat had become a member of the National Institute of Accountants and taken out professional assurance only days before his application, but the application listed outstanding practice debtors of $1,707,023. There was no investigation of how McCouat could have generated receivables of this order when it was evident that he had only recently joined the profession. In fact, McCouat did not have the receivables certified in his loan application. He repaid nothing on demand.

For one loan, the judge found that another director, Howes, participated in the fraudulent application and both Sheers and Howes stood to gain from the loan through their companies. After a trial, the judge awarded judgment against Dunn for $3,629,000. He agreed that the losses on these loans were suffered because of Dunn's failure as a director to ensure that adequate loan application assessment procedures were established and maintained. Dunn appealed.

The judges of the Queensland Court of Appeal concluded that there had been a breach of duty by Dunn. However, this breach did not necessarily cause the losses. In essence, if the directors were approving bad loans to their friends, the judges were not convinced that better credit assessment procedures would have made any difference. Therefore, the fact that Dunn did not put those procedures in place did not make him liable for the losses relating to the five loans.

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