

# RETHINKING THE SPECIAL EQUITY RULE FOR WIVES: POST GARCIA, QUO VADIS, WHERE TO FROM HERE?

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## Abstract

*The operation of the special equity principle can be seen where a wife does not understand the nature and effect of the guarantee she is induced to sign by the husband whereupon the transaction may be set aside. It should be remembered that women often become involved in these guarantees because of the existence of a personal relationship rather than because of any real appreciation of the legal relationship created. Credit providers such as banks involve women in this kind of 'sexually transmitted debt', 'emotional debt' or 'relationship debt' as a means of countering debtor default or to compensate for inadequate or non-existent debtor assessment procedures, rather than to make it more difficult for men to access credit. This article looks at the how the High Court's decision in *Garcia v National Australia Bank* has followed the special equity principle and raises questions concerning its status. It also looks at the application of the principle in *Garcia* in the modern context and the limitations and the future of that application.*

## Introduction: Special equity rule-the search for a principle

Consumer groups have complained about consumer credit practices causing women who have become guarantors or sureties for their spouses to eventually lose their homes and their financial security. One of their more urgent concerns has been the practice of credit providers requiring women to take some legal responsibility for credit provided to their male spouses or partners and from which the women involved receive no benefit.<sup>1</sup>

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<sup>1</sup> Trade Practices Commission, *Guarantors: Problems and Perspectives* (Discussion Paper, 1992) at 14.

Although for the present, the case law in respect of the special equity rule has been restricted to wives<sup>2</sup> there have been suggestions that the principle could be extended to a wider range of relationships of trust and confidence such as those involving husbands as well as wives; de facto relationships and same-sex arrangements; parents and grandparents in respect of their financial transactions with children or grandchildren; members of extended families, such as aunts and uncles; and close friends.<sup>3</sup>

The special equity rule originally evolved as a result of the courts' interpretation of the early English cases decided in respect of guarantees given by wives to secure the debts of their husbands. The courts did not apply the doctrines of undue influence or unconscionable conduct because they were somewhat vague in their deliberations and gave the impression that they were deciding the cases on the basis of a special principle which only applied to the guarantees wives gave.<sup>4</sup>

The existence of this special equity as an independent principle which applies to wives who became guarantors was clearly acknowledged in Australia in the landmark decision of *Yerkey v Jones*.<sup>5</sup> This case involved Mr and Mrs Yerkey, the plaintiffs who sued upon a covenant to pay principal and interest contained in a mortgage of land owned by Mrs Jones. Mr Jones intended to purchase a property from the plaintiffs for the purpose of poultry farming. A condition of the debt was that Mr Jones should procure from his wife a second mortgage over her property to secure £1,000 of the £3,300 final payment. The solicitor of the creditors prepared the mortgage and Mr Jones persuaded his wife to sign. Under the mortgage which was a "guaranteed mortgage", Mrs Jones was made personally liable to pay the £1,000. Mr Jones failed in his poultry business having occupied the farm for about a year without paying any interest and abandoning it altogether.

Mrs Jones sought equitable relief, claiming that she did not understand the nature of the transaction although the solicitor explained it to her in some detail. Mrs Jones did not receive any independent legal advice. In the Supreme Court of South Australia, Napier J held that on grounds of undue influence, misrepresentation and unilateral mistake, Mrs Jones was entitled to equitable relief against the personal covenant in the mortgage.

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<sup>2</sup> As is evident in, for example, *Yerkey v Jones* (1939) 63 CLR 649 and *Garcia v National Australia Bank* (1988) 155 ALR 614.

<sup>3</sup> Expert Group on Family Financial Vulnerability, *Good Relations, High Risks: Financial Transactions Within Families and Between Friends* (Report, 1996), 10.

<sup>4</sup> See *Turnbull & Co v Duval* [1902] A C 429 and *Chaplin & Co Limited v Brammall* [1908] 1K B 233.

<sup>5</sup> (1939) 63 CLR 649.

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In the High Court it was held that a wife like Mrs Jones stands in a special position, where she acts as a guarantor for her husband in that if she signs a written guarantee, she has a prima facie right to have it set aside if her consent was obtained by her husband and she did not understand its effect.<sup>6</sup> There Dixon J's judgment had come to represent the authoritative statement of how equity will provide relief for a wife who has agreed to be surety for her husband's debt. His Honour examined a number of authorities on the position of wives as guarantors for their husbands such as *Shears & Sons Ltd v Jones*,<sup>7</sup> *Turnbull & Co v Duval*<sup>8</sup> and *Chaplin & Co Ltd v Brammall*<sup>9</sup> and allowed the appeal explaining the position in this oft quoted passage:

If a married woman's consent to become a surety for her husband's debt is procured by the husband and, without understanding its effect in essential respects, she executes an instrument of suretyship which the creditor accepts without dealing with her personally, she has a prima facie right to have it set aside.<sup>10</sup>

Such an equitable principle was originally developed as a way of ameliorating the harshness of the common law, which prevented a woman from dealing with a property in her own name.<sup>11</sup> The position of married women under common law has been explained by Blackstone in the following way:

By marriage the husband and wife are one person in law. The very being or legal existence of the woman is by the common law suspended during the marriage, or, at least it is incorporated and consolidated into that of the husband, under whose wing, protection and cover she performs everything.<sup>12</sup>

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<sup>6</sup> Above n 5 at 683. It is an essential element of the principle in *Yerkey* that the wife obtains no tangible benefit from the transaction.

<sup>7</sup> (1922) 128 LT 218.

<sup>8</sup> [1902] AC 429.

<sup>9</sup> [1908] 1 KB 233.

<sup>10</sup> Above n 5, 683. See also *Warburton v Whitley* (1989) NSW Conv R 55-453; *Bawn v Trade Credits Ltd* (1986) NSW Conv R 55-290; *Broadlands International Finance Ltd v Sly* (1987) ANZ Conv R 329; *Bank of Victoria Ltd v Mueller* [1925] VLR 642, 648.

<sup>11</sup> Lee Aitkin, 'Equity, Third-Party Guarantees and Wife as Guarantors: Recent English Developments' (1992) 3 *Journal of Banking and Finance* 260, 264.

<sup>12</sup> Quoted in G Williams "Equitable Principles for the Protection of Vulnerable Guarantors: Is the Principle in *Yerkey v Jones* Still Needed?" (1994) 8 *Journal of Contract Law* 60, 69. See Aitkin, above n 11, 264.

## A Critical Analysis of The Yerkey Principle in the Context of *Garcia v National Australia Bank*

The *Yerkey* principle of special equity which provides wives with more liberal protection than the doctrine of undue influence was reluctantly applied in some cases<sup>13</sup> and distinguished in others.<sup>14</sup> Recent appellate courts in Australia<sup>15</sup> and in England<sup>16</sup> have rejected this principle. However, the recent surprising High Court decision in *Garcia v National Australia Bank Ltd*<sup>17</sup> has once again reignited the debate on the judicial basis of the rule in *Yerkey v Jones* by reviving it from the brink of judicial irrelevance. The High Court preferred not to adopt the views expressed by the House of Lords in *Barclays Bank v O'Brien*<sup>18</sup> by re-affirming the correctness of the *Yerkey* principle and addressing the strong criticisms against it. In so doing, the court provided an authoritative statement on the hitherto controversial status of *Yerkey v Jones*.<sup>19</sup> The High Court in *Garcia* found it unnecessary to consider *O'Brien* in detail, and merely made the observation that in that case the House of Lords discounted

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<sup>13</sup> *Warburton v Whiteley* (1989) 5 BPR 97-338; NSWLR Conv R 55-453; *Peters v Commonwealth Bank* (1993) NSW Conv R 55-629; *Garcia v National Australia Bank Ltd* (1993) ANZ Conv R 603; *ANZ Bank v McGee* [1994] ASC 56-278.

<sup>14</sup> *European Asian of Australia Ltd v Lazich* [1987] ASC 55-564; *European Asian of Australia Ltd v Kurland* (1985) 8 NSWLR 192; *Commonwealth Bank v Cohen* [1988] ASC 55-681; *Akins v National Australia Bank Ltd* [1994] 34 NSWLR 155; *Commonwealth Bank v McGlynn* (1995) ANZ Conv R 81; *ANZ Bank Ltd v Dunosa Pty Ltd* (1995) ANZ Conv R 86.

<sup>15</sup> *National Australia Bank Ltd v Garcia* (1996) 39 NSWLR 577; *Akins v National Australia Bank Ltd* [1994] 34 NSWLR 155. In *Gregg v Tasmania Trustees* (1997) 73 FCR 91 there was an action by a (school teacher ) wife to set aside a mortgage of the matrimonial home which she had given jointly with her husband (who later became a bankrupt) to a creditor, the Tasmanian Trustees for a loan to a company, Tasram, in which the husband had an interest. Here Merkel J ( at 113-114) gave a summary of social development in Australia stressing that fundamental changes in the role of women in the Australian workforce in recent years have negated the necessity for any legal equities in favour of wives. On this basis he pointed out that *Yerkey v Jones* was no longer good law and that the equitable presumption in favour of a vulnerable wife as enunciated by Dixon J in *Yerkey v Jones* in 1939 has now been subsumed and or superseded by general principles relating to unconscionability as laid down by the High Court in *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447.

<sup>16</sup> *Barclays Bank plc v O'Brien* [1994] 1 AC 180; *CIBC Mortgages p/c v Pitt* [1994] 1 AC 200.

<sup>17</sup> (1998) 155 ALR 614.

<sup>18</sup> [1994] 1 AC 180.

<sup>19</sup> J O'Donovan, "The Retreat from *Yerkey v Jones*: From Status Back to Contract" (1996) 26 *University of Western Australia Law Review* 309.

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what it understood was the special equity theory as stated by Dixon J in *Yerkey v Jones*.<sup>20</sup>

In *Garcia* the High Court expressed the view that *Yerkey v Jones* continues to state the law in Australia. In its analysis, the court did not see any requirement for any presumption of undue influence nor did it see any necessity to characterise the husband as the agent of the lender (as the House of Lords did in *O'Brien*). The essence of the principle lies in the relationship of trust and confidence that exists between the guarantor and the borrower, and the creditor's knowledge of this relationship.

The facts of *Garcia* are relatively uncomplicated. The appellant Mrs Garcia, a qualified physiotherapist, in 1979 gave a mortgage with her husband to secure a loan in relation to his business. The mortgage secured all moneys they might owe including moneys secured by future guarantees. Mrs Garcia between 1985 and 1987 executed a number of guarantees given by both her and Mr Garcia in support of the latter's businesses, which included a business of buying and selling gold through a company. She became shareholder and director of this company, although she was in reality not directly involved in its operations over which her husband had control. After her divorce in 1988, she sought a declaration that the mortgage and guarantees were not binding on her and should be set aside. The respondent bank demanded payment of \$327,189 under one of the guarantees ('the November 1987 guarantee') and claimed possession of the home, her husband's interest having been transferred to her in the divorce settlement. Mrs Garcia claimed that she did not understand the transaction, being under the mistaken belief that the guarantee was of limited overdraft accommodation to be applied only in the purchase of gold, and did not understand that her obligations under the guarantee were secured by the mortgage over her family home. The husband's business unfortunately proved to be a failure and the bank proceeded to sell the home for the debt owed. Mrs Garcia contended that she gave the guarantee in reliance of representations by her husband that it would be safe to do so. At first instance, her claim of actual undue influence on the part of the husband and another based on the *Contracts Review Act 1980* (NSW) both failed.<sup>21</sup> Her claim based on *Yerkey v Jones*, on the other hand, succeeded, was overturned by the Court of Appeal, but was eventually upheld by the High Court.

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<sup>20</sup> *Garcia v National Australia Bank* (1998) 155 ALR 614 at [15] per Gaudron, McHugh, Gummow and Hayne JJ.

<sup>21</sup> *Garcia v National Australia Bank Ltd*, above n 13.

## Majority Judgment

The majority of the High Court in *Garcia* was able to resurrect the *Yerkey* doctrine by including as a 'special disability' the disadvantage suffered by a wife who acted as guarantor in a transaction from which she had received no benefit and without adequate explanation as to its nature and effect. The High Court defied the latest judicial predictions and trend towards favouring the adoption of the doctrine of unconscionability as enunciated in *Commercial Bank of Australia v Amadio*<sup>22</sup> and indirectly criticised the lower courts' reluctance to accept the validity of the special equity rule<sup>23</sup> as evidenced by the majority of the justices cautioning that 'it is for this court alone to determine whether one of its previous decisions is to be departed from or overruled'.<sup>24</sup> The court contended that the 'special equity' rule for wives and the doctrine of unconscionability and notice have been crucial to the evolution of the modern law of guarantees. At the same time, in some situations, the development in these areas has also been affected by a number of statutory provisions.<sup>25</sup>

The High Court then expressed the view that *Amadio* was not intended to mark out the boundaries of the field of unconscionability.<sup>26</sup> The majority referred to what was said in *Amadio* that 'it is impossible to describe definitely all the situations in which relief will be granted on the ground of unconscionable conduct'.<sup>27</sup> Unlike *Yerkey*, the unconscionable conduct depicted in *Amadio* concerned actual misconduct which brought about the entry of the surety into the transaction.<sup>28</sup> The court was able to identify the crucial difference between the doctrine of *Yerkey /Garcia* and that of *Amadio*. The *Amadio* principle was used as a ground for setting aside a transaction for unconscionability in situations where the weaker party was under a special disability, and the disability was evident to the stronger party to make it unfair or unconscientious that he or she procure or accept, the weaker party's assent to the

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<sup>22</sup> (1983) 151 CLR 447.

<sup>23</sup> See, for example, *European Asia of Australia Ltd v Kurland* (1985) 8 NSWLR 192; *Akins v National Australia Bank Ltd* (1994) 34 NSWLR 155; *National Australia Bank Ltd v Garcia* (1996) 39 NSWLR 577; *Teachers Health Investments Pty Ltd Wynne* (1994) NSW Conv R 55-718; *Gregg v Tasmanian Trustees Ltd* (1997) 73 FCR 91; *Miles v Shell Company of Australia* (1998) 156 ALR 133.

<sup>24</sup> Above n 17, at 619 per Gaudron, McHugh, Gummow and Hayne JJ.

<sup>25</sup> See, for example, ss 51AA, 51 AC, 52.

<sup>26</sup> Above n 17, 622.

<sup>27</sup> *Ibid* 622.

<sup>28</sup> Above n 17, 622.

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impugned transaction.<sup>29</sup> If these criteria are met, the burden shifts to the stronger party to show that the transaction was fair, just and reasonable.<sup>30</sup>

The idea of a 'special disability' (when considering unconscionability) as mentioned is a pivotal one in *Amadio* where it must be sufficiently evident to the lender. In reality, there are a great number of cases in which practical problems encountered by guarantor wives have rendered them unable to demonstrate they are under a "special disability" that is sufficiently evident to the lender.<sup>31</sup> This means that the only option left for the court is to grant relief to the guarantor wife under the *Yerkey v Jones* principle, as is happening in *Garcia*.<sup>32</sup>

In *Amadio*, despite the fact that the bank did not leave the acquisition of the execution of the mortgage transaction to the son, it nonetheless had notice of the circumstances that the Amadios may have been acting under their son's influence and it did not succeed in making certain that they received independent advice. On the other hand, it should be noted that in *Garcia*, the guarantor wife's status as a professional, a director of the company, as well as her interest in the family business would not qualify her from relying on *Amadio*. Yet the circumstances may raise in the mind of the lender a suspicion or doubt as to the ability of the guarantor wife to secure the debt and her knowledge of financial matters to enter into the transaction. It is possible to look at this suspicion or doubt as being related to the concept of constructive notice.

Despite the questionable validity of the 'special equity' rule, the High Court has given its endorsement in *Garcia* which means that it will remain as good law in Australia for sometime to come. It is submitted that although a number of aspects of the judgment have been welcome, especially the concept that a wife's particular vulnerability may be extended to other relationships of 'trust and confidence' such as 'long term and publicly declared relationships short of marriage between members of

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<sup>29</sup> Above n 17, 622.

<sup>30</sup> *Bromley v Ryan* (1956) 99 CLR 362, 428-9.

<sup>31</sup> For example, *Teachers Health v Wynne* (1994) NSW Con R 55-718; *Akins v National Australia Bank* (1994) 34 NSWLR 155.

<sup>32</sup> See *Warburton v Whitely* (1989) 5 BPR 97-338; (1989) NSW Conv R 55-453. See also G Williams, 'Equitable Principles for the Protection of Vulnerable Guarantors: Is the Principle in *Yerkey v Jones* Still Needed?' (1993) 8 *Journal of Contract law* at 68-83; B Collier, 'Confusion Now Hath Made This Masterpiece' (1997) 25 *Australian Business Law Review* 190, 190-202.

the same or opposite sex',<sup>33</sup> *Garcia* has not adequately resolved many uncertainties which dominate this contentious area of the law.<sup>34</sup>

The main judgment was given by the majority, namely, Gaudron, McHugh, Gummow and Hayne JJ (with Callinan J delivering a separate judgment) who believed that the rule in *Yerkey v Jones* remains good law but did not go into a detailed analysis of conflicting authorities.<sup>35</sup> Their Honours nevertheless held instead that the reasons given in the judgment of Dixon J were 'not significantly different' from the reasons of the other members of the court.<sup>36</sup> The decision was to be seen as particular applications of accepted equitable principles which have as much application today as they did then.<sup>37</sup> The majority then concluded that the authority of *Yerkey v Jones* should be considered as of continuing legal utility because of the 'significant number of women in relationships...marked by disparities of economic and other power between the parties'<sup>38</sup> They argued that Dixon J conveniently examined two sets of circumstances in which it could be said that the guarantor was a volunteer, albeit a 'mistaken volunteer' who obtained no financial benefit from the transaction and who entered into an improvident bargain.<sup>39</sup>

The first circumstance is where there is actual influence by the husband over the wife. In this case, Dixon J said that it will not be sufficient to merely explain the effect of the guarantee to the guarantor. Their Honours quoting Dixon J in *Yerkey v Jones* explained that 'nothing but independent advice or relief from the ascendancy of the husband over her judgment and will would suffice'.<sup>40</sup> The second circumstance is where there is no undue influence, but where "if the creditor takes adequate steps to

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<sup>33</sup> *Garcia*, above n 17, [22] per Gaudron, McHugh, Gummow and Hayne JJ and [109] per Callinan J.

<sup>34</sup> Robyn Baxendale, 'Garcia v National Bank Limited - Ensuring Equity in Surety Transactions: A Legal Debt-End?' (1999) 21 *Sydney Law Review* 313 at 313. It should be pointed out that the thorny question of what relationships may be given protection in third party guarantees has been clarified. There is 'no rational cut-off point' as to the kinds of relationships which may be susceptible to undue influence in guarantee contracts. In the absence of banks evaluating the extent to which a debtor may have influence over a guarantor 'the only practical way forward is to regard banks as "put on inquiry" in every case where the relationship between the surety and the debtor is non-commercial'. See *Royal Bank of Scotland p/c v Etridge* (No 2) [2002] 2 AC 773, para 87 per Lord Birkenhead.

<sup>35</sup> Above n 17, at 618-619 where the majority gave only a superficial consideration to the judgment of Sheller J in *Garcia v National Australia Bank* (1996) 39 NSWLR 77, 598.

<sup>36</sup> Above n 17, 619.

<sup>37</sup> *Ibid* 619.

<sup>38</sup> *Ibid*.

<sup>39</sup> *Ibid* 621-2.

<sup>40</sup> *Ibid* 621.

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inform [the wife] and reasonably supposes that she has an adequate comprehension of the obligations she is undertaking and an understanding of the effect of the transaction, the fact that she has failed to grasp some material part of the document, or, indeed, the significance of what she is doing cannot give her an equity to set the instrument aside'.<sup>41</sup> In this situation, the High Court reasserts the proposition that to avoid the impeachment of a transaction of this nature, the creditor must take adequate steps to inform the wife, and the creditor must have reasonable ground to suppose that she has an adequate comprehension of the obligation she is undertaking and an understanding of the effect of the transaction.<sup>42</sup>

The majority contended that the changes in Australian society and the role of women since Dixon J's judgment should be viewed as 'particular applications of accepted equitable principles which have as much application today as they did then'.<sup>43</sup> The justices did not assess *Yerkey* on the basis of the alleged inferior economic, social and domestic position of women generally; instead, they observed that:

So far as *Yerkey v Jones* proceeded on the basis of the early decision of Cussen J in *The Bank of Victoria v Mueller*,<sup>44</sup> it is based on trust and confidence in the ordinary sense of those words, between marriage partners.<sup>45</sup>

The majority argued that it would be unconscionable for a creditor to enforce a guarantee against a surety-wife who was a volunteer, if it can be shown that she did not understand the object and effect of the transaction and the creditor took no steps to explain the transaction and did not reasonably believe that a competent, independent and disinterested stranger had done the same. Thus what made it unconscionable to enforce was a combination of circumstances, where:

in fact the surety did not understand the purport and effect of the transaction; the transaction was voluntary (in the sense that the surety obtained no gain from the contract the performance of which was guaranteed); the lender is to be taken to have understood that, as a wife, the surety may repose trust and confidence in her husband in matters of business and therefore to have understood that the husband may not fully and accurately explain the purport and effect of the transaction to his wife...<sup>46</sup>

The majority did consider the possibility of extending the rule in the future to husbands acting as sureties and to relationships which are 'long term and publicly

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<sup>41</sup> Ibid 622.

<sup>42</sup> Ibid 621-2, quoting *Yerkey v Jones* (1939) 63 CLR 649 at 684.

<sup>43</sup> Ibid 619.

<sup>44</sup> [1925] VLR 642.

<sup>45</sup> Above n 17, [21].

<sup>46</sup> Ibid 623.

declared relationships short of marriage between members of the same or opposite sex'.<sup>47</sup> The court stopped short of elaborating, pointing out that such issues were not the focus of the present case and that 'the resolution of questions arising in the context of other relationships may well require consideration of other issues'.<sup>48</sup> So, although no clear guidance is given, the possible extension of the rule in the future may signal a departure from the *Yerkey* principle in the sense that courts hereafter can look to cohabitation and emotional dependency rather than concentrate on the marital status of the parties.

### Minority Judgments

Kirby J contended that Dixon J's analysis in *Yerkey v Jones* was a 'judicial statement worthy of the greatest respect but not commanding obedience as a matter of binding precedent'.<sup>49</sup> His Honour delivered a strong dissent by saying that a principle which placed a wife in an 'advantageous position that she would not have enjoyed had she not been married to the principal debtor',<sup>50</sup> entrenched discriminatory stereotypes - a position that he held earlier as anachronistic when he was a member of the New South Wales Court of Appeal in *Warburton v Whitley*.<sup>51</sup> The rationale of his Honour's judgment is that if the legal basis of the *Yerkey* rule is challenged, it cannot be justified in terms of social policy and legal principle.

Kirby J made the observation that recent changes pertaining to the status of married women, and domestic relationships, require courts to refrain from classifying unnecessarily by gender, when more accurate and impartial principles could be discerned.<sup>52</sup> His Honour believed that qualities such as trust and confidence, vulnerability and dependence were not necessarily unique to marriage, but could be regarded as much wider 'relationship' issues.<sup>53</sup> His Honour did admit that there may

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<sup>47</sup> Ibid 620.

<sup>48</sup> Ibid.

<sup>49</sup> Ibid 633.

<sup>50</sup> Ibid 634.

<sup>51</sup> Ibid 635-6. See J Pascoe, 'Wives, Business Debts and Guarantees' (1997) 9 *Bond Law Review* 58-81.

<sup>52</sup> Ibid 631-33.

<sup>53</sup> Kirby J's reformulation has been described as 'a generally well-reasoned judgment'. His Honour's approach effectively removed the gender-based 'special equity' theory and replaced it with a formulation that is expressed in non-discriminatory terms. It encompassed all other categories of relationship that are 'emotional dependence' based. It has the advantage of recognising that a substantial proportion of business decisions are made by husbands, and at the same time, circumventing the legal foundation of equitable presumption of 'invalidating tendency'. See W Weerasoria and D Turner, 'High Court Re-

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be situations in which the *Yerkey* principle can give assistance to married women who might come within the ambit of the unconscionability rules of *Amadio*. These cases would, however, be better served by formulating a non-discriminating rule which is gender-neutral.<sup>54</sup> With this in mind, and drawing on the reasoning of the House of Lords in *Barclays Bank v O'Brien*,<sup>55</sup> Kirby J decided to restate the law in a 'principled and certain form'. To do this His Honour favoured a reformulation of the principle as expressed by Lord Browne-Wilkinson in *O'Brien*.<sup>56</sup>

Under the reformulated *O'Brien* principle of Kirby J, the creditor will be fixed with constructive notice if it knows facts sufficient to put it on inquiry as to the possibility of wrongdoing by the debtor.<sup>57</sup> When constructive notice is properly understood as a principle which is wide and flexible, there is no reason why it should not give rise to liability.<sup>58</sup> What is crucial is to recognise and identify the circumstances in which the creditor will be taken to have notice of the guarantor's equity to render the transaction unenforceable. Kirby J saw his modified *O'Brien* principle as having a wider application in that it is relevant to all other cases where there is a relationship of emotional dependence between the debtor and the person conferring the advantage. It may apply to the situation where the husband guarantees his wife's

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affirms and Re-embraces *Yerkey v Jones* and Disapproves of House of Lords Decision in *Barclays Bank v O'Brien*' (1998) 14 (3) *Banking Law Bulletin* 33, 34.

<sup>54</sup> See Murray Brown, 'The Garcia Code' (2003) 14 *Journal of Banking and Finance Law and Practice* 17, 21.

<sup>55</sup> [1994] 1 AC 180.

<sup>56</sup> Above n 17, 642-643. At 641 Kirby J restated the *O'Brien* principle thus: (1) where a person guarantees the debts of another and the creditor knows that there is a relationship involving an emotional dependence on the part of the guarantor towards the debtor, the surety obligation will be enforceable unless the guarantee was procured by the undue influence, misrepresentation or other legal wrong of the debtor; (2) where there has been undue influence, misrepresentation or other legal wrong by the principal debtor, unless the credit provider has taken reasonable steps to satisfy itself that the guarantor had entered into the contract freely, the credit provider will not be able to enforce the surety obligation because it will be fixed with notice of the guarantor's right to set aside the transaction.

<sup>57</sup> In *Bank of New South Wales v Rogers* (1941) 65 CLR 42, for example, where the debtor was the guarantor's uncle with whom she was in a dependency relationship, the court said that the credit provider knew enough about this relationship to put it on inquiry as to the circumstances in which the guarantee was given.

<sup>58</sup> D Fox, 'Constructive Notice and Knowing Receipt: An Economic Analysis', (1998) 57 (2) *Cambridge Law Journal* 391. See also *Manchester Inc v Bishopsgate Investment Trust* (No 3) [1995] 3 All ER 747, 769.

debts, or where the creditor is, or ought reasonably to be aware that the surety reposes trust and confidence in the debtor in relation to his financial affairs.<sup>59</sup>

Callinan J in a separate and minority judgment did not, unlike Kirby J, favour extending the special equity principle beyond married couples. Although conceding that sexual and matrimonial relationships in recent times have undergone changes, his Honour expressed the view that to state a principle to encompass all cases would not be a feasible idea. He pointed out that:

...given the diversity of human relationships...I would not with respect adopt the principle...that any exceptional rules formerly applicable to guarantees by wives of husbands' obligations should be extended to co-habitees in cases in which the creditor is aware of an emotional relationship between all co-habitees.<sup>60</sup>

His Honour believed in any case that this was an area for legislative rather than judicial intervention. He expressed his approval of *Yerkey* thus:

For myself I would take the view that the principles stated by Dixon J have now stood and been accepted for so long as the law in Australia, and that during that time they have served the ends of justice so well, they should be taken as the law unless and until this court has held or should now hold to the contrary.<sup>61</sup>

### **Where to From Here?**

The recent trend of case law before the appeal of *Garcia* to the High Court is unmistakable. There is not going to be any special entitlement to protection in equity according to the principle in *Yerkey*. A wife is to be treated like any other disadvantaged person and can get protection from equity if the transaction is 'unconscionable' as the term is explained in *Amadio*. At the same time, it appears that in the event that equity does not provide relief, it will not be available under the equitable remedies as embodied in, for example, the *Contracts Review Act 1980* (NSW).

The recent cases demonstrate that in the absence of any general duty to advise the guarantor, the creditor's position will be protected except in those situations where the guarantor gets no benefit from the transaction. *O'Brien*, which belongs to this category of cases raises, in addition, serious policy questions concerning whether women, particularly wives should constitute a special class of guarantors for whom

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<sup>59</sup> Above n 17, 642-643.

<sup>60</sup> Above 17, [109]. In light of the majority's reasoning, it is possible that Callinan J's comments may not survive future judicial extension of the principle to other relationships.

<sup>61</sup> *Ibid* [107].

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the transaction is more easily avoided than for others; or whether the test of unconscientious conduct as established in *Amadio* should be used in all situations of potential unconscionability leading to and justifying avoidance. *O'Brien* was not decided on the concept of the ignorant wife, but did recognise the fact that in most marriages it is still the husband who has the business experience and the wife who tends to be in the position of following his advice and not having a truly independent mind in making judgments concerning financial matters. The wife is nevertheless given tender treatment. One aspect of this treatment can be seen in the fact that *O'Brien* fixes a creditor with constructive notice of the wife's equity when the transaction is on the face of it not made to the wife's financial benefit and carries a risk of the husband committing a legal or equitable wrong resulting in the guarantee being set aside.

*O'Brien* can be seen as a viable synthesis of existing principles and is consonant with some recent Australian authority. In *European Asian Pty Ltd v Kurland*,<sup>62</sup> for example, it was forcefully stated that any special principle for wives which is based on *Yerkey* and which is seen to represent a woman's 'inferior position' is anachronistic and not applicable in contemporary Australian society.<sup>63</sup> The burden seems to fall on the creditor to show that informed consent has been obtained by the provision of independent advice. In *Beneficial Finance Corp v Karavas*,<sup>64</sup> Kirby P, for example, explained that for a transaction to be considered just (in this case within the terms of the *Contracts Review Act* (1980) (NSW)) a duty may have to be imposed on the lender to ensure independent legal advice is obtained although this may involve delay and cost.

When all is said and done, it can be concluded, however, that although one may be sympathetic with the approach in *O'Brien*, it is simply not up the courts in Australia to espouse it in open disregard to the approach taken by the High Court in *Yerkey v Jones*. To do so would be to ascribe too much importance to *O'Brien* which after all is a House of Lords decision having only persuasive authority in Australia.

It is submitted that the value judgments and assumptions which are implied in the High Court's decision in *Garcia* are not universally shared, and are therefore subject to criticisms. Despite the affirmation in *Garcia* of the *Yerkey* rule with its uncertainties, it is likely that courts will apply other general law and statutory regimes. Yet the decision in *Garcia* is instructive in many ways. It allows the High Court to give its endorsement of the time honoured proposition that guarantors who are vulnerable

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<sup>62</sup> (1985) 8 NSWLR 192, 200.

<sup>63</sup> See also *Commonwealth Bank v Cohen* (1988) ASC 58 at 146; *European Asian Pty Ltd v Lazich* (1987) ASC 55-564.

<sup>64</sup> (1991) 21 NSWLR 256.

and who are not just guarantor wives, often enter into contracts of guarantee only on the basis of a personal relationship and with no understanding of the legal implications involved. When seen in conjunction with the apparent inconsistency of the majority of the court in their widening of the application of the *Yerkey* principle with its historical basis, it may be possible to conclude that despite their endorsement, the demise of the principle is imminent. Although the limitations of the special equity rule are obvious enough, it has the effect of providing a legal mechanism to accommodate the wide number of specific pressures which arise where a domestic relationship takes on a commercial flavour.<sup>65</sup> In this sense, it can be said that the strength of *Yerkey* as applied in *Garcia* is that it is sufficiently flexible to accommodate a blurring of commercial and personal relationships by reducing a guarantor's burden of proving actual undue influence or unconscionable dealing.<sup>66</sup>

It is almost certain that in *Garcia*, the majority expressed the view that there is a presumption of undue influence arising from, but not confined to the relationship of marriage, leading to the risk that the guarantor may receive unsatisfactory explanation and the transaction be set aside for unconscionability. The judgments apply the concept of undue influence in requiring a relationship of trust and confidence, but bring the contract of guarantee into the ambit of an unconscionable transaction, by examining the quality of the assent of the party who has the stronger bargaining power. The presumptions of undue influence and unconscionability may be rebutted by the availability of independent advice, useful and helpful explanation, or evidence of the fact that the guarantor does not benefit from the transaction.

It will be interesting to see if or how far the courts in future will accept the High Court's invitation to broaden the scope of *Yerkey and Garcia* to include other types of relationships.<sup>67</sup> The judgment of Kirby J will no doubt generate interest in that it enquired why the High Court in *Garcia* should endorse a principle designed to apply specifically to one class of sureties, namely wives. His Honour's line of reasoning has delineated a broader principle which is not confined to one group whose members have attributed to them particular needs and vulnerabilities which are certainly not confined to that group.<sup>68</sup> As to whether the fears of Kirby J that women may use the 'special equity' to avoid their lawful obligations are realised remains to be seen.

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<sup>65</sup> Joellen Riley, 'Should the Lender Know if Directors Are Sleeping Together?' (1999) *Commercial Law Quarterly* 23; B Fehlberg, 'Women in Family Companies' (1997) 15 *Sydney Law Review* 345, 356-8.

<sup>66</sup> O'Donovan, above n 19, 309.

<sup>67</sup> Above n 17, 638 per Kirby J.

<sup>68</sup> *Ibid.*

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### The potential scope of the Garcia defence

Sufficient time has passed to allow us draw some conclusions about the approach of other courts to the High Court majority's suggestion of a possible extension of the special equity to an expanded class of vulnerable guarantors. The crucial question of course is whether, as discussed above, the principle applies only where the wife is guarantor for the husband's debts or whether it has a wider application. The recent court decisions on this point have tested these boundaries. They have on the whole demonstrated that the scope of the *Garcia* defence has been mixed so that there has been no uniform approach in its application.

The test that has attracted most attention, however, is still the one limiting the defence application to cases where the guarantor and the debtor are in a legal husband/ wife relationship or in a similar one.<sup>69</sup> That is to say, the decisions which have been most consistent is where the principle so far has only ever been applied in favour of a guarantor-wife.<sup>70</sup> However, other tests have also been proposed, for example, that the principle applies where 'the lender knew or ought to have known that the surety was emotionally dependent on the debtor'<sup>71</sup> or 'where the lender was aware that the surety and debtor were in a relationship of trust and confidence'.<sup>72</sup>

In *Watt v State Bank of New South Wales*,<sup>73</sup> the appellants Mr and Mrs Watt agreed to assist to be guarantors of the loan of their daughter and son-in-law and sought to rely on the *Garcia* defence, pointing out that they had not understood that the papers which they had signed contained guarantees and mortgages in favour of the respondent. Higgins CJ and Crispin P contended that the *Garcia* principle was based on the need to protect married women from the consequences of transactions entered into at the request of their husbands and turned upon 'special considerations of trust and confidence that arise from a marital relationship'.<sup>74</sup> Their Honours argued that although it was possible that the same considerations might apply in relationships similar to marriage, there was nothing to suggest that the principle could be extended to parents who had guaranteed the debts of their children. Whilst they accepted that parents often entered into improvident transactions at their children's request, they said that the parent-child relationship is very different from that between husband and wife. Thus it can be argued that although the appellants as

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<sup>69</sup> See, for example, *ANZ Bank Group v Alirezai* [2002] ANZ Conv R 597.

<sup>70</sup> See *Equitiloan Securities v Mulrine* [2000] ACTSC 48, [7] and *State Bank of New South Wales v Layoun* [2001] ANZ Conv R 487.

<sup>71</sup> *Equitiloan Securities v Mulrine*, above n 70, [7].

<sup>72</sup> *State Bank of New South Wales v Layoun*, above n 70.

<sup>73</sup> [2003] ACTCA 7.

<sup>74</sup> Above n 73, 20.

guarantors were entitled to 'every sympathy'<sup>75</sup> and are to lose their home and possibly their life savings, the *Garcia* principle was not available to them. Their Honours were of the opinion that the *Garcia* defence applies only to marriage and possibly similar relationships, as it is only in these relationships that the trust and confidence between the parties might be sufficient for one to act in 'unquestioning reliance' on a request by the other to become guarantor and as a result receive from the debtor no sufficient explanation of the transaction's purport and effect.<sup>76</sup> Their Honours explained their justification for this conclusion in the following terms:

The real vulnerability of parents usually stems not from a failure to comprehend the nature of the transactions in which they have been asked to participate or from insufficient information concerning their implications. It stems from their love of their children. Their desire to help and protect them, to advance their interests, to maintain a close relationship, to avoid causing disappointment, hurt or distress, to maintain the relationship may all make it difficult to say no. The principles in *Yerkey v Jones* and *Garcia* offer no protection for people lured into improvident transactions by feelings of this kind.<sup>77</sup>

*Armstrong v Commonwealth of Australia*<sup>78</sup> was decided in a similar way to *Watt*. In *Armstrong*, although the wife was a 25 per cent shareholder in the company which received the loan, Bryson J refused to extend the special equity principle of *Garcia* to de facto wives.

In some decisions an attempt has been made to limit what might be thought to be the potential scope of the *Garcia* defence. In *State Bank of New South Wales v Hibbert*,<sup>79</sup> for example, Bryson J adopted a conservative approach to the possible extension of *Garcia* to other committed relationships based on emotional ties by not granting relief to defacto partners who jointly provided a mortgage and guarantee in favour of the plaintiff bank by saying that:

the extension of the principles acted on in *Garcia* from wives to all married persons, or to all women, or to all persons who are living in defacto relationships...does not appear to me a development which the law can realistically be expected to take.<sup>80</sup>

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<sup>75</sup> Above n 73, 34.

<sup>76</sup> Above n 73, 21.

<sup>77</sup> Above n 73, 21.

<sup>78</sup> [1999] NSWSC 588.

<sup>79</sup> [2000] NSWSC 628.

<sup>80</sup> Above n 79, para 60.

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In *National Australia Bank v Starbronze*,<sup>81</sup> the court decided not to grant relief to a surety who entered into a guarantee following misrepresentations as to its effect by the borrower. This was because the relationship between the surety and the borrower, that of brothers-in-law was not sufficiently intimate to attract the operation of the *Garcia* principle. Coldrey J justified the decision of the court by commenting that 'the fact that a person may have trust and confidence in another cannot without the added dimension of intimacy, attract this aspect of the doctrine of unconscionability'.<sup>82</sup>

To a similar effect is *Equitiloan Securities Ltd v Mulrine*<sup>83</sup> where the court had to decide whether the *Garcia* defence should be applied where the creditor was aware that the guarantor was emotionally dependent on the debtor. On this basis, Master Conolly turned down relief for the surety as there was nothing in his relationship with the debtor to take it beyond a long-term friendship.<sup>84</sup>

Yet, in *Liu v Adamson*<sup>85</sup> the court showed a softening of attitude in *Groom v Hibbert*. The facts involve a de facto husband and wife who both signed a costs agreement with a solicitor for legal costs incurred in connection with the husband's restaurant and nightclub business. Under the costs agreement they also provided a guarantee and a mortgage over their jointly owned home. The wife brought proceedings to set aside the costs agreement and the mortgage under the special wives' equity. Master Macready in giving recognition to changes to the community's acceptance of de facto relationships said:

The matter before me involves a simple long-standing de facto relationship between a man and a woman...and the role each plays would fit many marriages. It has endured seventeen years and the parties to it have five children. In these circumstances it seems to me that the principle in *Yerkey v Jones* should be extended to cover the situation presently before me.<sup>86</sup>

The approach taken by the Australian Capital Territory Court of Appeal in *Watt* can be contrasted with that taken by the Victorian Court of Appeal in *Kranz v National Australia Bank*,<sup>87</sup> which rejected the argument that the *Garcia* defence could only be invoked where the surety is married to the debtor or is involved with the latter in a

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<sup>81</sup> [2000] VSC 325.

<sup>82</sup> Above n 81, 84.

<sup>83</sup> [2000] ACTSC 48.

<sup>84</sup> Above n 83, para 7.

<sup>85</sup> [2003] NSWSC 74 (21 February 2004); BC 200300579.

<sup>86</sup> Above n 85, para 23.

<sup>87</sup> [2003] VSCA 92 (25 July 2003).

similar long-term relationship.<sup>88</sup> According to the facts, Lefkovic asked his brother-in-law Kranz, the plaintiff, to provide further security for a loan from the bank. The object of the loan was to acquire a private placement of shares to be held by a shelf company which was set up by Lefkovic. Kranz executed a guarantee for the debts of the company in favour of the bank. Lefkovic defaulted on the loan and the bank decided to enforce the guarantee. The appellant Kranz who did not read the documentation, and did not have it explained to him by any one except Lefkovic (who misrepresented the facts), sought to set aside the guarantee, relying on the *Garcia* defence and arguing that the respondent either knew or should have known that the relationship of trust and confidence existed between himself and Lefkovic.

The Victorian Court of Appeal in *Kranz* adopted a more liberal view of the possibility of extending the *Garcia* principle to other relationships. Charles JA disagreed with the necessity of restricting the *Garcia* defence to only 'the most intimate of family relationships'. His Honour believed that this would 'confine the application of the principles applied in *Garcia* within limits that cannot be justified'. This softening of the approach of the court at the appellate level will probably in time lead to an opening of the door a little wider in future cases.

What then are we to make of these apparently conflicting authorities? It looks as if the *Garcia* principle must be applied at least where the lender is aware that a female surety and a male debtor are in a sexual and emotional relationship analogous to marriage - that is, where the lender is aware that the surety and the debtor are cohabiting. On this basis, there is no reason to treat these relationships as but pale shadows of marriage.<sup>89</sup>

Credit providers after the High Court's decision in *Garcia* should be more cautious and should not depart from their usual practices and procedures when dealing with a guarantor wife. This is so regardless of whether the woman is a director of the husband's company or just a participant or employee of his business. In the case of vulnerable guarantors of business debts who technically fall outside the ambit of the *Yerkey* principle, they may now have recourse to the new legislative remedy under s 51AC of the *Trade Practices Act 1974* (Cth).

Mrs Garcia could be regarded as being very fortunate in coming within the principle, and being given the benefit of any doubt by the High Court justices in respect of her status as a volunteer. This is despite her qualifications and professional experience, as well as the controversial evidence as to the precise details of her shareholding in her

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<sup>88</sup> See also *ANZ Banking Group Ltd v Alirezai* [2004] QCA 6 (6 February 2004); BC 200400178 which is to a similar effect.

<sup>89</sup> *Garcia v National Australia Bank*, above n 17.

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husband's companies. She was also a company director, with a history of investments, running her own business and yet was able to convince the court that she did not understand the nature of the obligation into which she entered. A consequence of the *Garcia* case is that there is now an onus on banks to make certain that their documentation is clear, their explanations thorough and comprehensible and there is a need to remove the traditional concepts that there is no obligation to disclose risks to guarantors especially where these are wives dealing with their husbands' debts.

It should be noted that the special equity for wives doctrine in *Garcia* remains unique to Australia, having been specifically rejected in England<sup>90</sup> New Zealand<sup>91</sup> and never been completely adopted in Canada.<sup>92</sup> In *O'Brien*, the House of Lords expressed the view that there was no need for a special wives equity because adequate protection could be afforded under ordinary principles.<sup>93</sup> As Lord Browne-Wilkinson observed, the *Yerkey* principle was based on uncertain foundations and failed to reflect the current requirements of contemporary society.<sup>94</sup> Under the *O'Brien* approach, a woman will not be able to set aside a transaction purely on the grounds that she did not understand it and was relying on ordinary principles of undue influence. The exception here would be in cases where undue influence is proven and the creditor knew of the marriage relationship. Ultimately, the creditor will not be able to enforce the contract of guarantee unless it can prove that it was reasonably satisfied that the wife understood the transaction and entered into it at her own free will.<sup>95</sup>

Confronted with perpetuating the relevance of the *Yerkey* doctrine in light of English developments, the High Court in *Garcia* came up against a range of competing legal and policy considerations. One of these was the discrepancy between the perception of modern gender roles and the reality of domestic relationships. At the same time,

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<sup>90</sup> *Barclays Bank p/c v O'Brien*, above n 16.

<sup>91</sup> See *Wilkinson v ASB Bank* (1998) 6 NZBLC 102,427, where the Court of Appeal adopted a modified *O'Brien* approach.

<sup>92</sup> In Canada there is no consistent approach. In British Columbia the *Yerkey* principle has been followed. This is evident in *E & R Distributors v Atlas Drywall Ltd* (1980) 118 DLR (3d) 339 which was nevertheless qualified in *North West Life Assurance Co of Canada v Shannon Heights Developments Ltd* (1987) 12 BCLR (2d) 346,349. The other Canadian provinces disapproved of *Yerkey*. See, for example, *Bank of Montreal v Featherstone* (1989) 58 DLR (4th) 567 (Ont CA); *Royal Bank of Canada v Poisson* (1977) 103 DLR (3d) 735. On the whole, it can be said that Canada seems poised to follow the approach taken in *O'Brien* considering that its defining guidelines were applied in the different context of a "knowing receipt" constructive trust in *Gold v Rosenberg* (1997) 152 DLR (4th) 385 (SCC).

<sup>93</sup> As was proposed in *CIBC Mortgages P/c v Pitt* [1994]1 AC 200.

<sup>94</sup> *Barclays Bank v O'Brien*, above n 16, 194-5.

<sup>95</sup> Above n 16, 194-5.

although contemporary society in this country accepts equality between the sexes and supports the concept of mutual respect between marriage partners,<sup>96</sup> it should be stressed that a large number of women remain subservient to their husbands, and would not normally question their spouses' business affairs. And the overturning of the security devices may have the effect of reducing the flow of private capital to businesses because of institutional cautiousness that would come about.<sup>97</sup> A final issue of concern is that the over-reliance on *Yerkey* may embolden husbands to find a way out of their obligations by allowing them to challenge the very explanations they themselves gave their wives of the need to execute guarantee transactions.<sup>98</sup>

It is also true to say that despite their many limitations, personal guarantees are extremely useful transactions since they are the main source of funding for the family and other forms of small business. Such guarantees must be protected and the common theme running through cases such as *Garcia* is the need to increase awareness of the nature and effect of these guarantees. A number of protective measures for the guarantors of relationship debts may be considered: relevant statutory provisions; industry codes of practice; making the debtor's loan application and creditor's offer available to the guarantor and the setting up of mechanisms for the review or termination of the guarantor's liability etc.

## Conclusion

It can be said that *Garcia* ensures the survival of the special equity rule for wives in *Yerkey v Jones*.<sup>99</sup> This states that if a wife is a volunteer to a guarantee contract, and does not understand its effects in essential respects, she may be in a position to set it aside, even if there is no unfair dealing involved, and even if the creditor did not make efforts to explain the transaction or to recommend the guarantor seek independent advice. Yet since *Garcia* was handed down solicitors and barristers did not think the decision had such a large impact on the law.<sup>100</sup> There has been some uncertainty concerning the scope of the application of the *Garcia* defence. Certainly,

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<sup>96</sup> See, for example, the *Sex Discrimination Act* (Cth) ss 5-6, 7 D (1); and *The Equal Opportunity Act* 1995 (Vic) ss 6-9.

<sup>97</sup> See *Barclays Bank v O'Brien*, above n 16, 188. See a criticism of this view in Anna Lawson, 'O'Brien and its Legacy: Principle, Equity and Certainty?' (1995) 54 (2) *Cambridge Law Journal* 280.

<sup>98</sup> See Kirby J in *Garcia v National Australia Bank*, above n 17, 644; see also S M Cretney, 'The Little Woman and the Big Bad Bank', (1992) 108 *Law Quarterly Review* 534.

<sup>99</sup> *Yerkey v Jones* above n 5.

<sup>100</sup> J Lovric, J Millibank, *Darling, Please Sign this Form: A Report on the Practice of Third Party Guarantees in New South Wales*, NSW Law Reform Commission, Research Report 11, 2003, xix.

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the decisions have demonstrated that the scope of the application of the defence has been mixed. Some cases have applied the principle to de facto spouses, for example, although the ones where the application has shown a consistent pattern are those which involve guarantor wives. There has also been confusion as to whether the principle extended to elderly parents while the claims of in-laws and close friends have all been denied in the cases reviewed. There is also great variation in terms of the courts' interpretation and application of the requirement that the claimant be a volunteer to the transaction in order to be granted relief.<sup>101</sup>

It can be said that whilst the High Court has been unwilling to extend the wives' equity principles beyond the narrow confines of the legal husband/wife relationship, it seems that the boundaries of *Garcia* are continually being tested, and it is not surprising that an increasing number of cases involving non marital situations are coming before the courts from time to time.

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<sup>101</sup> Above n 105.