

IMMEDIATE INDEFEASIBILITY FOR MORTGAGEES: A MORAL HAZARD?

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I Introduction

Since the global financial crisis of 2007, regulators and economists have analysed the moral hazards inherent in institutional arrangements which encouraged economic actors to act irresponsibly.¹ The process of institutional reform must extend to review of legal rules which allow transacting parties to internalise gains and externalise losses. Of prime concern are rules of the Torrens System which allow mortgage lenders to omit reasonable precautions to ensure that the borrower is the registered owner, and shift the risk of losses through identity fraud to persons who are external to the transaction.

In 1971, at the dawn of the era of financial deregulation, the High Court in *Breskvar v Wall*² adopted an interpretation of Queensland's Torrens statute known as 'immediate indefeasibility'. This is the rule that registration confers an indefeasible title to the interest shown, irrespective of whether the instrument is forged.³ The rule is subject to the statutory exception for fraud, and also to the power of a court of equity to make an order against the owner of the registered interest in personam to enforce a personal equity.⁴

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¹ 'Moral hazard' refers to the tendency of a party to take less care to avoid a loss-producing event if the loss is borne by someone else.

² (1971) 126 C.L.R. 376, 385-86 (Barwick CJ). The Court rejected the 'deferred indefeasibility' interpretation, which holds that a registration of a forged instrument gives the immediate transferee or mortgagee a defeasible title.

³ *Breskvar v Wall* did not involve a forged instrument, but a transfer given by way of security only that was fraudulently registered, and was also void for breach of statute. However the High Court left no doubt that the same rule would apply in a forgery case. Barwick CJ said: 'a registration which results from a void instrument is effective according to the terms of its registration': *ibid.*

⁴ *Ibid.*

Although *Breskvar v Wall* concerned the position of a transferee, it was not in doubt that the rule of immediate indefeasibility applied equally to a registered mortgagee. The High Court followed the ruling of the Privy Council in *Frazer v Walker*,⁵ which held that registered mortgagees were ‘proprietors’ of an ‘estate or interest’ within the meaning of ss 62 and 63 of the *Land Transfer Act 1962* (NZ), being the provisions which define the effect of registered titles and protect a purchaser from certain actions.⁶

In the long-running debate over deferred and immediate indefeasibility, it has generally been assumed in Australia and New Zealand that whichever rule is adopted should apply equally to registered mortgagees and registered transferees.⁷ But there are sound policy reasons for denying immediate indefeasibility to mortgagees, even if the rule is adopted for transferees. While Sackville defends immediate indefeasibility on the ground that it relieves transferees of the ‘onerous burden’ of having to verify the identity of the transferor,⁸ mortgage lenders are actually well placed to make inquiries and require borrowers to prove their identity to the mortgagee’s satisfaction. As between the mortgagee and the landowner, the mortgagee is the ‘cheaper cost avoider’ - the party that can at the least cost avoid identity fraud by adjusting their behaviour in the transaction. The landowner, who is typically ignorant of the fraudulent transaction, can do little or nothing to prevent it.

Calabresi argues that a rule will tend to reduce the incidence of a preventable adverse event if it allocates the risk of loss to the cheaper cost avoider.⁹ By relieving mortgagees against the risk of loss through identity fraud, the rule of immediate indefeasibility tends to weaken fraud control by undermining the incentive for mortgagees to prevent it.¹⁰ The actual effect of the rule on mortgagee’s behaviour

⁵ [1967] 1 AC 569. In *Gibbs v Messer* [1891] AC 248, the Privy Council had assumed, without expressly deciding, that the Victorian Torrens Act ‘makes no distinction between these two classes of proprietors’: at 254 (Lord Watson LC).

⁶ [1967] 1 AC 569, 583.

⁷ Very few jurisdictions extend immediate indefeasibility to mortgagees. See Pamela O’Connor, ‘Deferred and Immediate Indefeasibility: Bijuralism in Registered Land Title Systems’ (2009) 13 *Edin LR* 194.

⁸ Ronald Sackville, ‘The Torrens System - Some Thoughts on Indefeasibility and Priorities’ (1973) 47 *ALJ* 526, 531.

⁹ Guido Calabresi, *The Costs of Accidents: A Legal and Economic Analysis*, (1970). Calabresi’s conception is widely used in the scholarship of law and economics: Cento Veljanovski, *Economic Principles of Law* (2007) 5-6, 52.

¹⁰ Pamela O’Connor, ‘Registration of Invalid Dispositions: Who Gets the Property?’ in E Cooke (ed), *Modern Studies in Property Law Vol 3* (2005), 45, 61. The ways in which the law sets inadequate standards for mortgagees are detailed in Sharon Rodrick, ‘Forgeries, False Attestation and Imposters: Torrens System Mortgages and the Fraud Exception to

depends on other legal, regulatory and structural constraints. The legal constraints include the exception to indefeasibility for fraud by the mortgagee or its agents, and the enforceability of personal equities against the registered mortgagee in personam (the 'in personam exception').

For a couple of decades after *Breskvar v Wall*, the moral hazard inherent in immediate indefeasibility was largely held in check by regulatory and structural factors. But the era of easy credit which took off in the 1990s redrew the regulation, structure, organisation, lending practices, incentives and ethics of the mortgage lending industry. At the same time, judicial decisions narrowed the scope of the exceptions to indefeasibility, progressively enlarging the qualified immunity which immediate indefeasibility had bestowed on mortgagees. The net effect of the changes was to create new incentives for mortgage lenders to engage in risky lending practices, while passing the risk of identity fraud to registered owners.

II Changes in the mortgage industry

A *Pre-financial deregulation: the era of credit rationing*

At the time that the High Court decided *Breskvar v Wall*, the banking system was subject to wide-ranging regulatory controls. The interest rates that banks could charge on loans, their reserve and liquidity ratios, their credit guidelines and the quantity of their loans were tightly regulated.¹¹ Savings banks were the principal suppliers of housing finance, while finance companies provided second mortgages, riskier loans and consumer credit. Savings banks rationed credit for housing, reserving it as a reward for known customers with significant savings deposited with the bank for an extended period.¹² Banking was done in person at an extensive network of local branches, where borrowers were in many cases personally known to bank staff. Banks were highly risk averse and cautious in their lending practices. As

Indefeasibility' (2002) 7 *Deakin L R* 97. Toomey first posited a causal link between immediate indefeasibility and the incidence of forged mortgages: Elizabeth Toomey, 'Fraud and forgery in the 1990s: Can our adherence to *Frazer v Walker* survive the strain?' (1994) 5 *Canta LR* 424.

¹¹ Ric Battelino 'Australia's Experience with Financial Deregulation: Address to the China Australia Governance Program' (Melbourne, 16 July 2007).

¹² Parliament of Australia, House Standing Committee on Economics, Finance and Public Administration, Report: *Home loan lending: Inquiry into home loan lending practices and the processes used to deal with people in financial difficulty* (September 2007), 2.11.

loan to valuation ratios were low, there was unlikely to be a shortfall if the land had to be sold to pay out the mortgage.

Beginning in the 1970s, the waves of economic reforms known as 'financial deregulation' included policy changes directed to promoting competition in the banking and financial sectors. Interest rate controls on the banks were abolished in 1973.¹³ Subsequently, credit guidelines were abolished, and the entry of foreign banks was allowed. Despite these changes, there was a lag of about a decade, during which the savings banks retained their market dominance and high interest margins. New entrants lacking an extensive branch network found it difficult to challenge the market dominance of the banks.¹⁴

Eventually, a more competitive environment developed from the early 1990s, with the rise of specialist mortgage originators such as Aussie Home Loans, Wizard and RAMS.¹⁵ Mortgage originators are not authorised deposit taking institutions (ADIs) and are therefore not subject to prudential regulation by the Australian Prudential Regulation Authority ('APRA'). Since they have no customer deposits, mortgage originators source loan funds from investors through the process of securitization. This is an arrangement for pooling income-producing assets such as mortgages to produce tradeable securities, secured against the pooled assets.¹⁶ The mortgage originator sells its rights as mortgagee to a 'special purpose vehicle' ('SPV'), which in Australia is typically structured as a unit trust.¹⁷ The trustee of the SPV issues residential mortgage-backed securities (RMBS) to institutional investors, usually in the form of units in the trust.¹⁸ The trustee of the SPV takes title to each mortgage in the pool as the registered mortgagee.¹⁹

This method of financing provides a ready flow of funds to originators, enabling them to receive immediate payment for loans and to recycle the capital in making new loans.²⁰ By 2004, securitized mortgages accounted for 20% of housing finance in

¹³ Battelino, above n 11.

¹⁴ Ibid.

¹⁵ Reserve Bank of Australia, Bulletin: 'Innovations in the Provision of Finance for Investor Housing', December 2002, 2; Home Loan Lending report, above n 12, 2.8.

¹⁶ Reserve Bank of Australia ('RBA'), September 2004 *Financial Stability Review*, 48, 54.

¹⁷ Pelma Rajapakse, 'Assignment of Mortgage Loans to the Special Purpose Vehicle in Securitization Programs' (2005) 24 *Uni Tas LR* 47, 48-49, 66.

¹⁸ Ibid 49, 66.

¹⁹ Rajapakse reports that smaller banks and independent mortgage originators commonly sell their rights by equitable assignment to a sub-fund administered by a larger bank, but most are ultimately assigned to the SPV that issues the RMBS: *ibid*, 49, 59.

²⁰ Ross Foreman, 'Subprime Mortgage Crisis: A Legal Perspective' (2007) 45 *Law Soc J* 55, 56.

Australia, a four-fold increase from 1995.²¹ Banks also used securitisation as a source of finance, raising about 10% of their housing loans in this way by 2004.²²

One consequence of securitised lending is that the originator, who undertakes the initial credit assessment, deals with the borrower and processes the loan, does not bear the risk of the borrower's default or the unenforceability of the mortgage. Those risks are passed on to the investors. The originator's incentives lie in processing loans in volume rather than ensuring that the loans are properly made and that the borrower is able to repay them.²³

B *The rise of mortgage brokers*

Mortgage brokers played an important role in promoting a more competitive market for housing finance by enabling smaller lenders that lacked branch networks to increase their market share. Broker-initiated loans grew rapidly, and by 2008, 37% of housing loans in Australia were originated by brokers.²⁴

In 2007, the Australian Prudential Regulation Authority ('APRA') and the Reserve Bank of Australia ('RBA') expressed concern that the use of brokers creates risks for borrowers, as lenders tend to place too much reliance on brokers to provide the borrower's particulars, instead of verifying them directly with the borrowers.²⁵ The agencies expressed concern that 'broker's incentives may be aligned more closely with the volume of loans rather than their quality.'²⁶

The profession of mortgage broking remains substantially unregulated in most States,²⁷ despite concerns about the conduct of some brokers. In 2007 the Australian Securities and Investments Commission (ASIC) released a report by the Consumer Credit Legal Service detailing many problems faced by borrowers using the services of brokers, including 'predatory' lending practices (also known as 'asset lending') – the practice of procuring loans based on the value of the asset rather than the

²¹ RBA, 2004 Financial Stability Review, above n 16, 49.

²² *Ibid.*

²³ *Ibid.* 59.

²⁴ Senator the Hon Nick Sherry, 'The Future of Regulation in Your Industry', Speech to the Mortgage and Finance Association of Australia Annual Convention, Sydney, 16 May 2008.

²⁵ Joint RBA-APRA Submission to the Inquiry into Home Loan Lending Practices and Processes, 7-8 August 2007, 4.

²⁶ *Ibid.*

²⁷ Home Loan Lending report, above n 12, 5.30. When the *National Consumer Credit Protection Bill 2009* (Cth) is enacted, mortgage brokers will be regulated nationally by ASIC under a licensing regime.

borrower's ability to repay;²⁸ and fraudulent activity in relation to loan applications.²⁹ Participation by brokers in identity frauds presents a particular risk for registered proprietors, as courts have declined to hold that a finance broker as such is an agent of the lender,³⁰ even where the lender pays the broker a commission.³¹

C *Product innovation*

Along with new players and new sources of finance, the period since the 1990s saw product innovation, as supply-driven lenders sought to expand their market share. New 'equity release' products such as home equity loans, reverse mortgages and redraw facilities allow homeowners to borrow against their equity in their homes at lower rates than would be available under an unsecured overdraft or personal loan.³²

In an effort to extend their client base, banks as well as mortgage originators tailored products to attract borrowers who would once have been deemed ineligible. 'Low-doc' loans allow borrowers to self-certify their income in loan applications.³³ These loans were originally introduced to provide access to housing finance for the benefit of self-employed people and other borrowers with irregular income flows who have difficulty in providing the documentation required for a conventional housing loan. By August 2007, low doc loans accounted for 7% of all subsisting housing loans.³⁴

²⁸ RBA, *September 2008 Financial Stability Review*, 28. A finding that asset lending had occurred was made in *Perpetual Trustee Ltd v Khoshaba* [2006] NSWCA 41, [92] (Spigelman CJ), [128] (Basten JA); *King Mortgages Pty Ltd v Nader* [2008] NSWSC 108, [43]-[46]; *KM v Satchitanantham* [2006] NSWSC 1303.

²⁹ ASIC, Submission No 15, Home Loan Lending report, above n 12, Appendix A, 5; Consumer Action Law Centre, Submission no. 8, *ibid* 4.

³⁰ See, eg, *Permanent Custodians v Yazgi* [2007] NSWSC 279, [86]-[95]; *Steele-Smith v Liberty Financial Pty Ltd* [2005] NSWSC 398, [104]; *Perpetual Trustees Victoria Ltd v Ford* [2008] NSWSC 29, [98]-[101]; *Micarone v Perpetual Trustee* (1999) 75 SASR 1 at 123 at [632]; *Custom Credit Cooperation Ltd v Lynch* [1993] 2VR 469, 486-487, *Hilton v Gray* [2007] QSC 401, [39]-[40].

³¹ *Octapon Pty Ltd v Esanda Finance Corporation Ltd* (unreported, NSWSC 3 February 1989, Cole J), 28; a case relating to a finance broker arranging hire purchase finance. His Honour cited *Con-stan Industries of Australia Pty Limited v Norwich Winterthur Insurance (Australia) Limited* (1986) 160 CLR 226, 234 (insurance broker). Mortgage brokers are generally paid by the lender via a commission: Parliament of Australia, House Standing Committee on Economics, *Competition in the Banking and Non-Banking Sectors* (Nov 2008), 5.29.

³² RBA-APRA Submission, above n 25, 2.

³³ *Ibid* 4.

³⁴ *Ibid*.

Some non-bank lenders also offered 'non-conforming' loans to borrowers who were unable to satisfy the lending criteria normally required by lenders, usually due to chequered credit or payment histories.³⁵ Many of these were debt consolidation loans or refinancing following default on other mortgage loans.³⁶ Non-conforming loans accounted for 2% of the Australian market by 2007.³⁷

D *Lowering of lending standards*

In the intensely competitive housing finance market of the early 2000s, even mainstream lenders lowered their lending standards and took risks that would once have been unthinkable.³⁸ To save costs, physical inspection of premises was often omitted and valuation data gleaned from other sources.³⁹ Gambling that house prices would continue to rise, lenders raised their loan to valuation ratios to 90 or 95%, and some offered loans with no deposit at all.⁴⁰ This created a risk for home owners, who might find be left with negative equity in their homes if land prices fall.

The problem of excessive debt was compounded by new debt servicing ratio formulae used by lenders, including banks and building societies.⁴¹ APRA reported in 2007 that many lenders were using estimates of the borrowers' living expenses that were below the poverty line, in order to overstate their borrowing capacity.⁴² The Parliamentary Inquiry into Home Lending found that some non-bank lenders, mainly in the non-conforming sector, were engaging in predatory lending. The loans were made to borrowers with no capacity to pay, and the lenders were quick to take possession of the security when the borrower defaulted.⁴³

³⁵ Ibid 4.

³⁶ RBA, *Financial Stability Review*, March 2005, p. 33, Box C: Non-conforming loans'; Home Loan Lending report, above n 12, 2.37.

³⁷ RBA-APRA Submission, above n 25, 4, attachment to the submission.

³⁸ Home Loan Lending report, above n 12, 2.1.

³⁹ RBA-APRA Submission, above n 25, 6.

⁴⁰ Home Loan Lending report, above n 12, 2.23; RBA-APRA Submission, above n 25, 4.

⁴¹ In 2007, it was reported that one quarter of new loans were based on repayments that exceeded 30% of the borrower's gross income: Home Loan Lending report, *ibid*, 2.17-2.19; RBA-APRA Submission, *ibid*.

⁴² Home Loan Lending report, *ibid* 2.20.

⁴³ *Ibid* 4.7-4.9. Although the Uniform Credit Code, entitles debtors to apply for changes to a credit contract on grounds of hardship and to re-open unjust transactions, there were reports of lenders circumventing the Code by asking borrowers to complete a declaration that the loan was for business purposes, when it was in fact provided for personal or other purposes falling within the Code: *Ibid* 5.13-14.

Banks and non-bank lenders adopted human resources management practices that encouraged staff to maximise lending. A submission from the Finance Sector Union to the Home Lending Inquiry reported that finance sector staff members were being placed under pressure to push credit onto customers in order to meet the often unrealistic sales targets set for them.⁴⁴ The Union submitted that the trend to link achievement of sales targets to all pay increases was the product of an 'aggressive commercial culture' that was detrimental to customers and staff alike.⁴⁵ The Union reported that its members were aware of cases in which the pressure to meet sales targets resulted in inappropriate lending decisions.⁴⁶

E *The global financial crisis*

Similar developments in the home lending industry were occurring in other countries, particularly in the United States, where securitized 'sub-prime mortgages' by 2007 accounted for 10% of home loans. By 2007, a significant rate of default by sub-prime borrowers in the United States led to a collapse in investor confidence in RMBS. Securitisation of mortgages in Australia stalled, with the result that non-bank lenders were denied access to funds for lending.⁴⁷ The major banks started buying out financially distressed non-bank lenders. In 12 months, the banks' share of new housing loans jumped from 80% to 90%.⁴⁸

Concerned at the effects of reduced competition in the home lending market, the Treasurer announced in September 2008 that the Australian Office of Financial Management would facilitate the purchase of \$8 billion in RMBS over three years, to provide liquidity in the RMBS market and to ensure that smaller lenders would continue to have access to funds for residential mortgage lending.⁴⁹ Accordingly, it appears that mortgage originators and securitisation will continue to be a feature of the Australian home lending market for some time to come.⁵⁰

⁴⁴ Finance Sector Union, Submission to the Inquiry into Home Loan Lending Practices and Processes (Submission No 17), 1-2.

⁴⁵ Ibid.

⁴⁶ Ibid.

⁴⁷ The Hon Wayne Swan MP, Treasurer, *Government Initiative to Support Competition in Mortgage Market*, Press Release No 105, 26 Sept 2008.

⁴⁸ RBA, September 2008 Financial Stability Review, 60.

⁴⁹ Swan, above n 47; *Competition in the Banking and Non-Banking Sectors*, above n 31, xiii.

⁵⁰ In June 2009 it was reported that the Government was considering extending the program of buying back mortgage-backed securities to support non-bank lenders: Matthew Drummond, 'Support for non-bank lenders to spur competition' *Aust Fin Rev* Fri 19 June 2009, 7.

III Incentive effects – fraud prevention

The brief history above shows that the structure, roles, incentives and behaviour of key players in the mortgage lending industry and their approach to risk management have changed markedly since *Breskvar v Wall* was decided. A key effect has been the weakening of the incentive for mortgage lenders to guard against the twin risks of identity fraud and repayment default. This moral hazard particularly affects securitised mortgage lending, as the mortgage originator who completes the loan transaction does not bear the ongoing credit and title risks of a mortgagee.

Other jurisdictions have experienced similar changes in the behaviour of mortgage lenders. The Ontario courts have responded by moulding the rules of property law to place lenders under the necessity to undertake ‘due diligence’.⁵¹ The Ontario Court of Appeal invoked ‘cheaper cost avoider’ analysis in *Lawrence v Maple Trust Co & Wright*,⁵² in support of its decision to interpret the Ontario Land Titles Act consistently with deferred indefeasibility. An unknown forger had transferred title to Ms Lawrence’s home to ‘Thomas Wright’, following which an imposter claiming to be Thomas Wright had mortgaged the land to Maple Trust. Giving the judgment of the five-member court, Gillese JA said:⁵³

[U]nlike the [mortgagee], the homeowner has no opportunity to avoid the fraud. Ms. Lawrence had no ability to discover that her home was being fraudulently sold and mortgaged. By contrast, Maple Trust made the decision to advance money and had the opportunity to avoid the fraud. By interpreting the Act in accordance with the theory of deferred indefeasibility, the law encourages lenders to be vigilant when making mortgages and places the burden of the fraud on the party that has the opportunity to avoid it, rather than the innocent homeowner who played no role in the perpetration of the fraud.

Australian courts have taken the opposite approach. In the period since *Breskvar v Wall*, judicial interpretation has intensified the moral hazard for mortgagees through

⁵¹ Prior to the Court of Appeal’s decision in *Lawrence v Wright*, Echlin J held in *Rabi v Rasu* (2006) 48 RPR (4th) 1, 83 OR (3d) 37 that a mortgagee was unable to rely on a registered title since it had failed to exercise due diligence which, if exercised, would have revealed the fraud. See also Jasmine Girgis, ‘Mortgage Fraud, the Land Titles Act and Due Diligence: The *Rabi v Rasu* decision’ (2007) 22 *BFLR* 419.

⁵² (2007) 278 DLR (4th) 698.

⁵³ *Ibid* [58].

restrictive development of the exceptions to indefeasibility and related doctrines, viz, the scope and meaning of ‘fraud’ under the Torrens statutes, the circumstances in which a mortgage is defeasible for the fraud of the mortgagee’s agent, and the types of conduct for which proprietary relief may be granted against the mortgagee in personam to enforce a personal equity. It is the combined effect of these related doctrines, and not just the extension of immediate indefeasibility to mortgagees, that has seriously undermined the incentives for mortgagees to prevent identity fraud.

IV Fraud and agency

A *The statutory exception*

Fraud is an express statutory exception to the rule of immediate indefeasibility,⁵⁴ but is not legislatively defined. As the statutes abrogate the equitable doctrine of notice, it is evident that ‘fraud’ was not intended to bear its equitable meaning. It has been construed more narrowly, as requiring something akin to ‘personal dishonesty or moral turpitude’.⁵⁵ Since fraud involves an allegation of serious misconduct, cogent evidence must be adduced by anybody seeking to impugn a registered title.⁵⁶ To impeach a registered interest, the fraud must be ‘brought home’ to the registered proprietor of the relevant interest or his agents.⁵⁷ Since institutional mortgagees are usually corporations who act through their servants and agents, the scope of the mortgagee’s defeasibility for the fraud of its agents is crucially significant.

B *Scope of agency*

Australian courts have significantly limited the liability of registered proprietors, including mortgagees, for fraud of their agents through restrictive interpretation of the scope of agency. In *Schultz v Corwill Properties Pty Ltd*,⁵⁸ Street CJ distinguished between a case where the agent commits a fraud (‘the first case’), and a case where the agent knows of a fraud in the transaction (‘the second case’). In the first case, His Honour adopted the general statement in *Bowstead on Agency* that ‘the act of an agent

⁵⁴ The fraud exception is expressly mentioned in the ‘paramountcy’ provision found in each of the Torrens statutes, of which s 42(1) of the *Transfer of Land Act 1958* (Vic) is an example.

⁵⁵ *Butler v Fairclough* [1917] 23 CLR 80, 90 (Griffith CJ); *Assets Co Ltd v Mere Roihi* [1905] AC 176, 210; *Wicks v Bennett* (1921) 30 CLR 80, 91; *Stuart v Kingston* (1923) 32 CLR 309, 329.

⁵⁶ *Briginshaw v Briginshaw* (1938) 60 CLR 336, 362-63 (Dixon J); 343-44 (Latham CJ); *Permanent Custodians v Yazgi* [2007] NSWSC 279, [84]; *Farah Constructions v Say-Dee Pty Ltd* (2007) 81 ALJR 110, [170]; *Young v Hoger* [2001] QCA 415, [17], [21]; *Davis v Williams* [2003] NSWCA 371, [142] (Young CJ in Eq).

⁵⁷ *Assets Co Ltd v Mere Roihi* [1905] AC 176, 201.

⁵⁸ [1969] 2 NSW 576.

within the scope of his actual or apparent authority does not cease to bind the principal simply because the agent was acting fraudulently and in furtherance of his own interests'.⁵⁹ In the second case, the Chief Justice said where the agent learns of a fraud in the transaction in circumstances that give rise to a duty to communicate that information to the principal, knowledge of the fraud will be imputed to the principal on the basis of an irrebuttable presumption of communication.⁶⁰ Exceptionally, if the agent is party to the fraud, the registered proprietor will be permitted to rebut the presumption of communication.⁶¹

On the facts before him, Street CJ found that Mrs Schultz's mortgage was not defeasible for the fraud of her solicitor, Galea, who had attested the execution of the mortgage as one of the directors of Corwill Properties Pty Ltd and forged the signature of another director. His Honour held that Galea had acted outside the scope of agency in forging the mortgage. Moreover the presumption of communication of knowledge of the fraud by the agent to Mrs Schultz as principal was rebutted because the fraud was committed by Galea for his own benefit. It is not clear why His Honour thought the latter question relevant, since the facts fell squarely within the first case (fraud by agent). The presumption of communication relates only to the second case (agent's knowledge of a fraud in the transaction).

As to the first case, fraud by agent, it is respectfully submitted that Street CJ formulated the test correctly in his quote from *Bowstead on Agency*, but made two errors in its application. First, His Honour pre-empted the inquiry by defining the scope of Galea's agency in overly specific terms. He said that Mrs Schultz had authorised Galea to register a *valid* mortgage, and that in forging the co-director's signature he acted outside the scope of his actual or apparent authority.⁶² Second, His Honour gave determinative weight to the finding that Galea's wrongdoing was for his own benefit. The finding that the registration of a forged mortgage benefited the wrongdoer should have been treated as a relevant but not a decisive factor in that inquiry.⁶³

Schultz v Corwill Properties Pty Ltd has been criticised by a five member bench of the New Zealand Supreme Court. In *Dollars and Sense Finance Ltd v Nathan*,⁶⁴ a finance

⁵⁹ His Honour cited the work as '13th ed, p 242': [1969] 2 NSW 576, 583.

⁶⁰ *Ibid* 537-39.

⁶¹ *Ibid* 583.

⁶² *Ibid*.

⁶³ *Dollars and Sense Finance Ltd v Nathan* *ibid* [41]-[42]; *Davis v Williams*, *ibid*; *Lloyd v Grace, Smith & Co* [1912] AC 716.

⁶⁴ [2008] NZSC 20 (8 April 2008).

company agreed with Nathan to lend him a sum of money on the security of a mortgage over his parents' home, and gave him the instruments to arrange execution by them. Nathan forged his mother's signature on the instrument of mortgage, which the finance company registered without knowledge of the forgery. The Supreme Court held that the finance company constituted Nathan as its agent for the purpose of obtaining the mortgagors' signatures.

The question was whether Nathan's forgery of his mother's signature was an act done within the scope of agency. In his dissenting reasons, the President of the Court of Appeal, William Young P, had relied upon *Schultz v Corwill Properties* to hold that the forgery was beyond the scope of Nathan's authority because it was not authorised by the finance company. Blanchard J, giving the judgment of the Supreme Court, said that this reliance on *Schultz* was misplaced. His Honour said that the question was not whether the agent's conduct was authorised, but whether it 'fell within the scope of the task that the agent was asked to perform'.⁶⁵ A fraudulent act may still be within the scope of agency whether done by the agent entirely for his own benefit, or for the benefit of both the agent and the principal.⁶⁶ The forgery was done to achieve the task that Rodney had been asked to undertake, namely, to obtain a registrable mortgage, and the mortgagee was therefore defeasible for his fraud.⁶⁷

The Supreme Court said that it was not relevant to ask, as the trial judge had done, whether the knowledge by Rodney of his own fraud should be imputed to the mortgagee.⁶⁸ This question, which had been asked by Street CJ in *Schultz v Corwill Properties*, was misplaced. The Court was persuaded by Peter Watt's argument that the exception to the imputation of the agent's knowledge, to which Street CJ referred,⁶⁹ does not exist.⁷⁰ The so-called exception was based on the false premise that liability for a fraud committed in the course of agency depends on the attribution of blame or fault to the principal.⁷¹

The reasoning of the New Zealand Supreme Court in *Dollars and Sense Finance Ltd v Nathan* is a timely reminder that liability for acts of an agent is imposed for public policy reasons. One who creates an agency in which there is a risk of fraud by the

⁶⁵ [2008] NZSC 20, [39].

⁶⁶ *Ibid* [35], [41], citing *Lloyd v Grace, Smith & Co* [1912] AC 716.

⁶⁷ *Ibid* [46], [50].

⁶⁸ *Ibid* [43].

⁶⁹ *Schultz v Corwill Properties Pty Ltd* [1969] 2 NSW 576, 583-84 (citing Williams on Vendor and Purchaser, 4th ed, 306).

⁷⁰ [2008] NZSC 20 (8 April 2008), [43], citing Peter Watts, 'Imputed Knowledge in Agency Law: Excising the Fraud Exception' (2001) 117 *LQR* 300.

⁷¹ *Ibid* [39].

agent should bear responsibility when the risk materialises and causes loss to third parties.⁷² Australian authorities appear to be swayed by the idea that it is contrary to the policy of the Torrens System to hold blameless registered proprietors responsible for their agents' fraud. That approach, when applied to mortgage lenders, relieved them from the consequences of their failure properly to select, train and supervise their agents. The relaxation of standards for mortgagees was first observed in the false attestation cases.⁷³

C *False attestation by an agent of the mortgagee*

In the 1980s and early 1990s, there were several cases in which agents of the mortgagee falsely attested the signature of the landowner as mortgagor without knowing that the signature was forged. A line of authorities held that the mortgage was defeasible on the basis that registration was obtained by fraudulently misrepresenting to the registrar that the signature had been duly witnessed.⁷⁴ In *Australian Guarantee Corporation Ltd v De Jager*, Tadgell J observed that the registrar relies on attestation to prove that the mortgagor has in fact signed the mortgage, and that a clear signal should be sent to mortgagees that attestation must be taken very seriously.⁷⁵

We have seen that in the era of easy credit, mortgage originators and bank loan officers had significant financial incentives to complete mortgage loan transactions, and were in some cases under intense pressure to meet sales targets. There was strong temptation to 'cut corners' in order to get the job done, particularly where poorly trained staff viewed the attestation of instruments as a mere formality. Just at a time when a firm approach was needed, the courts determined that false

⁷² Ibid [40], [42], [48]. Blanchard J said that this was the tenor of *Lister v Hesley Hall Ltd* [2002] 1 AC 215, the Canadian authorities cited therein, viz *Bazley v Curry* [1999] 2 SCR 534 and *Jacobi v Griffiths* [1999] 2 SCR 570, and subsequent cases such as *S v Attorney-General* [2003] 3 NZLR 450 (CA).

⁷³ Referring to the Australian authorities on the fraud exception, Owen J observed: 'The courts will not lightly hold the principal liable for the acts of the agent': *Conlan v Registrar of Titles* [2001] WASC 21, [239].

⁷⁴ *Australian Guarantee Corporation Ltd v De Jager* [1984] VR 483; *National Commercial Banking Corporation of Australia Ltd v Hedley* (1984) 3 BPR 9477; *Beatty v ANZ Banking Group* [1995] 2 VR 301; *Westpac Banking Corp v Sansom* (1994) 6 BPR 13790; *Grgic v Australian and New Zealand Banking Group Ltd* (1994) 33 NSWLR 202.

⁷⁵ [1984] VR 483, 497-99.

certification of a forged signature by an agent of the mortgagee followed by registration does not, without more, render the mortgage defeasible for fraud.⁷⁶

In *Russo v Bendigo Bank Ltd*,⁷⁷ a conveyancing clerk employed by a solicitor on the panel of a mortgagee bank falsely attested the mortgagor's signature without knowing it was forged. Although the clerk had been instructed by her employer never to attest a signature unless she had seen the person sign, her conduct was not found to evince the actual dishonesty required for statutory fraud. The trial judge found that the clerk believed that 'it was a formality... While [she] did falsely witness, I do not believe that she thought of it that way'.⁷⁸ Counsel for Mrs Russo had failed to prove that the clerk understood that in falsely attesting the signature, she was setting the mortgage on the path to registration.⁷⁹ There was no intention to adversely affect Mrs Russo's rights.⁸⁰

The Court of Appeal then considered whether the bank's title was defeasible for the actions of the bank's solicitor in allowing the mortgage to be lodged for registration upon the faith of an attestation clause which his clerk knew to be false. The Court held that it was not possible to impute fraud to the mortgagee based on aggregating the solicitor's knowledge of the consequences of registration, and the clerk's knowledge of the falsity of the attestation, since neither had behaved with the required element of 'conscious dishonesty or moral turpitude or wickedness'.⁸¹

Ormiston JA distinguished the case from *AGC v De Jager*, where the employees of the mortgagee had forwarded the mortgage for registration knowing that it had been

⁷⁶ See also, *Davis v Williams* [2003] NSWCA 371; *Conlan v Registrar of Titles* (2001) 24 WAR 299. Rodrick argues that *Russo v Bendigo Bank Ltd* [1999] 3 VR 376 represents a significant departure from the approach adopted in the earlier cases on false attestation: Rodrick, above n 10, 100, 105.

⁷⁷ [1999] 3 VR 376.

⁷⁸ Cited by Ormiston JA, *ibid* 389.

⁷⁹ 386-87. Rodrick, above n 10, 109-110 criticises the refusal of the court to infer such knowledge, given that the clerk had three years experience handling conveyancing matters for a solicitor on the mortgagee's panel. Cf *Graham v Hall* [2008] NSWSC 505, where a furniture dealer and honorary JP who attested Mrs Hall's signature without seeing her sign was held personally liable to her in negligence, the court holding that he should have realised that the mortgage was likely to be registered and that he was placing her interest at risk: [47]-[49] (Ipp JA).

⁸⁰ [1999] 3 VR 376, 386.

⁸¹ *Ibid* 389 (Ormiston JA, Winneke P and Batt JA agreeing). In *Davis v Williams* [2003] NSWCA 371, Hodgson JA at [26] and Gzell JA at [253] were of the view that a fraudulent misrepresentation to the Registrar would amount to fraud even if there was no intention to affect anybody's rights. Young CJ in Eq disagreed, preferring to follow *Russo*: [111]-[114].

falsely attested.⁸² It seems that if the knowledge of the falsity of the attestation and the intention to obtain registration of the mortgage had come together in the person of one agent, Ormiston JA (Winneke P agreeing) would have imputed fraud to the mortgagee.⁸³ Batt JA would not have imputed to the mortgagee any fraud on the part of the clerk, because an employee of an agent was, in His Honour's view, too remote from the mortgagee.⁸⁴

Rodrick comments on the decision as follows:⁸⁵

[T]he approach taken in *Russo* allows mortgagees to shelter behind an employee's inexperience and ignorance of the registration process. Thus the case provides no incentive for banks to train and supervise their officers properly. If mortgagees choose to use inexperienced persons to attest signatures then they should bear the consequences of so doing rather than be rewarded for so doing.

The approach in *Russo* also rewards outsourcing, decentralisation and specialisation of mortgage processing functions. If different persons are responsible for various steps in the transaction, it will be difficult to find a single person with the requisite knowledge and dishonest intention that can be imputed to the mortgagee as fraud. In fact, mortgage processing functions have in many organisations become compartmentalised and centralised, with much less work being done by local branches. The defeasibility of the mortgage in *AGC v De Jager* depended on the agents exercising a particular combination of functions, which in *Russo* were vested in different persons.

D *Wilful blindness*

The fragmentation of mortgage processing functions presents particular difficulties for registered owners who seek to show that the mortgagee's agents acted with wilful blindness or reckless indifference to a fraud in the transaction. According to Lord Lindley in *Assets Co Ltd v Mere Roihi*, fraud may be brought home to a registered proprietor whose suspicions, or those of his or her agent, were actually aroused and the failure to make further inquiries was due to fear of learning the truth.⁸⁶ This

⁸² Ibid 389.

⁸³ Ibid 390.

⁸⁴ Batt JA, *ibid* 392. In *Hilton v Gray* [2007] QSC 401, Douglas J found it unnecessary to rule upon an argument which relied on the view of Batt JA: at [42].

⁸⁵ Rodrick, *above* n 10, 122.

⁸⁶ *Assets Co Ltd v Mere Roihi* [1905] AC 176, 210.

formulation assumes that a single agent acts for the mortgagee, or if multiple agents are involved, there is a single controlling mind which aggregates and evaluates all incoming information, draws inferences and decides whether to initiate further inquiries. That is, it assumes that somebody performs the role of the old-fashioned branch manager or loans manager who oversees the whole transaction.

The realities of contemporary mortgage processing are far removed from this model, as illustrated by the case of *Yazgi v Permanent Custodians Limited*.⁸⁷ Mrs Yazgi sought to challenge a securitised mortgage held by Permanent Custodians over her jointly owned family home. The mortgage had been procured by the forgery of her signature on the loan and mortgage documents.⁸⁸ Mrs Yazgi had no knowledge of the transaction until after her husband had taken the entire proceeds of the loan and departed the country.

Securitised mortgage programmes operate through a complex chain of entities with specific, specialised and compartmentalised functions. In this case, loans were approved on behalf of AMS, the fund manager, by AFIG, a mortgage originator. AFIG in turn retained Royal Guardian, a 'first tier' mortgage originator, to introduce prospective borrowers and obtain specified documents from them. Royal Guardian had received a home loan application through a broker, in which Mr and Mrs Yazgi were shown as borrowers, but had not dealt with Mrs Yazgi directly.

Harrison AsJ identified a number of circumstances which should have led the mortgagee's agents to inquire further and discover the fraud. Royal Guardian knew or ought to have known that almost half the loan was for future investment purposes and more than half the proceeds were to be paid to the broker.⁸⁹ It was conceded by the mortgagee's solicitors that the latter circumstance was so unusual as to be a 'cause for real inquiry',⁹⁰ yet no inquiry was made. The agent of Royal Guardian falsely certified to AFIG that Mrs Yazgi had been interviewed. Had she been interviewed as required by AFIG's guidelines, the fraud would have been prevented. Harrison AsJ said that the solicitor for AMS should have realised, if she had read the loan documents, that much of the content was nonsensical, indicating that the borrowers did not understand what they were signing and could not have received

⁸⁷ *Permanent Custodians v Yazgi* [2007] NSWSC 279. The decision of Harrison AsJ was set aside by the Court of Appeal on grounds not presently relevant in *Yazgi v Permanent Custodians* [2007] NSWCA 240.

⁸⁸ *Ibid.* Harrison JA found that Mrs Yazgi's signatures were forged and falsely attested but made no finding about who forged them. Mr Yazgi failed to appear or file a defence in the proceedings.

⁸⁹ *Ibid* [94].

⁹⁰ *Ibid* [42].

independent legal advice.⁹¹ This realisation should have prompted the solicitor to discover that Mrs Yazgi had never been interviewed and that the broker was to receive over half the loan monies.⁹²

Although the mortgagee was fixed with the knowledge of its agents, Harrison AsJ held that *Permanent Custodians* was not defeasible for fraud as it 'did not act consciously through its officers knowing that Mrs Yazgi's signatures were false'.⁹³ The broker who submitted the application on behalf of the borrowers knew that the signatures of Mrs Yazgi were forged and falsely attested. However this knowledge could not be imputed to the mortgagee because the broker was not an agent of the mortgagee.⁹⁴

There were plenty of circumstances that ought to have prompted the mortgagee's agents to make further inquiries, but this was to no avail unless Mrs Yazgi could prove that the failure to inquire was due to fear of discovering fraud. Australian authorities insist that constructive notice of a fraud in the transaction is not enough to bring fraud home to the mortgagee; there must be actual dishonesty, such as a dishonest failure to inquire.⁹⁵ Proof of the element of dishonesty is extremely difficult, particularly where a securitised mortgage programme conducts its operations in such a way that nobody has full field vision and control. AFIG, which approved the Yazgi loan on behalf of AMS, did not itself deal with borrowers, but relied on certifications from Royal Guardian that it had undertaken specified actions and held specified documents on its file, such as a record of interview with the borrowers and evidence of income.⁹⁶ Since Royal Guardian had provided the certifications, there was no reason for AFIG to suspect fraud.

In a securitised mortgage processing scheme of this kind with a chain of entities in specialised roles, it is unrealistic to assume that originators or other agents will undertake non-standard inquiries to satisfy themselves that the transaction is without fraud. Even in non-securitised lending, there is no incentive for mortgagee's agents to be vigilant to detect identity fraud in the transaction. The interests and rewards of all the agents and the mortgagee are aligned with the completion of the transaction at

⁹¹ *Ibid* [44].

⁹² *Ibid*

⁹³ *Ibid* [105].

⁹⁴ *Ibid* [89]

⁹⁵ *Pyramid Building Society (in liq) v Scorpion Hotels Pty Ltd* [1998] 1 VR 188, 192-94; *Young v Hoger* [2001] QCA 453, [11]-[17]; *Hilton v Gray* [2007] QSC 401, [46]; *Royalene Pty Ltd v Registrar of Titles* [2008] QSC 64, [48].

⁹⁶ *Permanent Custodians v Yazgi* [2007] NSWSC 279, [28]-[29].

minimal cost. The agents will not undertake further inquiries when what is discovered could cost them a transaction, and what is left undiscovered is at the landowner's risk.

In these circumstances, it is very difficult for a defrauded landowner to persuade a court, mindful of *Briginshaw v Briginshaw*,⁹⁷ to infer that the abstention from inquiry was due to dishonesty, where the incentive structure provides other plausible explanations. In other cases where fraud was alleged, courts have instead found that sloppy practices of mortgagees' agents and solicitors were due to naivety,⁹⁸ carelessness,⁹⁹ inexperience¹⁰⁰ inadvertence to consequences,¹⁰¹ stupidity,¹⁰² administrative disorganisation,¹⁰³ incompetence,¹⁰⁴ and a 'gung-ho' lending culture among 'low-doc' lenders.¹⁰⁵

V The personal equities exception

A *Negligence on the part of the mortgagee*

In a number of cases, persons affected by the registration of a forged mortgage have sought to argue that even if the conduct of the mortgagee's agent fell short of what was required to prove wilful blindness or reckless indifference, the landowner had a personal equity to set aside the mortgage on the basis of breach of duty of care by the mortgagee.

It has long been recognised that statutory indefeasibility does not preclude a court from granting equitable relief against a registered proprietor in personam, based on a recognised *legal or equitable* cause of action, save for the types of action specifically prohibited by the relevant Torrens statute. In *Breskvar v Wall* Barwick CJ explained that a remedy granted by a court of equity acting in personam can have the effect of

⁹⁷ (1938) 60 CLR 336 at 362-63 (Dixon J); see text accompanying n 56, above.

⁹⁸ In *Young v Hoger* [2001] QCA 453, the Court of Appeal overturned a finding of wilful blindness amounting to fraud on the part of the mortgagee's solicitor, stating that 'an unacceptable explanation that he was naïve is at least as consistent with a desire to explain away his lack of care or competence as with his being dishonestly involved in the fraud on the first respondent': [25].

⁹⁹ *Ibid* [31]; *Hilton v Gray* [2007] QSC 401, [47]; *Vella v Permanent Mortgages Pty Ltd* [2008] NSWSC 505, [383].

¹⁰⁰ *Russo v Bendigo Bank Ltd* [1999] 3 VR 376.

¹⁰¹ *Davis v Williams* [2003] NSWCA 371, [27] (Hodgson JA).

¹⁰² *Ibid* [113] (Young CJ in Eq), [140].

¹⁰³ *Royalene Pty Ltd v Registrar of Titles* [2008] QSC 64, [47]-[49].

¹⁰⁴ *Hilton v Gray* [2007] QSC 401, [24].

¹⁰⁵ *Vella v Permanent Mortgages Pty Ltd* [2008] NSWSC 505, [122].

depriving the registered proprietor wholly or partially of the benefit of his or her registered title.¹⁰⁶

A landowner seeking to sue a registered mortgagee in negligence faces a number of obstacles. The first is the need to establish that the mortgagee or its agent owes the registered proprietor a duty of care and has breached that duty. In *Pyramid Building Society Ltd (In Liq) v Scorpion Hotels Pty Ltd*,¹⁰⁷ a mortgage in favour of Pyramid was fraudulently executed on behalf of the respondent company by affixing the company seal attested by a person who was not a director. The mortgagee's solicitor had obtained a company search which, if he had examined it, would have shown that the person who attested the affixing of the seal was not a director. Hayne JA (Brooking and Tadgell JJA concurring) held that there was no evidence that the solicitor knew of the false attestation or that he dishonestly failed to inquire.¹⁰⁸ The court also rejected the respondent's alternative argument, that it had a claim in negligence against the mortgagee which entitled it to a personal equity to set the mortgage aside. Hayne JA said:¹⁰⁹

I very much doubt that a solicitor confronted with another solicitor who claims to be acting for a borrower owes the borrower a duty to take care that the solicitor is right in the assertion that he or she has been properly retained by the borrower.

His Honour added that even if there were such a duty and a breach thereof, the remedy would be in damages but would not entitle the respondent to a personal equity to set the mortgage aside.¹¹⁰ His Honour did not discuss whether such an action for damages would fall within the class of actions prohibited by the 'protection of purchasers' provision in s 44(2) of the *Transfer of Land Act 1958* (Vic).

It seems that in some circumstances the mortgagee may be under a duty of care to the registered owner. In *Grgic v Australian and New Zealand Banking Group*,¹¹¹ a bank officer attested the signature of an imposter posing as the registered proprietor, Mr Grgic. Although the person had only just been introduced to him, the officer certified that the person signing was 'personally known' to him, and the bank manager signed on behalf of the bank. Mr Grgic sought to set aside the bank's registered mortgage on

¹⁰⁶ (1971) 126 CLR 376, 385-86.

¹⁰⁷ [1988] 1 VR 188.

¹⁰⁸ *Ibid* 193-94.

¹⁰⁹ *Ibid* 195.

¹¹⁰ *Ibid* 196.

¹¹¹ (1994) 33 NSWLR 202.

a number of grounds, including breach of duty of care. The Court of Appeal was prepared to proceed on the basis that the bank was in the circumstances under a duty of care to Mr Grgic to take reasonable care to verify the identity of the person signing as mortgagor, but found no breach of the duty.¹¹² The Court noted that the imposter had been introduced to the bank officers by known customers, and that he had the certificate of title and a document bearing the signature of Mr Grgic.¹¹³

The decision in *Grgic* sets a remarkably low standard of care for mortgage lenders. Their Honours did not remark on the officers' failure to call for identifying documents bearing Mr Grgic's photograph, nor did they place any weight on the officers' knowledge that the family members who introduced the imposter were to receive the whole of the loan funds secured by the mortgage. Since standards of care are influenced by conveyancing practices, it is possible that a different view would be taken of similar conduct today.

Even if a breach of duty of care could be shown, it does not follow that the registered owner would have a remedy against the mortgagee. In *Vassos v State Bank of South Australia*,¹¹⁴ Hayne J said that the in personam remedies and personal equities to which Barwick CJ referred in *Breskvar v Wall* were available only in circumstances where equity would act to restrain conduct which is unconscionable or unconscientious.¹¹⁵ Hayne J said that even if the mortgagee bank in *Vassos* 'did not act without neglect', it could not be said to have acted unconscionably.¹¹⁶

The requirement of an element of unconscionability appears to be a broad, generic obstacle to a claim to a personal equity based on negligence alone, although this aspect of Hayne J's reasons in *Vassos* has not been unequivocally accepted in later authorities. In *Grgic* the New South Wales Court of Appeal expressed no view on this aspect of Hayne J's reasons, even though it was argued on behalf of the respondent bank.¹¹⁷ Their Honours chose instead to dismiss Grgic's negligence claim on the

¹¹² Ibid 223-24.

¹¹³ Ibid.

¹¹⁴ [1993] 2 VR 316.

¹¹⁵ Ibid 333. His Honour's statement on this point have often been cited with approval and followed: eg, *Grgic v Australian and New Zealand Banking Group Ltd* (1994) 33 NSWLR 202 (NSWCA), at 217-18; *Story v Advance Bank Australia* (1993) 31 NSWLR 722 (NSWSC), at 736; *Duncan v McDonald* [1997] 3 NZLR 669 (NZCA) at 683-84; *LHK Nominees Pty Ltd v Kenworthy* (2002) 26 WAR 517 (WASCA); *Pyramid Building Society (In liquidation) v Scorpion Hotels Pty Ltd* [1998] 1 VR 188 (VCA), at 196 *Perpetual Trustees Victoria Ltd v Cipri* [2008] NSWSC 1120, [100].

¹¹⁶ *Vassos* ibid.

¹¹⁷ (1994) 33 NSWLR 202, 217.

narrower ground that there had been no breach by the mortgagee of its duty of care.¹¹⁸ More recently, in *Vella v Permanent Mortgages Pty Ltd*, Young CJ in Eq cited *Vassos* in support of his conclusion that ‘mere carelessness’ by the lender was not enough to establish a personal equity.¹¹⁹ Mere carelessness is not the same thing as a breach of a duty of care.

VI Legislative Measures

A Impact of AML-CTF Rules

While the rules of the Torrens System allow mortgagees to omit precautions against identity fraud, regulatory measures introduced for other reasons demand higher standards. The standard of care required of mortgage lenders to verify the identity of their clients is now significantly affected by the requirements of the *Anti-Money Laundering and Terrorism Financing Act 2006* (Cth) (‘the AML-CTF Act’) and the *Anti-Money Laundering and Terrorism Financing Rules Instrument 2007 No 1* (‘the AML-CTF Rules’).

Under the AML-CTF Act, all financial institutions which provide a ‘designated service’ are ‘reporting entities’.¹²⁰ Section 6, Table 1 lists a number of financial services that are ‘designated services’, including ‘making a loan, where the loan is made in the course of carrying on a loans business’.¹²¹ Before providing a designated service to a customer, a reporting entity must undertake a customer identification procedure in accordance with an AML/CTF program adopted by the entity.¹²² All reporting entities were required by December 2007 to adopt such a program, which must specify procedures for identifying customers, and must comply with the Rules.¹²³

The Rules specify different procedures for individuals, companies and other types of customer. For example, in the case of individuals, the procedures must include a procedure for lenders to collect specified ‘know your customer’ information;¹²⁴ appropriate risk-based systems and controls enabling the entity to determine what

¹¹⁸ See text accompanying n 112 above.

¹¹⁹ [2008] NSWSC 505, [377]-[383].

¹²⁰ AML-CTF Act 2006, Section 5, definition of ‘reporting entity’.

¹²¹ AML-CTF Act 2006, s 6, Table 1, item 6.

¹²² AML-CTF Act 2006, ss 32, 5.

¹²³ AML-CTF Act 2006, s 84(1), (3).

¹²⁴ AML-CTF Rules, r 4.2.3.

other information will be collected;¹²⁵ a procedure for verifying the information based on reliable and independent documentation or electronic media or both;¹²⁶ and appropriate risk-based systems and controls enabling the entity to respond to any discrepancy in the information in order to enable it to be reasonably satisfied that the customer is the person whom he or she claims to be.¹²⁷ Breach of the rules gives rise to civil pecuniary penalties but does not invalidate a transaction.¹²⁸ Reporting entities were given a no-prosecution period ending on 11 March 2009 to bring their procedures into compliance with the above provisions.¹²⁹

While the AML-CTF Act provides protection from civil or criminal suit for a person in relation to anything done, or omitted to be done, in good faith by the person in fulfilment or purported fulfilment of the Act,¹³⁰ it is expected that the 'standard of meticulous conduct' for lenders will be judged by reference to their AML/CTF program. It will indirectly raise the standard of care for mortgage lenders. However this will not overcome the other obstacles to negligence-based actions under the personal equities exception to indefeasibility by defrauded landowners against registered mortgagees discussed above.

B *Conditional indefeasibility for mortgagees – the Queensland amendments*

Queensland and New South Wales have adopted a more radical approach to the problem of lax client identification procedures by some mortgage lenders.¹³¹ In 2005, Queensland amended its Land Titles Act to require that the mortgagee must before the instrument is registered take reasonable steps to ensure that the person who executed the mortgage as mortgagor is, or is about to become, the registered owner of the lot.¹³² A mortgagee is deemed to take reasonable steps if it complies with the

¹²⁵ AML-CTF Rules, r 4.2.5.

¹²⁶ AML-CTF Rules, r 4.2.8, and definitions in r 1.2.1.

¹²⁷ AML-CTF Rules, r 4.2.9.

¹²⁸ AML-CTF Act 2006, ss 32(2), 175, 243.

¹²⁹ Austrac Guidance Note, Application of the Policy (Civil Penalty) Principles 2006, Dec 2007, 3-4.

¹³⁰ AML-CTF Act 2006, s 235.

¹³¹ Qld, *Parliamentary Debates*, Legislative Assembly, 8 November 2005, 3761 (Hon H Palazczuk, Minister of Natural Resources and Mines). The Minister reported that a number of title frauds had been perpetrated by 'organised crime' using forged certificates of title to obtain loans, and that lack of due diligence by 'lenders of last resort' had been a contributing factor. See also, Michael Weir, 'Indefeasibility – Queensland Style' (2007) 15 *APLJ* 7.

¹³² *Land Title Act 1994* (Qld), s 11A(2).

manual of land title practice for the identification of mortgagors.¹³³ Similar requirements apply on transfer of a mortgage.¹³⁴ A mortgagee does not obtain the benefit of indefeasibility if the mortgagee failed to comply with its obligations to verify the identity of the person signing as mortgagor, and the mortgage was in fact executed by someone other than the registered proprietor of the lot.¹³⁵ A mortgagee seeking the protection of indefeasibility bears the onus of proving that it complied with the provisions.¹³⁶ A mortgagee is not entitled to compensation from the State for deprivation, loss or damage that can fairly be attributed to the person's failure to comply with the provisions.¹³⁷

The 2005 Queensland amendments introduced a conditional rule of immediate indefeasibility for registered mortgagees. By aligning the rule with the mortgagee's incentives to prevent fraud, the Queensland government intended to change the risk management processes of mortgage lenders. It hoped that this would ensure that the State would not be unnecessarily burdened with compensation claims for frauds that could be prevented by the mortgagee's due diligence.¹³⁸

In 2009, New South Wales amended the *Real Property Act 1900* by inserting s 58C.¹³⁹ The new section places mortgagees under a duty to take reasonable steps to verify the identity of the person executing as mortgagor, and establishes record-keeping procedures and inquiry powers to enable the Registrar-General to monitor compliance. Section 58C(6) gives the Registrar-General power to cancel the entry of a mortgage in the Register where the mortgage was executed in fraud of the registered proprietor of the land and the mortgagee was either in breach of its duty to confirm the identity of the mortgagor or had actual or constructive notice that the person executing the mortgage was not the registered proprietor.

VII Conclusion

When immediate indefeasibility was first introduced into Australian law by judicial interpretation, the rationale relied on arguments of statutory interpretation rather than consequentialist policy reasoning. There was, though, at the time a clear

¹³³ *Land Title Act 1994* (Qld), s 11A(3), s 9A(2)(c).

¹³⁴ *Land Title Act 1994* (Qld), s 11B.

¹³⁵ *Land Title Act 1994* (Qld), s 185(1A).

¹³⁶ *Land Title Act 1994* (Qld), s 185(5).

¹³⁷ *Land Title Act 1994* (Qld), s 189(1)(ab).

¹³⁸ Parliamentary Debates, above n 131.

¹³⁹ Inserted by the *Real Property and Conveyancing Legislation Amendment Act 2009* (NSW), sched 1 [4].

recognition that immediate indefeasibility would be moderated by other doctrines and was not necessarily determinative of the outcomes of cases. In *Frazer v Walker*, the Privy Council indicated that the rule was moderated by the fraud exception, the powers of equity to enforce personal equities in personam, and the Registrar's powers of correction.¹⁴⁰ The consequences of the rule change would depend on how these exceptions were applied.

Over the following decades, judicial decisions restricted the scope of the exceptions, pursuant to a policy of promoting security of transaction over security of title. Statutory fraud has been narrowly interpreted with, since *Russo*, increasingly frequent judicial references to the seriousness of the allegation and the need for cogent proof. The heavy burden of proof falls on a person external to the transaction, and is not discharged by pointing to circumstances which should have alerted the mortgagee's agents to the fraud. Courts are highly reluctant to draw inferences of fraud against agents of mortgagees, preferring less pejorative explanations which are consistent with the agents' lack of incentive to check the borrower's identity.

The judgment of Tadgell J in *Australian Guarantee Corporation v De Jager*¹⁴¹ represented the high water mark of standard-setting for mortgagees, although similar statements have recently been directed at solicitors and attesting witnesses.¹⁴² Since *Russo v Bendigo Bank Ltd*, courts have virtually stopped using the fraud exception to send a firm signal to mortgagees about the standard of care expected of them when dealing with other people's property. The change of approach occurred at the time when lenders were restructuring their mortgage processing operations in ways which incidentally diminished safeguards against identity fraud.

The exception for personal equities has become more closely aligned with the scope of the fraud exception, particularly since the High Court decision in *Farah Constructions v Say-Dee Pty Ltd*.¹⁴³ It is now rare for an action in personam to succeed in any case in which a forged mortgage has been registered and the fraud exception is not engaged.¹⁴⁴ It seems that personal equities are destined to play no role in

¹⁴⁰ [1967] 1 AC 569, 585.

¹⁴¹ [1984] VR 483, 497-99 (Tadgell JA).

¹⁴² *Graham v Hall* (2006) 67 NSWLR 135, [47]-[49]. [60] (Ipp JA).

¹⁴³ (2007) 230 CLR 89, [110]-[158], [193]-[196]. The High Court rejected the use of unjust enrichment as a basis for establishing recipient liability under the first limb of *Barnes v Addy* (1874) LR 9 Ch App 244 at 251-252, and affirmed that actual dishonesty and fraud is required to establish accessory liability under the second limb.

¹⁴⁴ The notable exception is the ruling in *Mercantile Mutual Life Insurance Co. Ltd v Gosper* (1991) 25 NSWLR 32, which involved the unauthorised use by a mortgagee of the mortgagor's certificate of title to register a variation of mortgage. The ruling has been

controlling negligent behaviour by mortgage lenders. Doctrinal innovation in the area of personal equities will be constrained by the High Court's firm opposition to the extension of restitutionary principles based on unjust enrichment and to doctrinal innovation by lower courts.¹⁴⁵

With the constriction of the exceptions and related doctrines, there is now little to moderate the incentive effects of immediate indefeasibility.¹⁴⁶ By shifting the fraud risk to a person external to the loan transaction, the rule relieves mortgagees of any necessity to ensure that they are dealing with the landowner. This consequence was controlled in the days of credit rationing, when the opportunities for identity fraud were limited by institutional arrangements such as branch banking, preference for known customers, and vertically integrated mortgage lending practices. Subsequent changes in the mortgage lending industry have radically altered the mortgagee's incentives, mode of operation and attitude to risk, in ways that unleash the moral hazard inherent in immediate indefeasibility.

Two States have belatedly recognised the problem and have legislated to place mortgagees under a positive obligation to take reasonable steps to verify the identity of the person executing as mortgagor. Queensland substituted a conditional form of the rule of immediate indefeasibility, under which a mortgagee which fails to comply with its obligation to verify and registers a forged mortgage obtains a defeasible title. New South Wales has empowered the Registrar-General to cancel the registration of a fraudulently executed mortgage where the mortgagee has failed to take reasonable steps to verify the identity of the person executing as mortgagor or had actual or constructive notice of the identity fraud.

distinguished in subsequent cases: *Ginelle Finance Pty Ltd v Diakakis* [2002] NSWSC 1032; *Vassos v State Bank of South Australia* [1993] 2 VR 316.

¹⁴⁵ In *Farah Constructions*, *ibid.* and other cases, the High Court has sent strong signals to lower courts to desist from doctrinal innovations: Keith Mason, 'A Cost-Benefit Analysis of Judges Being Offensive to Each Other' (Judicial Conference of Australia Conference, 6 October 2007) (copy on file with the author); Michael Kirby, 'Equity's Australian Isolationism', speech to Queensland University of Technology, 19 November 2008 (copy on file with the author).

¹⁴⁶ Judges who have sought to use the doctrines to uphold higher standards of conduct for mortgagees have found themselves in the minority on this point or overturned on appeal: eg the dissent of Gzell JA in *Davis v Williams* [2003] NSWCA 371, [253]-[264] (upholding the finding of the trial judge on fraud); Kirby P in *Mercantile Mutual Life Insurance Co. Ltd v Gosper* (1991) 25 NSWLR 32, 35-38, agreeing with the reasons of Cohen J at first instance. Mahoney JA concurred with Kirby P in the order, but on narrower grounds (see n 144, above).

It is too early to say if other States and Territories will reform their Torrens statutes to qualify the rule of immediate indefeasibility for mortgagees. Some jurisdictions may decide to await the results of the AML-CTF regime or the National Consumer Credit Reform package¹⁴⁷ to see if these regulatory regimes introduced for other purposes incidentally reduce the prevalence of identity fraud in mortgage lending. It is submitted that the Queensland and New South Wales reforms are likely to be more effective in promoting fraud prevention, since they go beyond a regulation and compliance model. By denying immediate indefeasibility to mortgagees who breach their verification obligations, the reforms realign the mortgagee's incentives with the prevention of identity fraud.

¹⁴⁷ This is a package of reforms to be introduced in stages to give effect to an agreement reached by the Council of Australian Governments in 2008 that the Commonwealth would assume responsibility for regulating consumer credit, including, including non-bank lenders mortgage lenders and mortgage brokers.