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Marshalling securities and construing releases in equity*

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[626] The unanimous decision of the Victorian Court of Appeal in *Burness v Hill*[1] is a timely reminder of the advantages to a junior secured creditor of the equitable doctrine of marshalling, and of the distinct ways in which common law and equity treats a release.

Factual background

A simplified summary of the salient facts is as follows. Before his bankruptcy and death in 2016, Mr Thomas Love had borrowed substantial amounts from the Commonwealth Bank of Australia, secured by registered mortgages over three properties, A, B and C. Mr Antony Hill was Love's solicitor in extensive and prolonged litigation. Love granted a second mortgage over property A to secure his indebtedness to Hill. Love was in default to the bank, which exercised its power of sale in 2011 and sold Property A for some $10 million. That was insufficient to discharge Love's indebtedness to the bank. In the meantime, Hill sued Love in the Country Court of Victoria and, in 2013, reached an agreement whereby judgment would be entered in the amount of $2.2 million, with execution stayed for up to a year. The agreement contained a generally worded release. In 2014, the bank sold Property B, but once again the sale proceeds were insufficient to discharge Love's indebtedness to it. Hill lodged a caveat over Property C, asserting a right to be subrogated to the bank's mortgage, and later commenced proceedings seeking an entitlement to be paid the $2.2 million judgment debt plus interest and costs from the proceeds of sale. The bank sold Property C in 2016 and used part of the proceeds to discharge Love's indebtedness. The remaining $6 million was paid into court. Love was made bankrupt in 2016, and died a few months later.

The issue was whether Hill was entitled to be repaid (in full) from the balance of the proceeds of sale of Property C, or had to participate as an unsecured creditor in Love's bankrupt estate.

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1 [2019] VSCA 94.

Both at first instance and on appeal Hill succeeded in upholding an entitlement to payment as a secured creditor from the proceeds of sale. Equity regarded Hill as being entitled by way of marshalling to the remaining proceeds of sale of Property C, notwithstanding (a) that he had only had a second mortgage over property A, and (b) the release he had given in 2013. It is, perhaps, timely to explain how equity treats this sort of situation.

Marshalling of Securities

First, putting to one side the release, it is clear that had the bank sold the properties in a different order, Property C then B then A then the surplus after Love's indebtedness to the Bank would have been produced from the proceeds of sale of Property A, such that Hill would be paid in full as second mortgagee. This illustrates the basis on which equity intervenes. "A person having resort to two funds shall not by his choice disappoint another, having one only", as Sir William Grant MR wrote in *Trimmer v Bayne*,[2] approved by the joint judgment of Dixon CJ, Menzies and Windeyer JJ in *Miles v Official Receiver in Bankruptcy*.[3] That position is well-settled in England,[4] New Zealand[5] and Canada.[6] The position is different in the United States of America. Joseph Story adopted a view prevalent in 17th and 18th century English decisions, holding that the singly secured creditor can compel the doubly secured creditor to resort [627] first to the property in respect of which the latter creditor is exclusively interested, provided there was no prejudice.[7] It seems that the Scottish doctrine of "catholic securities" is closer to the United States position.[8] There are an excellent accounts of the doctrine by Professors Gummow and Stumbles,[9] and Professor Hare,[10] complementing the standard work by Professor Ali.[11]

Marshalling is ordinarily only available where there is a common debtor. Love's trustees in

2 (1803) 9 Ves Jun 209 at 211; 32 ER 582 at 583.
3 (1963) 109 CLR 501 at 511; [1963] HCA 24.
4 *Morris v Rayners Enterprises Incorporated* [1998] 1 AC 214; [1997] UKHL 44, *Szepietowski v National Crime Agency* [2014] AC 338
5 See *Tegel Foods Ltd v Coastal Cuisine NZ Ltd* [2013] NZHC 899.
6 See P Ali, *Marshalling of Securities* (Oxford University Press, 1999), p 39 and see *Green v Bank of Montreal* 1999 CanLII 821 (ON CA) at [10].
7 "[By] compelling [the doubly secured creditor] to take satisfaction out of one of the funds no injustice is done to him … But it is the only way by which [the singly secured creditor] can receive payment. And natural justice requires, that one man should not be permitted from wantonness, or caprice, or rashness, to do an injury to another": J Story, *Commentaries on Equity Jurisprudence* (2nd ed 1892), pp 514-516. *See Sowell v Federal Reserve Bank*, 268 US 449 at 457 (1925); *Shedoudy v Beverly Surgical Supply Co*, 161 Cal Rptr 164 (1980).
8 See Lord Reed's account in *Szepietowski v National Crime Agency* [2014] AC 338; [2013] UKSC 65 at [81]-[83].
9 W Gummow and J Stumbles, "Marshalling, the Personal Property Securities Act 2009 and third party securities: Highbury and Szepietowski – New applications of enduring principles" (2014) 25 *JBFLP* 106.
10 C Hare, "Marshalling Marshalling" in P Davies, S Douglas and J Goudkamp, *Defences in Equity* (Hart Publishing 2018), ch 11.
11 P Ali, *Marshalling of Securities* (Oxford University Press, 1999).

bankruptcy submitted that Hill had no right to marshall, because his debt was the judgment debt created in 2013, which did not exist at the time Property A was sold. The trustees relied on the fact that when a final judgment is entered, "the rights and obligations in controversy, as between those persons, cease to have an independent existence: they 'merge' in that final judgment".[12] So much is trite, but it did not mean that there was no debt at the relevant time so as to sustain the equitable doctrine. What matters is that, at the time the doubly secured creditor enforces its security, the junior creditor's mortgage secured a debt. It appears to have been accepted that any non-compliance by Hill of his disclosure obligations did not affect the fact that an amount was owing to Hill which was secured by the second mortgage.[13]

Second, the trustees submitted that Hill had no right to marshal because there had been an arrangement, albeit one falling short of an enforceable contract, between the bank and Hill, pursuant to which Property A was sold first. The Court rejected the trustees' submission that it was sufficient to find that the sale of Property A was pursuant to a non-binding arrangement, so that the bank's conduct was neither arbitrary nor capricious. A much narrower test applies. Lord Neuberger had said that either a contractually binding obligation "or something close thereto" would suffice; his Lordship instanced an estoppel. The Victorian Court of Appeal added that a statutory obligation would suffice. What seems to be essential is that the senior creditor is *obliged* to proceed against the doubly secured property.

Was the Right to Marshall Released?

However, like most equitable rights, the right to marshall may be released, and the trustees' next submission was that Hill had done so at the time the County Court proceedings had been compromised. It will be recalled that Hill had commenced Country Court proceedings in 2012. That litigation did not concern marshalling, and neither the bank nor Hill's wife (who also claimed an interest in Property A) were parties. In 2013, Hill had released Love "from all claims, suits, demands and actions the parties now have; or but for these terms would in the future have, arising out of this proceedings and the allegations, acts, facts or matters the subject of this proceeding."

As an ordinary question of construction, there might be thought to be a strong argument that the generally worded release extended to the equitable rights of Hill to participate, by way of

12 *Tomlinson v Ramsey Food Processing Pty Ltd* (2015) 256 CLR 507; [2015] HCA 28 at [20].

13 It seems that no separate submission was advanced to challenge the primary judge who said at [60] that "There was always and still is an amount owing to Hill. The debt and liability remained unaffected by any non-compliance with solicitors' obligations of disclosure and the like ..."

marshalling, in the proceeds of sale of any of Love's other properties which were mortgaged to the bank. Plainly enough the debt owed by Love to Hill fell squarely within the release, and insofar as it was secured, by 2013 the bank had sold the only property over which Hill had a security for Love's indebtedness to him, and was presumably in the process of selling the Properties B and C.

[628] But it was also accepted that in 2013 neither Hill nor Love knew that Hill had a marshalling claim. This proved to be highly significant.

As is well known, there are some special principles which apply to the construction and application of releases. The generality of the terms of a release will commonly be read down by the particular occasion – by reference to the particular disputes existing between the parties at the time. It is possible for a party to bind itself to release another from disputes of which it is presently unaware, but very clear language is required. The decision of the Victorian Court of Appeal is a timely reminder of the different approaches at common law and in equity which continue to apply in Australia, which contrast with the position as now understood in the United Kingdom. Equity will have regard to the subjective understanding of the releasor.

Construction of Releases in Equity

Releases operated differently in equity. This was explained by Dixon CJ, Fullagar, Kitto and Taylor JJ in *Grant v John Grant & Sons Pty Ltd*:[14] "[W]hatever construction is to be given by law to the deed, in equity it would be restrained according to the knowledge and intent of the parties respectively claiming and denying the benefit of the release." Their Honours went on to state that "[f]rom a very early time the Court of Chancery applied its special doctrine to the unconscientious reliance upon the general words of a release". The key difference between the approaches at common law and in equity was stated by Pollock, cited in the joint judgment.[15] Courts at law would put a restricted construction on general words when it appeared on the face of the instrument that it could not have been the parties' real intention. Pollock stated that "Courts of equity went farther, and did the like if the same conviction could be arrived at by evidence external to the instrument." These are all statements to the effect that a release may not be enforced if a party is subjectively unaware that it extends so far.

This distinction seems to have been lost in the United Kingdom. In *Bank of Credit and Commerce*

14 (1954) 91 CLR 112; [1954] HCA 23 at 124.
15 F Pollock, *Principles of Contracts* (13th ed 1929), p 412.

International SA (in liq) v Ali (an appeal argued over three days and decided a mere 6 weeks later),[16] the House of Lords denied that there was a separate approach at law and in equity to the construction of releases, despite having reviewed the authorities, including *Grant v John Grant & Sons Pty Ltd*, and instead applied "not a rule of law but a cautionary principle which should inform the approach of the court to the construction of [a release]".[17] The reason was, in the leading speech of Lord Bingham, that "more than a century and a quarter have passed since the fusion of law and equity". Lord Nicholls likewise accepted that a different apprach had occurred in the past, but said that this was "now a matter of historic interest and no more", and that there was "no room today for the application of any special 'rules' of interpretation in the case of general releases".[18] In the Court of Appeal, only Buxton LJ had considered that there was a separate narrow principle of equity, distinct from the unconscientious exploitation of the releasor's ignorance, to the effect that "equity will not permit general words in a release to debar the party using them from asserting claims that arise from circumstances of which he had no knowledge and matters that he did not contemplate".[19] Sir Richard Scott VC adopted an approach similar to that of the House of Lords, while Chadwick LJ found that the release applied as a matter of construction, but that it would be unconscionable for BCCI to be permitted to enforce it.

The Meaning and Continuing Force of Grant v John Grant & Sons

Naturally, *Grant v John Grant & Sons* remains authoritative in Australia. It is possible that the House of Lords failed to understand the force of *Grant* because of its procedural complexities. It is important to recall that that was an appeal from a pre-Judicature Supreme Court of New South Wales. The plaintiff brought an action at common law in debt, to which the defendant pleaded a release. By way of three separate replications, the plaintiff [629] denied the sufficiency of the defence of release.[20] The first two replications relied on common law rules as to the construction of a release, but the third was a replication in equity, a practice authorised by s 97 of the *Common Law Procedure Act 1899* (NSW).[21] The idea was that even if the release be valid at law, there might be circumstances where equity would intervene to prevent the defendant from relying on it. Thus, the

16 [2002] 1 AC 251; [2001] UKHL 961.
17 At [17].
18 At [24]-[26].
19 *Bank of Credit and Commerce International SA (in liq) v Ali* [2000] 3 All ER 51 at [92].
20 As Sofronoff P has recently mentioned,when applying the common law and equitable principles, the pleader was T E F Hughes, then a junior, who by dint of the plea earned his second reported appearance in the High Court led by WJV Windeyer: see High Court Centenary: Reminiscences and reflections (2003) 77 *ALJ* 653 at 662, cited in *Wichmann v Dormway Pty Ltd* [2019] QCA 31 at [7].
21 See See K Jacobs, "Law and Equity in NSW after the Supreme Court Procedure Act, 1957, Section 5" (1959) 3 *Syd Law Rev* 83. and R V Gyles, "Equitable Defences at Common Law: Application of Promissory Estoppel in New South Wales" (1961) 3(3) *Syd Law Rev* 517.

plaintiff alleged that it did not know that its had a money claim against the defendant, that it did not intend to release the defendant from any such claim, and that the defendant did know and had not disclosed that it owed money to the plaintiff. That was intended to engage chancery's "special doctrines to the unconscientious reliance upon the general words of a release". As pleaded, the third replication was ambiguous. On one view it referred to a case where a party was entitled to rescission (for example, for mistake or non-disclosure). But the High Court distinguished that category from cases where equity would "have the general words of a release confined to the true purpose of the transaction ascertained from the scope of the instrument and the external circumstances".[22] The High Court regarded the third replication as falling within this category, rather than asserting a right to rescind the release as a whole. It is thus clear authority for a separate rule of construction of releases in equity.

The decision of the Victorian Court of Appeal reaffirms the separateness of the equitable rule governing the efficacy of releases. It relied in terms on the equitable principle stated in *John Grant*.[23] The trustees alleged there was error in taking into account Hil's subjective intention, but the Court of Appeal crisply rejected the submission:[24]

> "The trustees' second contention challenges that finding, on the basis that the trial judge erred in taking Hill's subjective intention into account in construing the words of the release. The emphasised words in the summary of the equitable principle in *Grant* ... are directly inconsistent with the second contention; which must therefore fail. Specifically, the trial judge was justified in referring both to Hill's subjective intention and the fact that Hill was ignorant of his marshalling claim at the time he entered into the terms of settlement."

With respect to what was held in *Bank of Credit and Commerce International SA (in liq) v Ali (No 1)*, there seems to be no reason to consider that the administrative fusion of common law and equitable jurisdiction somehow altered the position. Indeed, the result had already been reognised by common law courts before judicature legislation was enacted, and that the equitable rule continued to be available after judicature legislation came into force in 1875 in the United Kingdom, shortly thereafter in other Australian States and after 1972 in New South Wales. As to the first proposition, an example is *Lyall v Edwards*.[25] Pollock CB expressly applied "a principle long sanctioned in Courts of equity". Martin B ("we are required to call in aid the rule in equity") and Wilde B ("The doctrine of a Court of equity is, that a release shall not be construed as applying to something of which the party executing it was ignorance, and we have now to act on that doctrine

22 At 130.
23 [2019] VSCA 94 at [73], [74], [77] and [78].
24 [2019] VSCA 94 at [78].
25 (1861) 6 H & N 337; 158 ER 139. The common law court was addressing an equitable defence, as permitted by the *Common Law Procedure Act 1854* (UK) 17 & 18 Vict c 125.

in a Court of Law") were just as clear. Nothing in the Judicature legislation altered that result; hence the reasoning in *Turner v Turner; Hall v Turner*,[26] where a release given by the beneficiaries of the estate of J W M Turner was construed by reference to the subjective knowledge of the parties. Malins VC said that "it is the duty of the court to construe the instrument [630] according to the knowledge of the parties at the time, and according to what they intended". This was a reference to the parties' subjective knowledge and intentions, rather than what was to be imputed to them.

True it is that the distinct equitable principle may seem anomalous. The fifth member of the High Court in Grant, Webb J, was of that view: 'It may seem remarkable that, say, an utterly indifferent plaintiff should acquire such an equity based solely on his own inexcusable ignorance against a defendant to whom no fault can be imputed, not even inadvertence; yet the authorities … indicate that such is the case." Webb J nonetheless applied those authorities. The principles is an exception to conventional approaches to admissibility of evidence on construction, because evidence of a party's subjective belief is relevant. It might seem attractive to treat *Grant* as confined to cases where equity prevents the unconscientious reliance by the other party on the terms of a release. But *Grant* on a fair reading, not least by reason of its endorsement of the principle as formulated by Pollock, proceeds on the basis of construction, and so such a reading would seem to be a matter for the High Court and that court alone. However, it should perhaps be emphasised that in most cases little will turn on this. What was absent from a releasor's *actual* subjective understanding will very commonly be entirely absent from the surrounding circumstances which will be admissible to determine whether the generality of the release applies. The distinction becomes acute, however, when there is a new or relatively obscure claim, which is available on facts known to the parties, but of which they were subjectively unaware. That was the position of Hill and Love, who knew all about the sale of Property A, but nothing about marshalling in equity. It was also the position of Mr Ali, whose claim (for "stigma" damages) had only been recognised in 1997,[27] years after signing his release. It was also the position in another modern Australian appellate decision which applied the equitable rule in *Grant.* In *Torrens Aloha Pty Ltd v Citibank NA*,[28] Sackville J, with whom Foster and Lehane JJ agreed, applied what had been said in *Grant* and by Sir Frederick Pollock to a release executed five years before the change in law effected by *David Securities Pty Ltd v Commonwealth Bank of Australia*.[29]

MJL

26 (1880) 14 Ch D 829.
27 In *Malik v Cank of Credit and Commerce International SA (in liq)* [1998] AC 20.
28 (1997) 72 FCR 581 at 59-600.
29 (1992) 175 CLR 353.