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Goodridge appeal — legal principles governing assignment and novation of contracts

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The recent decision of the full bench of the Federal Court in *Leveraged Equities Ltd v Goodridge*[1] has unanimously overturned the contentious first instance decision of Rares J[2] and, in doing so, has restored clarity to the legal principles governing assignment and novation of contracts. Although the decision centred on the enforcement of margin lending arrangements and the proper construction of an ambiguously drafted contract, the case has wider implications for syndicated loans, securitisations and commercial transactions generally.

The first instance decision caused much consternation in financial and legal circles, as it appeared to challenge existing legal principles and practice regarding the novation and assignment of contracts. Although several commentators suggested that the statements from the *Goodridge* decision should be confined to the specific facts, there was concern that if applied more broadly, the *Goodridge* decision undermined the validity of existing loan transfers, securitisations and other commercial transactions.

The appeal decision has put such fears to rest, while providing a cogent and authoritative summation of the Australian law on novation and assignments, in line with both English and US authorities. Nevertheless, there are some aspects of the decision which may require further clarification.

Background

The litigation arose in the wake of the global financial crisis and the stock market crash of February 2009. Plunging stock prices saw Mr Goodridge receive a series of margin calls under his margin loan with Leveraged Equities Ltd (Leveraged Equities). After Mr Goodrige failed to meet these margin calls, Leveraged Equities exercised its right to sell Mr Goodridge's portfolio at what, in hindsight, was the bottom of the market.

The case was further complicated by Macquarie Bank Ltd's (Macquarie's) sale of its $1.5 billion margin loan book to Leveraged Equities in January 2009 — only one month before the margin calls were made. Mr Goodridge's margin loan, which had originally been entered into with Macquarie in 2003, was sold and purportedly transferred to Leveraged Equities (via an intermediate securitisation entity) as part of that sale.

Mr Goodridge challenged the validity of the margin calls and Leveraged Equities' right to exercise its power of sale. The arguments on these points were primarily concerned with the proper construction of the margin call and the default clause of an ambiguously drafted loan and security agreement (LSA). More importantly, Mr Goodridge also challenged the validity of Macquarie's transfer of his margin loan to Leveraged Equities in 2009 and whether Macquarie's rights under that contract were legally capable of assignment.

First instance decision

The trial judge, Rares J, decided all issues of construction in favour of Mr Goodridge, finding that under the terms of the LSA the margin calls were invalid and that Leveraged Equities had no authority to sell Mr Goodridge's portfolio.

However, the more controversial aspects of the decision related to the finding that the transfer of Mr Goodridge's loan book from Macquarie to Leveraged Equities was ineffective, and on that basis Leveraged Equities was not entitled to exercise any rights under the LSA.

Among other things, Rares J held as follows.

- The *novation* was not effective, as it was impossible for Macquarie to novate the LSA to a third party without the participation and knowledge of Mr Goodridge. Moreover, the prospective consent to novation provided by Mr Goodridge under cl 21.2 of the LSA was described as "nebulous" and characterised as no more than an "agreement to agree".[3]

- The purported *assignment* of Macquarie's rights to Leveraged Equities was not effective because:
  - — Macquarie's rights (such as the right to require repayment) were so interconnected with its obligations (such as the obligation to make further advances under the LSA) that the rights were incapable of assignment;
  - — the tripartite arrangements under which Leveraged Equities assumed the rights of the lender while Macquarie retained further funding obligations were "unworkable";
  - — the wide discretions given to the lender suggested that the identity of the lender was important to Mr Goodridge, and therefore the lender's rights were personal and not capable of assignment; and
  - — under s 12 of the Conveyancing Act 1919 (NSW), to perfect an assignment Mr Goodridge needed to receive actual notice of the assignment (which Rares J considered had not been demonstrated on the facts).

Appeal decision

On appeal, the Full Court of the Federal Court (in a leading decision by Jacobson J, with whom Finkelstein and Stone JJ agreed) decisively rejected each of these findings. In doing so, the court has provided clear guidance regarding the legal principles applicable to the novation and assignment of receivables, and to contracts generally. Nevertheless, there are some aspects of the decision which may require further clarification.

Novation

The court held that the novation from Macquarie to Leveraged Equities was effective. Contrary to Rares J's findings, it was not impossible for a contracting party to prospectively authorise a novation to be made by another party unilaterally.

The court cited Australian,[4] English[5] and US[6] authorities before unreservedly concluding that Rares J's findings did not represent Australian law.[7] In doing so, Jacobson J flagged and tacitly concurred with stinging criticism of the first instance decision levelled by Cook J in *Habibsons Bank Ltd v Standard Chartered Bank (Hong Kong)*,[8] which described Rares J's conclusion as "wholly uncommercial" and a "purist point" which is contrary to the development of the law of contract.[9]

The court considered that cl 21 of the LSA made it sufficiently clear that Mr Goodridge (as borrower) had given prospective consent to all the elements needed to give effect to a novation.[10] Clause 21 permitted the substitution of a new lender on the same terms and conditions as the LSA. Accordingly, there was "no uncertainty about the terms and conditions of the new contract to which Mr Goodridge consented to be a party"[11] and the consent was not, as Rares J had found, simply a "nebulous" agreement to agree.

Although the court ultimately decided that a proper construction of cl 21 permitted the novation by Macquarie, it closely analysed the drafting of the novation clause and noted that the language used was crucial. Jacobson J commented that the drafting clearly fell short of the clear terms of the syndicated loan novation clause which was discussed and approved in the English case of *Argo Fund Ltd v Essar Steel Ltd.*[12]

In practice, assignment and novation clauses in commercial documents rarely contain the detailed transfer or substitution mechanics commonly included in syndicated loan agreements, and the *Goodridge* assignment and novation clauses were by no means atypical. Nevertheless, the *Goodridge* decision suggests that a novation clause should, at a minimum, address each element required to give effect to a novation, namely that:

- the new party will assume the rights and obligations of the outgoing party;
- the outgoing party will be released from those rights and obligations; and
- the new contract will be novated on the same terms and conditions as the existing agreement.

While the drafting in cl 21 was ultimately held to be sufficient to authorise a novation, Jacobson J nevertheless commented that the draftsperson may have failed to give sufficient attention to the distinction between assignment and novation.[13] In light of this comment, lawyers would be wise to revisit the drafting of precedent novation clauses to ensure that they adequately and unambiguously address each of the key elements referred to above.

Trustee limitation of liability

Another reason why the trial judge held the novation to be ineffective was the "substantive difference" between the obligations of Macquarie and those assumed by Leveraged Equities.[14] As part of the novation, Leveraged Equities entered into the documents solely in its capacity as trustee and limited its liability to the extent of its actual indemnity from trust assets. Rares J considered that this limitation of liability was a substantive change that Mr Goodridge had never consented to in advance.[15]

On appeal, Jacobson J disagreed and held that the limitation of liability clause did not alter the obligations owed by Leveraged Equities to Mr Goodridge. In his view, the clause was only related to the capacity in

which Leveraged Equities had entered into the documents. As Leveraged Equities entered into the documents solely as trustee, it was consistent that any recourse be limited to the assets of the trust.[16] He considered that this view was further supported by a clause of the LSA which specifically provided for "novation to any trustee or manager or any securitisation programme".[17] Jacobson J held that Rares J's approach precluded any such novation to a trustee.[18]

With respect, although limitation of liability clauses are industry standard for trustees (including in securitisations or syndicated lending arrangements), a trustee need not include such a limitation in its contracts and a failure to include such a clause does not preclude the novation. Unlike a company or natural person, a trust is not a separate legal entity. As a consequence, the trustee (not the trust itself) is personally liable for all liabilities incurred in its capacity as trustee and must rely on its right to be indemnified from the assets of the trust fund. The risk that a trustee's personal liability may exceed its actual indemnity from the trust, while commercially unpalatable, does not legally preclude a party from contracting in its capacity as trustee.

To reconcile this with the statements of Jacobson J, one must assume that he also concluded that the scope of Mr Goodridge's consent (which expressly referred to securitisation programs) by implication extended to the inclusion of a limitation of liability clause in a form typically required by such trustees. Accordingly, where documents do not expressly provide for novation to a trustee, there remains some doubt as to whether the inclusion of a trustee limitation of liability clause may require further consent from the borrower.

Assignment

Although the court had decided that the novation from Macquarie to Leveraged Equities was effective, it went on to consider whether Macquarie's rights were capable of assignment to Leveraged Equities.[19] In concluding that the rights were capable of assignment, Jacobson J noted that:

- the LSA expressly provided that Macquarie's rights were capable of assignment without Mr Goodridge's consent, and clearly contemplated that this might occur; and
- in light of such express consent, the rights were assignable unless they constituted personal obligations of a character which could not be assigned in law or in equity (such as an employer's rights to the benefit of an employee).

Jacobson J did not consider that the rights were of such a personal nature and held that Rares J's approach was contrary to both established authorities and texts.[20] In any event, Rares J appeared to have incorrectly focused on whether *all* rights granted to Macquarie were capable of assignment, rather than whether the specific rights relied upon by Leveraged Equities to issue a margin call notice and sell the securities were assigned. As pointed out in the case of *Don King Productions Inc v Warren*, "assignability is not a matter of all obligations under a contract or none at all".[21]

Jacobson J also noted that, although the contractual arrangements under which Macquarie's loan book was sold were complex, there was a clear division between Leveraged Equities' rights as assignee and Macquarie's ongoing obligations to fund. As Jacobson J explained:

> … the ultimate effect of the Transaction Documents, so far as they concerned assignment, was that Macquarie bore the ultimate financial responsibility of providing further advances to the borrower, while Leveraged Equities, as assignee, had the right to repayment of the funds and the right to exercise powers on default.[22]

On a closer examination of the contractual documents, the arrangements were not unworkable and there were not two "banks" that could independently exercise the rights of a lender.[23] Accordingly, "[w]hether or not there was any bifurcation of rights as the primary judge suggested, there was certainly no duplication".[24]

This finding clarifies that there is no legal barrier to a lender assigning its right of repayment under a partially drawn or revolving loan while retaining the obligation to make future advances.

Notice

Jacobson J also disagreed with Rares J's interpretation of ss 12 and 170 of the Conveyancing Act. Rares J held that to perfect a legal assignment in accordance with s 12, the debtor must receive *actual* notice of assignment, and that deemed service in accordance with the service provisions of s 170 is insufficient. Although the comments were *obiter dicta*,[25] Jacobson J noted that where s 170(1)(b) is satisfied,[26] there will be a presumption under s 160 of the Evidence Act 1995 (Cth) that the notice was received, unless there is sufficient evidence to raise doubt as to the presumption.[27]

Unconscionable conduct

Rares J previously found that in requiring Mr Goodridge to meet the margin call deadline, Leveraged Equities had unconscionably insisted on its rights in breach of s 12CB of the Australian Securities and Investments Commission Act 2001 (Cth) (ASIC Act).

The court overturned this finding, stating that:

- s 12CB only applies to financial services of a kind ordinarily acquired for personal, domestic or household use;[28] and

- in any event, there is nothing unconscionable in a margin lender enforcing its legal rights to protect itself against a fall in the value of its security.[29]

The LSA contained a number of representations and warranties by Mr Goodridge. One of them was that the loan would be applied by Mr Goodridge wholly or predominantly for business or investment purposes. The court stated that whether the funds were subsequently invested for the purpose of providing for his retirement was not relevant to the question of whether s 12CB was engaged.[30]

In reaching this conclusion, it is unclear what weight was given to Mr Goodridge's business purpose representation. Whether financial services are of a kind ordinarily acquired for personal, domestic or household use is generally considered to be a question of fact.[31] The ASIC Act does not contain express provisions allowing business purpose declarations to be relied upon by a lender for the purpose of s 12CB. Nonetheless, given that the ordinary nature of margin lending arrangements was not discussed in detail, it appears that the court considers business purpose declarations to be of some relevance in considering whether such provisions of the ASIC Act are engaged.

Lessons to be learned

The *Goodridge* appeal contains a number of practical lessons for both bankers and lawyers.

Drafting

Clarity of drafting is critical.

The Goodridge litigation was primarily concerned with issues of construction which "would not have arisen had the Loan and Security Agreement (LSA) been competently drafted".[32]

In a short judgment focusing solely on the drafting quality of the LSA, Stone J noted that "[i]t is difficult to understand how the imprecision and ambiguity of the documentation could have escaped the scrutiny of competent and sophisticated parties and their advisors", and that "[m]ore precise use of language may well have avoided this expensive and time consuming litigation".[33]

In light of such scathing judicial comment, it is no surprise that law firms involved in the appeal have felt the need to expressly disclaim any involvement in the original drafting of the LSA. This is a forceful reminder to practitioners to ensure that contracts, particularly complex or standard form documents, are drafted clearly and precisely.

Assignment and novation clauses

Courts will give effect to clearly worded clauses prospectively authorising the assignment or novation of contractual rights and obligations (however, these clauses should be revisited in light of this judgment).

The decision clarifies that courts will give effect to clearly worded clauses prospectively authorising the assignment or novation of contractual rights and obligations. However, in light of this decision, assignment and novation clauses included in precedents and standard form documents should be revisited and may need to be amended. To avoid disputes, a clause granting prospective consent to the novation of a contract must clearly address and authorise all essential elements of a novation.

Notice provisions

Notice provisions should be carefully considered for each individual transaction.

Although Jacobson J indicated that parties may rely upon certain evidential presumptions regarding service, it is apparent that supporting evidence may still be required in limited cases.

Parties therefore need to consider if electronic communications such as email should be permitted under the terms of the document as an alternative to, or in addition to, traditional methods of post or fax. Not only is the dispatch and receipt of electronic communications governed by mostly uniform state and Commonwealth legislation,[34] but electronic communications may simplify record keeping and be easier to prove in the event of dispute. Notice provisions should not be blindly inserted as boilerplate, but rather need to be discussed with clients in light of their real-life systems and procedures.

Unconscionability

In the absence of any improper conduct, there is nothing unconscionable in a margin lender enforcing its legal rights to protect itself against a fall in the value of its security.

Provided that lenders act in accordance with the terms of their lending documents, to protect against adverse effects on the value in the security, it will be difficult for borrowers to challenge enforcement sales on unsubstantiated claims of "unconscionability".

Appeal

On 11 February 2011, Mr Goodridge filed an application for special leave to appeal to the High Court. The application submits that the Full Court of the Federal Court erred in finding that:

- there was a valid novation and assignment of the LSA; and
- that Leveraged Equities was authorised to sell Mr Goodridge's securities.

In considering whether to grant the application for special leave, s 35A of the Judiciary Act 1903 (Cth) states that the High Court may have regard to any matters that it considers relevant but must have regard to:

- whether the proceedings involve a question of law that is of public importance, or in respect of which there is differing judicial opinion; and
- whether the interests of the administration of justice require consideration by the High Court.

Even if special leave is granted, following such a critical and comprehensive rejection of the first instance decision, it is clear that any successful appeal by Mr Goodridge will need to overcome significant legal hurdles.

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Footnotes

1. *Leveraged Equities Ltd v Goodridge* [2011] FCAFC 3.
2. *Goodridge v Macquarie Bank Ltd* [2010] FCA 67.
3. *Goodridge v Macquarie Bank Ltd* [2010] FCA 67 at [120].
4. *Pacific Brands Sport & Leisure Pty Ltd v Underworks Pty Ltd* (2006) 149 FCR 395 at [32]; *Harry v Fidelity Nominees Pty Ltd* (1985) 41 SASR 458 at 460.
5. *Argo Fund Ltd v Essar Steel Ltd* [2005] 2 Lloyd's Law Reports 203; *Habibsons Bank Ltd v Standard Chartered Bank (Hong Kong)* [2010] EWHC 702 (Comm) at [28]; *Habibsons Bank Ltd v Standard Chartered Bank (Hong Kong)* [2010] EWCA (Civ) 1335 T at [20]–[22].
6. *216 Jamaica Avenue LLC v S & R Playhouse Realty Co,* 540 F 3d 433 (2008).
7. *Leveraged Equities Ltd v Goodridge* [2011] FCAFC 3 at [317].
8. *Habibsons Bank Ltd v Standard Chartered Bank (Hong Kong)* [2010] EWHC 702 (Comm).
9. *Leveraged Equities Ltd v Goodridge* [2011] FCAFC 3 at [313].
10. Above at [324].
11. Above at [328].
12. *Argo Fund Ltd v Essar Steel Ltd* [2005] 2 Lloyd's Law Reports 203; *Argo Fund Ltd v Essar Steel Ltd* [2006] 2 Lloyds Rep 134 at [320].
13. *Leveraged Equities Ltd v Goodridge* [2011] FCAFC 3 at [324].
14. Above at [329].
15. Above at [329]; *Goodridge v Macquarie Bank Ltd* [2010] FCA 67 at [111].
16. *Leveraged Equities Ltd v Goodridge* [2011] FCAFC 3 at [330].
17. Above at [331].
18. Above at [333].
19. Given that Jacobson J had concluded that the novation was effective, the comments regarding assignment may be considered *obiter dicta*.
20. *Leveraged Equities Ltd v Goodridge* [2011] FCAFC 3 at [360].
21. *Don King Productions Inc v Warren* [2000] Ch 291 at [319].
22. *Leveraged Equities Ltd v Goodridge* [2011] FCAFC 3 at [378].
23. Jacobson J noted that Leveraged Equities has the sole right to determine the "Market Based Limit".
24. *Leveraged Equities Ltd v Goodridge* [2011] FCAFC 3 at [386].
25. On the basis that Jacobson J held that actual notice was provided to Mr Goodridge: above at [410].
26. That is, a notice is left at or sent by post to the last known residential or business address of the person to be served.
27. *Leveraged Equities Ltd v Goodridge* [2011] FCAFC 3 at [414].
28. Above at [416].
29. Above at [417].
30. Above at [416].
31. *Barclay v English* [2009] QSC 258. See also Miller R, *Miller's Annotated Trade Practices Act Australian: Competition and Consumer Law* (31st edn), Law Book Co, Sydney, 2010, p 94, in relation to the identical term used in the definition of "consumer" under the (former) Trade Practices Act 1974 (Cth).
32. *Leveraged Equities Ltd v Goodridge* [2011] FCAFC 3 at [3].
33. Above at [11].
34. Electronic Transactions Act 1999 (Cth); Electronic Transactions Act 2000 (SA); Electronic Transactions Act 2000 (Tas); Electronic Transactions (Victoria) Act 2000 (Vic); Electronic Transactions Act 2003 (WA); Electronic Transactions Act 2001 (ACT), Electronic Transactions Act 2000 (NSW); Electronic Transactions (Northern Territory) Act 2000 (NT); and Electronic Transactions (Queensland) Act 2001 (Qld).