

Hopkinson v Rolt **no answer to** **McDonald's pickle**

*McDonald's Australia Limited v Bendigo and Adelaide Bank Limited
and Benalla Retail Investments Pty Ltd [2014] VSCA 209*





A recent decision from the Victorian Court of Appeal provides several important lessons in the area of commercial leases and mortgages. Report by **Matthew Bransgrove** and **Mark Poplewell**.

The Victorian Court of Appeal has unanimously upheld a decision denying McDonald's as lessee a right to setoff and any priority against Bendigo and Adelaide Bank as mortgagee.

McDonald's Australia Limited v Bendigo and Adelaide Bank Limited and Benalla Retail Investments Pty Ltd [2014] VSCA 209 concerned a parcel of land in Benalla, Victoria.

The case is replete with lessons for practitioners advising on commercial leases and mortgages, and dealing with issues of priority.

Background

The mortgagor/lessor borrowed \$1 million from the bank to purchase the land in October 2006.

The mortgagor/lessor entered into an agreement for lease with McDonald's in May 2007. This was provided to the bank by the mortgagor/lessor at the time, but this was only said to be 'for its records'. McDonald's itself apparently did not provide this document to the bank at this time.

The agreement to lease provided for McDonald's to build a restaurant on the land before the grant and commencement of the lease. Once the restaurant was built and the lease was on foot, the mortgagor/lessor was then required to pay McDonald's an amount capped at \$1.4 million for the costs it had incurred in building the restaurant. McDonald's was entitled to setoff the mortgagor/lessor's outstanding contribution against future rent.

In August 2007 the mortgagor/lessor sought finance from the bank to fund this looming debt based on the improved value of the land with the restaurant complete. This was offered by the bank in November 2007.

McDonald's had completed the works by December 2007, and the restaurant began trading.

The lease was formally granted in February 2008. The bank consented to the lease but at no point was its consent either sought or obtained to the agreement to lease.

Critically, McDonald's right to setoff was stipulated in the agreement to lease, but the lease itself made no mention of the arrangement.

The funds to pay out McDonald's were provided by the bank to the mortgagor/lessor in February 2008; however, McDonald's had not formally claimed the funds by this time and no requirement was imposed that these be advanced to McDonald's. The result, in the mild words of the trial judge, was that the funds were "deployed elsewhere" by the mortgagor/lessor.

The evidence from the bank's lending manager was that he was not aware that McDonald's had any right to setoff, and that he may have approached the advance differently had he become aware of that.

For reasons unknown, McDonald's delayed in formally claiming payment from the mortgagor/lessor between December 2007 and April 2009. One might speculate that this was due (at least in part) to insufficient staff allocation during peak business periods and/or a systematic breakdown in communication between 'McCafe' staff and those at the main counter.

Despite the delay, McDonald's did take some steps to protect its position. It lodged a caveat against the land in April 2008, asserting a caveatable interest by virtue of the mortgagor/lessor's unpaid (and as yet unclaimed) contribution towards the cost of building the restaurant. However, the evidence was that this caveat (and the assertion of an interest in the land of this kind by McDonald's) did not come to the bank's attention until 2009.

The funds provided by the bank to pay McDonald's were gone by the time that McDonald's formally claimed the mortgagor/lessor's contribution of \$1.4 million in April 2009. McDonald's presumably started to press its right to setoff rent against the mortgagor/lessor as a result.

In July 2011 the bank entered into possession of the land, directing that McDonald's pay rent to it. As the annual rent payable under the lease was \$169,000, it seems likely that at least \$1 million was still owing to McDonald's at this time for the cost of building the restaurant.

Dispute

The practical outbreak of the dispute involved a scuffle over McDonald's assertion of its right to setoff against the rent payable to the bank in possession. Out of that there emerged a full-blown priority dispute.

Unfortunately for McDonald's, the Court of Appeal agreed with the trial judge that McDonald's right to setoff in the agreement to lease was merely a personal right between it and the mortgagor/lessor.

While the mortgagor/lessor might have been bound, it did not affect the estate or interest in land of the bank in possession, assuming the mortgagor/lessor's position under the lease.

Further, because the court considered this to be the proper construction and characterisation of the lease and the agreement to lease, McDonald's failed to make out the elements of an equitable lien. The parties had structured their arrangements in such a way that McDonald's had only a personal right to recover the payment – it was not unconscientious for that structure to be maintained.

Hopkinson v Rolt?

The rule in *Hopkinson v Rolt* (1861) 11 ER 829 was considered among the contentions raised by McDonald's.

Both at first instance and on appeal, the court held that McDonald's did not adequately plead or advance a case of this kind at trial. In doing so, the court considered the rule and made some pertinent observations:

1. In its seminal form, the rule held that a first mortgagee whose mortgage is taken to cover what is then due, and also future advances, cannot claim the benefit of such future advances in priority over a second mortgagee of whose mortgage it had notice at the time of execution and before it made the future advances. In other words, it cannot claim that such future advances are tacked onto the first mortgage in priority to the second mortgagee.
2. The rule is nowadays not confined to competing mortgages.
3. The rule operates only when the first mortgagee has made a further advance or advances which are 'voluntary'. It has no application when the first mortgagee is bound to make, and the mortgagor bound to accept, advances made after the date of the second mortgage.

4. The rule does not operate when the further advances are made under a building mortgage so that each advance facilitates the construction of the building and increases rather than diminishes the value of the security.
5. The rule does not depend on the doctrine of estates. It rather derives from the equities arising out of the contractual relationship, which make it unconscionable for the mortgagor to further charge the property to secure a subsequent advance made by the mortgagee. The unconscionability of the mortgagor is then brought home to the mortgagee where there is notice.
6. While the rule does not require fraud, or any intention on the part of the mortgagee to displace the subsequent encumbrancer, it does require sufficient notice to the mortgagee in order to affect the conscience of the mortgagee (in addition to that of the mortgagor).

Sufficiency of notice

A key issue for any attempt to rely on the rule in *Hopkinson v Rolt* will therefore be the sufficiency of notice to the mortgagee.

Against the case made by McDonald's, the trial judge approved the remarks of Anderson J in *OCBC v MKIC and Aljade* [2003] VSC 495 at 547 that, in order for the rule to be operative, sufficient notice is required to sustain a charge of equitable fraud against the mortgagee.

This is consistent with the New South Wales authority of *Westpac Banking Corporation v Adelaide Bank Limited* [2005] NSWSC 517 (per White J), which gives practical content to this principle. In rejecting the applicability of the rule to certain advances in that case, his Honour held that although notice to the mortgage manager would be imputed to the bank, notice to the mortgage manager required notice to the person or persons representing its directing mind and will in relevantly controlling advances. Notice conveyed to a discharges clerk employed by the mortgage manager was insufficient according to this test.

Lessons

The trial judge did not consider the caveat lodged by McDonald's to be a form of notice or sufficient notice. Instead, he commented that in circumstances in which McDonald's knew that there was a mortgage and the identity of the mortgagee, it had effectively done nothing to communicate the nature and status of its claimed equity to the bank.

Merely lodging a caveat cannot be regarded as adequate notice to an existing mortgagee. Rather, specific notice to the mortgagee is required. The following propositions arise in terms of prudent practice for those acting for a mortgagee or lessee (or other party seeking to rely on some equity against an existing mortgagee) in the absence of a deed of priority:

1. You should write to the existing mortgagee before the additional interest comes about (be it a mortgage, lease, or other interest) giving it clear notice.
2. In the case of a corporate mortgagee, the letter should be addressed to those persons representing the directing mind and will of the mortgagee in respect of the advance of monies on account of the existing mortgage.
3. The letter should set out the nature of the interest of which notice is given, and any instruments under which it is said to arise.
4. The letter should refer to what is understood to be the amount for which the existing mortgagee has security (and therefore will have priority).



Matthew Bransgrove is senior partner at Bransgroves Lawyers and co-author of *The Essential Guide to Mortgage Law in Australia* (LexisNexis, 2014). Mark Popplewell is a partner at Bransgroves Lawyers specialising in mortgage and funder law.

Image credits: page 14 ©iStock.com/AndreyTTL, page 16 ©iStock.com/graf