Security over land

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Introduction

Lending secured on land remains an important part of their business for many lenders, whether they are providing commercial, investment or development finance, or lending to homebuyers. This briefing paper provides an overview of taking security over land in England and Wales. It is not intended to be comprehensive, and the focus is on commercial and investment property.

For the sake of convenience, we refer to the person giving the security (the mortgagor or chargor) as the “borrower” and the person taking it (the mortgagee or chargee) as the “lender”. The term “land” is used rather than a more technical legal term such as “real property”. It is assumed that title to the land is registered.

Form of security

Charge by way of legal mortgage

A lender will usually take security in the form of a “charge by way of legal mortgage”. This is a form of security created by statute, land being one of the very few types of asset where a charge can be legal rather than equitable. If the borrower is a company the mortgage may be contained in a debenture, as considered further below.

Land Registry issues

The mortgage may be a relatively short document and incorporate a set of standard terms by reference. More commonly in the case of commercial property, it will set out the terms in full. Use of the Land Registry form for a mortgage (CH1) is not, at present, compulsory. Like any other document referred to on the register, the mortgage is a public document and may be inspected, unless it can be designated an “exempt information document” containing potentially prejudicial information.

A lender may have its standard forms of mortgage approved by the Land Registry, which will simplify the registration process. A standard printed form of mortgage is also likely in practice to discourage negotiation of the document by the borrower. If an approved standard form mortgage does require any material amendment in a particular case, the changes may be put into a deed of variation, or the MD number on the document (allocated by the Land Registry to an approved standard form) may be crossed out and the registration application amended as appropriate.

Equitable mortgages and charges

If there is an agreement to create a legal mortgage, or the borrower itself only has a beneficial interest in the land rather than the legal title, the lender can only have an equitable mortgage or charge. This may also be the case where there is a defect in the formalities required to create a legal mortgage, but this will depend on the defect, and the lender may be left with no security.

In order to be effective, an agreement to create a legal mortgage must be in writing, signed by both the lender and the borrower, and must incorporate all the terms which have been expressly agreed. It should also be protected by a notice on the registered title.

The ability to create security merely by depositing a land certificate or the title deeds with the lender and, in the case of registered land, filing a “notice of deposit” at the Land Registry was abolished in 1995. Merely depositing a land certificate or the title deeds with the lender no longer creates an equitable mortgage, because an agreement in writing is required.

Mortgages by trustees or nominees

Practice varies, but if it is known that the registered owner holds it as a bare trustee or nominee, the beneficial owner is likely to be joined as a party in order to mortgage its beneficial interest in the land, and to avoid any possible claim that the mortgage constituted a breach of trust.

Security over part of the land

If the mortgage is over part only of an area of land, it should make provision so that, on a disposal on enforcement, appropriate rights are taken over or reserved against the land falling outside the mortgage.

Fixtures and chattels

A mortgage of land includes all fixtures annexed to the land, other than trade fixtures installed by a tenant under a lease granted while the borrower is in possession (i.e. before the lender has taken possession on enforcement). Such fixtures remain the property of the tenant. If there are occupational leases, tenant’s fixtures will often be expressly excluded from the mortgage. Where the borrower is itself a tenant, landlord’s fixtures are usually excluded from the mortgage.
If the mortgage includes fixtures or personal goods then the lender may sell them under the mortgagee’s statutory power of sale, but this does not allow it to sell them separately from the property. An express power to do so is sometimes included but, if given by an individual or partnership, this is likely to be void under the Bills of Sale Acts.

**Mortgage or debenture – the security package**

Whether, in the case of a corporate borrower, a lender takes a legal mortgage over land, or a debenture over all assets, is partly a commercial matter, but a number of issues are worth mentioning. A debenture is required if the borrower’s business is to be disposed of as a going concern.

A lender will generally require a debenture from an operating company or group. This will incorporate fixed and floating charges over all the borrower’s assets, including a legal mortgage over land which the borrower currently owns, and a charge over land which it may later acquire. Some lenders routinely take both a debenture and a mortgage over specific property, although this is unlikely to add much unless the debenture contains few detailed provisions about the lender’s land.

It is also common practice to take a debenture from a single-asset company, even though the land may be its only substantial asset. One reason for this originally was to enable the lender to appoint an administrative receiver under the debenture. By doing so, the lender could block the appointment of an administrator, which might otherwise delay or interfere with realisation of the security. Although a lender is in most cases no longer able to appoint an administrative receiver, there may still be advantages for the lender in taking a debenture, either because the borrower may have other assets for which a floating charge is appropriate, or because the lender may wish to enforce its security by itself appointing an administrator, as explained further below.

In any event, so far as practicable, the security should enable the lender to realise the full value of the secured assets, and it is difficult to cover fluctuating assets such as stock by way of a fixed charge. With property such as a hotel, the lender may require a debenture to cover assets such as stock, goodwill and business licences, and will also take security over assets such as the hotel management agreement. In the case of development finance, a full security package is likely to include assignments of the building contract, consents, plans, appraisals, warranties from sub-contractors, site purchase and sale agreements or agreement for lease, and security over matters such as shares in the borrower. The lender is also likely to require collateral warranties and step-in agreements from the contractor and members of the professional team, and often cost overrun and interest shortfall guarantees.

It is not possible to take a debenture covering all assets from an individual or a partnership (other than a limited liability partnership), because it would be ineffective as regards assets such as stock under the Bills of Sale Acts.

**Assignment of rent**

It is common for lenders to insist on an express assignment or charge over rental income from the property, either in the mortgage itself, or in a separate document. This is despite the fact that on enforcement the lender becomes entitled to future rental payments whether or not there has been an assignment of rent. There will often be provision for rental income to be paid to an account with the lender, and for this to be used to service interest on the loan.

**Might the security be re-characterised as floating?**

Concern has been expressed that the security may only take effect as a floating charge if the borrower is left free to enjoy rental income from the property. The analogy is with the many cases on security over book debts and other receivables, where the security will be floating if the borrower is left free to collect the book debts and to use the proceeds to fund its working capital needs.

A legal mortgage over land should not, however, be re-characterised as a floating charge merely because the borrower is left free to receive rental income until there is a default. Land is a capital asset, and the distinction between a capital asset and income from it is well established. The point may, however, be arguable in some situations, such as where there is a pre-agreed mechanism for releases of parts of the security. In addition, a charge over substantial plant and machinery may be floating where the borrower is free to replace it in the ordinary course of business.
Nonetheless, where the lender requires a fixed charge over rental income from the outset, is it advisable to include in the security document a specific charge or assignment over rent and a covenant to pay it into a blocked account, or to require an arrangement with the managing agent having an equivalent effect. Such an arrangement will also routinely be used where the lender is looking to rental income to meet interest and/or repayments of principal.

Security trustee
Where the loan is syndicated, the security should be held by a security trustee for the lenders. Failing that, the security itself may need to be transferred if there is a change in the syndicate. If the security is held only as agent for the lenders, and the property is not charged to all the lenders, there may also be difficulty in establishing that they are secured creditors on the borrower’s insolvency.

Execution of the mortgage
The borrower must execute the security document as a deed in order to ensure that the lender has a legal mortgage and the statutory power of sale under the Law of Property Act 1925, and that any power of attorney in the document is effective. It is common practice for the lender to sign the document as well, although not usually as a deed, and for it to state that it incorporates the terms of any side letter. The reason for this is to ensure that any agreement in the mortgage for the disposal of land – such as an agreement to mortgage property acquired after the date of the mortgage – is effective, since such an agreement must be in writing and signed by both parties.

Stamp duty
Mortgages are not liable to Stamp Duty Land Tax, and there is no requirement to submit a Land Transaction Return or to complete a self-certificate.

Registration

Land Registry
The mortgage will require registration at the Land Registry, which will send the lender a “title information document” on completion of registration. Lenders should request that original documents such as mortgages and priority agreements are returned to them by the Land Registry. Documents such as a facility letter referred to in the mortgage need no longer be lodged with the Land Registry. If the borrower is a company, the original certificate of registration at Companies House should be sent to the Land Registry, failing which the fact that the Land Registry has not seen it will be noted on the title.

A floating charge including land may be protected by the registration of a notice at the Land Registry. A purchaser will require a certificate of non-crystallisation (from the lender) if it acquires property against which a floating charge has been noted.

Companies House
A mortgage over land (wherever situated) by a company or limited liability partnership registered in the UK, including a registered overseas company, must also be registered with the Registrar of Companies within 21 days after the date of creation, failing which it will be void against a liquidator or administrator and any creditor of the company or limited liability partnership.

A mortgage or charge created by other non-UK companies no longer requires registration with the Registrar of Companies, although the practice of trying to do so – the so-called “Slavenburg” registration – has not yet entirely died out. It may also be appropriate to comply with any local filing requirements in the company’s place of incorporation.

Insurance
The lender will require the mortgaged property to be adequately insured, either in joint names or with its interest noted on the policy. It will generally insist that the policy includes a non-vitiation clause (so that it is not avoided as against the lender by any non-disclosure by the borrower), provision that the insurer will notify the lender before the policy is allowed to lapse for non-payment of premiums, and a waiver by the insurer of any right of subrogation against the lender. Some flexibility
may be needed where the mortgaged property is leasehold and the landlord insures under the terms of the lease, or there is a covenant to insure under a prior mortgage. The mortgage will generally require insurance proceeds to be used either to repay the lender’s facility or in reinstatement of the premises, subject again to the terms of any lease.

Since 1993 the amount of cover available against acts of terrorism from commercial insurance policies has been limited. The lender will usually want the right to require additional cover, which is generally available by making use of the Pool Reinsurance Company (known as Pool Re), but at an additional premium.

**Title and valuation**

**Investigation of title**

In practice, lenders will either instruct their solicitors to investigate title to the property, or will take a certificate of title from the borrower’s solicitors. The choice may depend on cost, the value of the transaction, complexity of title and timing. In either case the requirement is to obtain a good and marketable title, and to identify matters which might affect value or marketability. Various standard forms of certificate of title are likely to be acceptable to the lender, such as the City of London Law Society form for commercial property.

Where the security is over leasehold property, the lease should be reviewed, any necessary consent to the creation of the security obtained from the landlord, and notice of the mortgage given to the landlord where required.

**Valuation and survey**

In most cases the lender will instruct valuers to value the property, and the loan agreement may contain a covenant by the borrower to maintain a given loan to value ratio. Any discrepancy between the valuation and the purchase price, or a recent transfer of the property at a substantially lower price, are warning signs which require further investigation. A structural survey of the property is often also required.

**Environmental liability**

Lenders should seek to establish that land taken as security is free of any contamination or other environmental liability which might reduce the value of the security, or even potentially expose the lender (as a “deep pocket”) to liability for environmental clean-up costs. In particular, liability may potentially arise under the environmental legislation or at common law if a lender has taken possession.

The investigation of title should check that the local authority has not required any remediation of the property or any neighbouring land under the Environment Act 1995, and has not carried out any works the cost of which could be recovered from the owner of the property or charged on the property.

Under the Contaminated Land Regime found in the Environmental Protection Act 1990 a lender is potentially liable for clean-up costs as a person causing or knowingly permitting contamination (if it participates in the management of the borrower’s business) or as owner or occupier (but only if it is a mortgagee in possession).

In practice, there is little evidence of lenders being forced to meet environmental liabilities, but the concern is a real one, and in appropriate circumstances the lender should make a satisfactory environmental survey addressed to it a condition precedent. In addition to insurance cover, another possibility may be an appropriate indemnity (if available from the borrower group). An environmental risk assessment may also be appropriate before any enforcement of the security.

**Occupiers and co-owners**

A prime concern where the security includes residential property is that, on enforcement, the lender is able to dispose of the property free of any third party interest in the property or right of occupation. The considerations are, of course, different with rented commercial property, where the lender will require covenants in the mortgage requiring its consent to matters such as lettings, sub-lettings, surrenders and variations of leases, which might adversely affect the value of its security.
Overriding interests

The investigation of title should establish the existence of any “overriding interests” over the property, to which the lender’s security may be subject. Such interests may affect the value of the security, while any occupier’s rights will need to be waived or postponed to the interests of the lender in order to allow the property to be sold free of them. Where the right in question is a beneficial interest in the property or in the proceeds of sale, the owner of the right should generally be required to charge their beneficial interest to the lender or to enter into a deed of postponement, under which they acknowledge the lender’s priority in the event of enforcement.

Undue influence

Numerous cases demonstrate the risk to a lender that its security over residential property may be void on the ground of undue influence, particularly where it is, or contains, an element of third party security; for example where a jointly owned matrimonial home is charged to secure the business debts of, or obligations under a guarantee given by, either the husband or wife. Similar issues arise in relation to the waiver or postponement of an occupier’s rights. The risk of a successful challenge is minimised if the by now well known “Etridge” procedures are followed, by disclosing sufficient details of the transaction to the person providing security (with the borrower’s prior approval), requiring them to take independent legal advice, and obtaining written confirmation from the solicitor providing the advice to that effect.

Misrepresentation

Like any contract, a mortgage is at risk of being rescinded if there has been misrepresentation. In particular, it may be set aside if it can be shown that a misrepresentation was made by the borrower as agent for the lender or that the lender had actual, constructive or implied knowledge of the misrepresentation. The Etridge procedures should again be followed. Indeed in many cases where there is undue influence there will also be misrepresentation.

Other vulnerable security

Preference and undervalue

The principal ground on which security over land is likely to be challenged on insolvency is as a preference. This requires the borrower to have done something with the intention of putting one of its creditors or guarantors in a better position than it would otherwise have been in on an insolvent liquidation, such as granting it security for an existing guaranteed debt.

It had been generally accepted that the grant of security does not amount to a transaction at an undervalue, since it does not, in itself, deplete the borrower’s assets, but this now seems not to be invariably the case.

Clogs and collateral advantages

Lenders should also be aware of other rules which may make provisions of the mortgage unenforceable. One is the rule against a “clog [or fetter] on the equity of redemption”, which makes it unlawful for the terms of the mortgage to leave the borrower with no realistic possibility of redeeming it, although the application of the rule is now much diminished. Another is the rule against “collateral advantage” by, for example, requiring the borrower to pay the lender part of the profits of a hotel after redemption of the mortgage.

Corporate capacity and authority

A further issue for a lender is whether or not it is prepared to rely on various statutory provisions to confirm that the execution of security by a corporate borrower is within the borrower’s capacity and has been duly authorised. Opinion is divided on the point and it remains common practice for lenders either to rely on a certificate from a director or company secretary of the borrower, or to require certified copies of the relevant corporate authorities.
Third party security

Where security is provided by a person other than the borrower, a number of other issues arise.

Such security may comprise a guarantee backed by a mortgage over the guarantor’s property, or a mortgage over a third party’s property to secure the obligations of the borrower but without any personal obligation by the third party to pay. Whichever method is used, the third party is commercially in the position of a guarantor, and the same legal rules apply. A third party mortgage should include the usual protective provisions intended to guard against an inadvertent release of a guarantor by, for example, a variation of the terms of the loan agreement without the guarantor’s consent. Best practice is always to obtain written consent and re-confirmation from a guarantor or person providing third party security when the underlying facility is varied or replaced.

Third party security may be vulnerable to challenge on insolvency on grounds such as preference, or for lack of corporate benefit. The unanimous approval of shareholders to the giving of security will usually prevent a challenge that giving the security was a breach of the directors’ duties for lack of corporate benefit, but will not preclude a challenge on the ground of preference.

Priority and further advances

Securing further advances (tacking) and overdrafts

Whether or not a mortgage secures further advances depends, of course, on how the secured liabilities are defined. Where there is more than one registered charge over the same registered land, the holder of the first charge cannot, in any event, generally make (or “tack”) further advances ranking ahead of the second charge. The exceptions are where it has not received notice of the second charge, or is under an obligation under the terms of the first charge to make further advances and this is noted on the registered title at the time of creation of the second charge, or where the first charge secures a maximum stated amount and this is noted on the register at the time of creation of the second charge, or where a variation of priorities has been agreed between the lenders.

The point is particularly important with security for an overdraft if a second mortgage is registered. The general rule is that payments into the account are deemed to repay the earliest debits to the account, and further advances/drawings will rank behind the second mortgage. On becoming aware of a second mortgage, the borrower’s account should be “ruled off” to prevent the security for the then outstanding debt being reduced.

In practice, a lender wishing to make further advances is also protected if its mortgage secures further advances, and contains a restriction preventing the creation of any subsequent mortgage without its consent, which is noted on the title register. If so, it can insist on an appropriate inter-creditor agreement as a condition of consenting to the second mortgage.

Enforcement

Remedies

The lender will have rights in contract against the borrower for repayment, and also against any guarantor. So far as security is concerned, its main remedies against the property under a legal mortgage are to take possession, to sell the property, or to appoint a receiver (or, in some cases, an administrator). Although the term “foreclosure” is sometimes used to describe any enforcement process under a mortgage, it has a particular technical meaning under English law of extinguishing the borrower’s interest in the property and passing title to the lender. It requires a court order and is very rarely used.
Taking possession

Taking physical possession of the property will usually be a necessary preliminary to the sale of any residential property and will require a court order. In the case of tenanted commercial property, taking possession means stepping into the borrower’s shoes, in particular by notifying the tenants that future instalments of rent must be paid to the lender.

Lenders are reluctant to take possession of commercial property because, as a “mortgagee in possession”, they are then liable to account to the borrower and any subsequent secured lender not just for actual receipts, but for what they should have received from a proper management of the property, and must also take reasonable care of the property. There is some uncertainty whether or not a security package containing a specific assignment or charge over rent and requiring the borrower (or managing agent) to procure from the outset that it is paid to a blocked charged account with the lender will make the lender a mortgagee in possession. Many would regard this as “market standard”, and it is unlikely to amount to the lender having taken possession. The risk is probably greater where notice of the arrangement has been given to the tenants, but this is arguably still distinguishable from a true taking of possession (in the sense of depriving the borrower of control of the property) on an enforcement.

Appointment of receiver

The traditional way to deprive a defaulting borrower of control of the property, and also to avoid potential liability as a mortgagee in possession, is to appoint a receiver to collect rent, manage and dispose of the property. Such receivers are often known as “Law of Property Act”, “LPA”, “fixed charge” or “non-administrative” receivers, because they are usually appointed using the statutory power in the Law or Property Act 1925, under a fixed charge or mortgage (rather than under a floating charge), and also to distinguish them from administrative receivers.

The receiver acts technically as agent of the borrower, at least until any liquidation of the borrower, but is effectively acting on behalf of the lender. The receiver will often require an indemnity from the lender, but this should not extend to liability arising from any negligent conduct of the receivership.

The power to appoint a receiver is conferred by statute where the mortgage is by deed. A purely contractual power of appointment may also be contained in the mortgage. The powers conferred on a receiver by statute will be extended in the mortgage, but the receiver cannot deal with (or at least cannot retain the proceeds of) assets falling outside the fixed charge under which he or she was appointed. An LPA receiver may be removed by an administrator.

An administrative receiver is a receiver or manager of the whole or substantially the whole of a company’s property appointed by the holder of a debenture secured by an all-assets floating charge. The power derives from the Insolvency Act 1986. For debentures created after 15 September 2003, however, a lender may only appoint an administrative receiver in certain limited circumstances – principally in relation to capital markets and major project finance transactions – so such an appointment is now seldom possible in a property finance transaction.

Appointment of administrator

Since that date, a lender may itself appoint an administrator out of court if it has a floating charge security over the whole or substantially the whole of the borrower’s assets and the charge contains a power to appoint an administrator. Where there are no unsecured creditors, or little likelihood of any recovery for them, the administrator’s duties are likely to be little different in practice from those of an administrative receiver, and administration may be a viable means of enforcement, particularly if the borrower operates a business such as a hotel from the premises.

The consent of the administrator or of the court is required to enforce security (for example by selling it) when an application to appoint an administrator has been made or while the borrower is in administration.

Sale

The lender may sell the property either under the power derived from the Law of Property Act (where the mortgage is by deed) or under an express power of sale in the mortgage. The sale will be free of any subsequent mortgage, but subject to any prior mortgage. A receiver may sell the property if given power to do so in the mortgage, but will do so as agent for the borrower, so any subsequent mortgage will not automatically be overreached and must be paid off and a release obtained.
Both a lender and a receiver are under a duty to the borrower and any guarantor to achieve the best price reasonably obtainable on any disposal, but they are not obliged to delay a sale in a rising market, or to take steps to improve the property before a disposal. The prudent course is to obtain proper advice as to marketing, and preferably a valuation from two independent sources.

A lender cannot sell to itself, nor can a receiver sell to the lender, without the leave of court (the “self-dealing rule”), but it appears that a lender may sell to an associated person, so long as it takes rigorous steps to demonstrate that a proper price has been obtained (the “fair dealing rule”).

Remedies against third parties

The lender may also have remedies against third parties such as professional advisers; for example against a valuer if the property was overvalued when the security was taken. It is important that any relevant valuation was addressed to the lender. The lender must have relied on the valuation, but this is not necessarily displaced by the lender having mortgage indemnity insurance. Such alternative remedies should be taken into account in formulating the lender’s recovery strategy, particularly where a shortfall is likely on a disposal of the property.

Foreign borrowers

If the borrower is incorporated outside England and Wales, the lender should generally require a legal opinion from lawyers qualified in the borrower’s place of incorporation, covering matters such as the corporate existence and good-standing of the borrower, due execution of the documents, and any local taxation or registration requirements. The lender will also need to be satisfied, where applicable, that the borrower obtains clearance from HM Revenue & Customs to receive rental income without deduction of tax.

Difficult issues may arise on the remedies available on the insolvency of a non-UK company borrower. Simplifying slightly, for a lender with a qualifying floating charge to be able to appoint an administrator, the borrower must be a company registered in England and Wales or Scotland, or incorporated in another EEA state, or with its centre of main interests in an EU member state (other than Denmark). As the law stands, however, a receiver appointed under a debenture over the assets of a non-UK company should not be at risk of being an administrative receiver. If they were, the appointment would be unlawful because, as mentioned above, such an appointment can no longer be made in respect of a UK company, unless one of the exceptions applies.

Regulated security and consumer credit

Regulated mortgages

Since 31 October 2004, certain mortgage lending, administration, arranging, advising and advertising has been regulated by the Financial Services and Markets Act 2000 (“FSMA”). Briefly, FSMA applies where the borrower is an individual or trustee, the mortgage is secured by a first legal charge over UK property, and the property is at least 40% occupied by the borrower (or his immediate family). This has had a significant impact on those lending on residential mortgages. Mortgages by companies (unless a trustee for an individual) and second or subsequent mortgages are excluded. In order to take a regulated mortgage the lender must itself be authorised by the Financial Services Authority to make such loans. This can be an issue for lenders who only wish to make such loans on an occasional basis, which we are sometimes asked to advise on.

Consumer credit mortgages

The Consumer Credit Act 1974 regulates certain mortgages, but not where the mortgage is subject to FSMA. Such mortgages must be in a prescribed form and are only enforceable by court order. There are exemptions for loans to certain high net worth individuals where the credit exceeds £60,260, and for loans exceeding £25,000 made for predominantly business purposes.

Contact

For further information, please speak to your usual contact at Field Fisher Waterhouse.
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