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PRACTICE GUIDE FOR SECOND MORTGAGES

DEFAULT AND EXECUTION OF SECURITY

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Lenders often leave considerations regarding default and execution of security until it becomes necessary. After all, who grants a loan expecting it to default? This however often leaves lenders without a plan, or with the wrong impression about what they can do if a default arises.

In this publication, we will be addressing the rights and obligations of lenders if a default happens, and provide you some important tips about responding to a default and exercising your rights under land mortgages predominantly, but also other security.

This publication is designed for second mortgages, but some of the comments in this publication also apply to first mortgages, and of course apply to third and other subsequent securities for lenders with that risk appetite.

DISCLAIMER: *The advice in this publication is general in nature and should be viewed in light of your specific circumstances and transaction requirements. We encourage you to contact us to discuss your needs.*

RIGHTS OF A SECOND MORTGAGEE

Before diving into the manner of responding to a default and effecting execution of a mortgage, let's recap on the unique position of second mortgages and the rights of a second mortgagee.

Firstly, you will have learned from prior publications that in some jurisdictions such as Queensland, a second mortgage can be registered without the need to contact the first mortgagee. A second mortgagee in Queensland may wish to contact a first mortgagee to negotiate some specific requirements and sign a Deed of Priority, but may otherwise proceed with registration and rely on its rights at law.

In some other jurisdictions, such as New South Wales, a second mortgage cannot be registered without the written consent of the first mortgagee and this will usually result in a Deed of Priority being signed as a condition of that consent, should it be given.

We learned that once a mortgage is registered, ordinarily the first mortgagee is prevented from capturing in its security any additional advances made after the registration of the second mortgage, unless those advances where provided for in the loan document, which is one of the reasons why obtaining full details of the first mortgage security is very important for second mortgage lenders.

We also learned that caveats do not afford this protection. Whilst a caveat will prevent the registration of subsequent documents on title (subject to each jurisdiction), a caveat is not a mortgage and cannot be relied upon to effect power of sale.

WHAT TO DO WHEN A DEFAULT ARISES

This publication is designed for private lenders therefore we will not be considering the application of the Banking Code of Conduct. Lenders undertaking coded loans also need to have regard to the terms of the Credit Code.

The loan agreement will usually outline what qualifies as an event of default. Individual security documents may also include additional events of default. Defaults typically range from the obvious, such as failure to repay the loan on time, to less obvious, such as adverse changes in the Borrower's circumstances that affect the Borrower's ability to repay, this could include legal action involving the Borrower, loss of business, a project stalling. Insolvency is usually an event of default.

Here are our most important tips for when a default arises:

1. **Don't default the Borrower unless you mean to go through with it**

   Even if issuing a default notice will have beneficial effects such as increased interest rates, you should not issue a default notice unless you are prepared to call in the loan and execute. Anything short of this will only worsen your relationship with the borrower and/or affect your credibility, and will only serve to hinder any hope of a repayment or refinance by agreement.

2. **Always consider all consequences and risks of issuing a default notice**

   Shaky grounds of default can place you at risk of a damages claim if your notice of default has adverse consequences on the borrower, such as by triggering default on the first mortgage security or other credit arrangements of the borrower. Be sure to have all information necessary to satisfy yourself that a default has arisen. In some cases, you may prefer to wait for a payment default rather than relying on adverse change or other 'catch all' default grounds. Your lawyer will assist you in making the right decision for your particular circumstances.

3. **Have the notice of default prepared professionally**

   Most States and Territories have strict rules regarding effecting power of sale, including as to the form and contents of a notice of default. Whilst written demands issued by the lender may sometimes qualify, seek legal advice as to the strict requirements of the notice in the subject State or Territory of the mortgage, as failure to comply with the requirements could delay the exercise of power of sale, or worse, place you at risk of a damages claim should you proceed with power of sale on an incorrect notice.

4. **Don't forget your obligations to third parties**

   Most Deeds of Priority contain a requirement for a mortgagee to notify each other mortgagee when a default arises. They may also go beyond this and place limitations or procedural requirements on the exercise of power of sale. Don't forget to tell your lawyer about any Deeds of Priority and other agreements with third parties that may affect your exercise of default rights.

EFFECTING POWER OF SALE

Beyond the terms of your Deed of Priority with another mortgagee (if applicable) check with your lawyer as to any statutory requirements to notify other mortgagees on title when issuing a notice of default or undertaking power of sale.

Usually, it will be possible to appoint a real estate agent and commence the procedures to find a buyer once the notice of default has expired. However, most jurisdictions specify that a transfer of land by the mortgagee cannot be executed until at least a minimum time has elapsed from the issue of the notice of default.

THE QUEENSLAND POSITION

For most of our clients, who take mortgages of Queensland property, the statutory law does not contain any requirement to notify another mortgagee of the issue of a notice of default or the undertaking of any steps towards power of sale. Having said this, there may be obligations of this kind under a Deed of Priority and it is usually necessary to have some communication with other lenders on title, we will explain why.

A mortgagee can 'sell through' any mortgage or caveat subsequent to it. This means you do not require the consent or willing discharge of any subsequent mortgagee when effecting power of sale. A mortgagee must however account to any subsequent mortgagee for any excess proceeds.

A mortgagee cannot unfortunately sell through a mortgage ahead of it. A second or subsequent mortgagee will need to obtain the willing discharge or any mortgagee ahead of it. The only alternative to Queensland mortgagees is to require a transfer of the earlier mortgage in exchange for payout of the earlier mortgage.

An earlier mortgagee's priority however extends beyond these rights. If an earlier mortgagee becomes aware that a subsequent mortgagee has entered into possession or is effecting power of sale, the earlier mortgagee can enter into possession itself rendering the second mortgagee powerless. For this reason, and the need to obtain a discharge, it is wise for second and subsequent mortgagees to contact the first mortgagee to discuss what will happen. However, in the absence of a Deed of Priority requiring notice, a second mortgagee will need to make a tactical decision as to when to contact the first mortgagee.

EFFECTING POWER OF SALE

TAKE-OUT RIGHTS

The transfer right that exists in Queensland which we have just outlined may also exist separately in a Deed of Priority in what is sometimes referred to as a 'take-out' right. A take-out right is a right by which a mortgagee may require another mortgagee to either transfer or discharge its security upon payment of the total owing under that security.

Take-out rights in Deeds of Priority are a creature of the Deed of Priority document and must be interpreted strictly on their wording. Mortgagees should be aware if they are the subject of a take-out right and what effect this may have on their actions in connection with the default. For example:

1. **Check the payout figure before effecting take-out.**

   In some cases a take-out right is irrevocable, so it is important to get a payout figure advice before deciding whether to exercise the take-out right.

2. **Check if the other mortgagee will be exercising take-out.**

   You may be under an obligation to notify another mortgagee if a default occurs, that mortgagee may then have a period of time within which to exercise a take-out right. Generally, you should wait until this time frame has passed or obtain a written waiver before commencing significant or costly steps towards effecting power of sale as those costs may not be recoverable, particularly if you have little equity left to work with.

EFFECTING POWER OF SALE

ADVERTISING AND SELLING UNDER POWER OF SALE

Each jurisdiction will have specific requirements for effecting power of sale, including as to advertising and the mode of sale.

In Queensland, at least 30 days must have elapsed from a notice of default was given before exercise of the power of sale can be made, usually interpreted as the date of settlement of the sale contract. A statutory declaration to this effect will need to be attached to the transfer of land.

The Property Law Act 1974 (Qld) states that a mortgagee is under a duty to take reasonable care to ensure that the property is sold at market value. In particular, this means that you must, unless you have reasonable excuse:

1. Adequately advertise the sale (at least 4 weeks);
2. Obtain reliable evidence of the property's value (independent valuation);
3. Maintain the property, including by undertaking reasonable repairs (you have an obligation to properly present the property and any costs you incur can be added to your payout); and
4. Sell the property by auction, unless it is appropriate to sell it in another way.

Effecting sale is of course subject to the property not being occupied by the registered owner. If this is the case, possession is required before you can settle the sale of the property (naturally), and this will require a demand for possession, which, if not obliged with, will require an application to the relevant court for an order for possession. This can sometimes delay matters considerably.

If the property is unoccupied or occupied by a tenant, you can proceed to exercise power of sale without needing to enter into possession of the property, and this is always preferable as it avoids certain additional obligations that arise if you were to enter into actual possession, such as taking out insurance.

EFFECTING POWER OF SALE

We will now take the time to answer some frequently asked questions regarding advertising and selling under power of sale:

1. **The market for this property is really bad at the moment, can I wait a bit? do I have to?**

   You are not required to sell immediately but you should consider what would be a reasonable time. We recommend you proceed on the basis of written advice from a competent real estate agent. If you cannot wait, then you are not required to do so. The obligation to obtain market value is not an obligation to maximise value in so far as market conditions or waiting times might allow. You can sell immediately even if the market is not at its best.

2. **Can I sell the property to myself or a related entity for the amount in the valuation?**

   Generally, no. Foreclosure, that is the transfer of the property to a mortgagee in forfeiture of the debt, is a court awarded remedy only. Even if the lender proposed to pay the Borrower or if the Borrower agrees to the transaction, you still need to consider any other person who may be affected by the transaction. In some cases, even when 'market value' is offered, a court order is the only safe way to proceed.

3. **Do I have to have an auction? What if I have a really good offer on the table?**

   The Property Law Act 1974 (Qld) clearly states that a mortgagee can sell other than by auction if the circumstances warrant it. If going to auction may upset a great offer which is unlikely to be matched at auction, then these may be reasonable grounds to sell without an auction. To assist you against any later complaint, we recommend you obtain written advice from a competent real estate agent that recommends the manner in which you wish to proceed, if not by auction.

EFFECTING POWER OF SALE

4. Do I have to set the reserve at the valuation amount?

No. However, a mortgagee has a duty to take reasonable care to ensure the property is sold at market value. Evidence of value is required to give an indication, and care should be taken when setting the reserve. You can sell below the valuation amount if you need to, but you need to be satisfied that you did everything reasonable to achieve market value.

5. If the property is passed in, do I have to hold another auction?

It depends. If you are struggling to move the property by auction, then another manner of sale may be advisable. Possibly, you might want to wait for the market to improve, or there could be grounds to auction again with a lower reserve. There is no hard and fast rule, but you are required to take reasonable care to achieve market value. We recommend that you proceed on the written advices of a competent real estate agent.

6. Am I required to state in the advertisement that it is a 'mortgagee sale'? Can I?

There is no requirement to either say or not say that the property is being sold under a mortgagee sale, but you are required to take reasonable care to obtain market value, which may be affected by your decision. Again, speak to your agent about making this decision. The preference is usually not to include reference to the sale being a mortgagee sale in the advertising, though disclosure will be made when the auction contract is made available for viewing.

7. Are there any special terms that should be included in the contract for a sale by mortgagee?

Yes. There are terms in each jurisdiction's standard form real property contract that are unlikely to be suitable for mortgage sales, such as warranties you may not be in position to provide. If a buyer is likely to be put off by extensive disclaimers or 'as is where is' clauses, then another possibility may be to limit the buyer's rights to simply a refund of the deposit. This depends on your jurisdiction. We recommend you obtain legal advice and have the lawyer prepare their recommended set of special conditions to attach to the contract of sale.

EXERCISING OTHER FORMS OF SECURITY

It's easy for lenders to focus on selling the mortgaged property when a default arises. After all, the loan has usually been granted on the basis of the mortgage property being the primary security. However, loan facilities often include additional types of security which may be useful in some cases. Certainly, when providing a loan, you should consider all security that could be taken in connection with the facility.

PERSONAL PROPERTY SECURITY AND GSAS

You have probably heard of a 'GSA', your loans probably include it as a required security, but you may not know exactly what it is and how it works. A General Security Agreement or GSA is a mortgage over all personal property (both present and future) owned by the person or company it relates to, called the 'Grantor'.

Personal property is most things other than land and includes equipment, vehicles, as well as business assets and goodwill. Under the old system, a GSA over a company would have been known as a 'fixed and floating charge' and a GSA over a person's assets would have been known as a 'bill of sale'. Critically, the new system does away with a lot of technicalities by lumping all non-land property under the one category and encumbering it by this method of umbrella security, which applies both to property currently held and which is acquired in future while the GSA is in effect.

A GSA needs to be registered on the personal property securities register. Your lawyer will ordinarily attend to this as part of the settlement of the facility.

A GSA can be a useful security where the Grantor runs a business, because the GSA can then be used to requisition property of the business and possibly sell the business as a going concern. The usefulness of a GSA can however be affected by other GSAs that might be registered ahead of it and the specific security interests of suppliers and other third parties over specific assets.

Consideration of the application and execution of GSAs is beyond the scope of this paper, but it will suffice to say that you should not forget your GSAs! If the Borrower conducts a business or has sizeable personal property, bring this to the attention of your lawyer and seek advice about what can be done under the GSA.

PERSONAL GUARANTEES

Almost all loans to companies will come with a personal guarantee by the directors. In some cases, personal guarantees may be given by a third person such a parent. Personal guarantees can be tricky, it is important to get legal advice about the enforceability of a personal guarantee, which can sometimes be affected by the circumstances of the loan or the relationship of the guarantor.

Generally however, a personal guarantee is useful because no guarantor wants to become bankrupt. For some guarantors this can have worse consequences than others. A demand on guarantors should always be given in connection with the exercise of any other security.

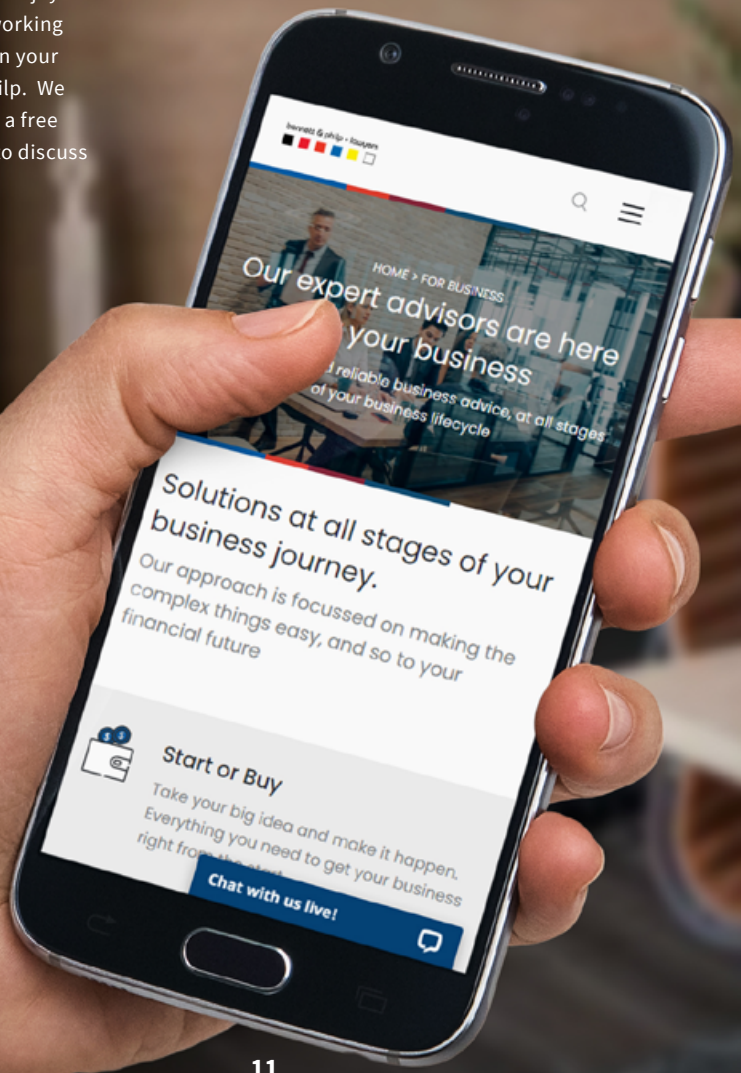
You should also bear in mind that most guarantees contain a charging clause. A charging clause allows a mortgage to be registered on the property of the guarantor. If you know of significant property in the name of a guarantor, be sure to bring this to your lawyer's attention.

CONCLUSION

We hope that this publication as assisted you in learning a bit more about your rights and obligations in case of a default. We hope we have given you some things to think about in terms of your current procedures and documentation.

If you have any questions regarding this publication or wish to discuss your policies and procedures with us, please don't hesitate to contact us.

Bennett & Philp provides practical, tailored and cost effective solutions for all mortgage transactions. Our clients enjoy regular advice, education and networking opportunities, which are included in your benefits as a client of Bennett & Philp. We provide all prospective clients with a free initial consultation, so call us now to discuss how we may be able to help.



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Contact us today and talk to us about how we can assist you in achieving your business goals and objectives.