SECURITY SERIES: Getting the most out of

Ben Sewell provides a series of articles to assist Credit Managers with techniques to obtain security from debtors to bolster debt recovery prospects. The subjects in the series are personal guarantees, mortgages over real property, fixed and floating charges, and trading stock.

This article aims to give Credit Managers an overview on how to obtain an effective security over real property and explains some of the pitfalls that may undermine the security.

Ben Sewell

What is a security? It is collateral that supports the payment of an obligation. The American Uniform Commercial Code defines a security simply as "an interest in property which secures payment or performance of an obligation".

Scenario: You're approached by one of your customers, Mr X, a director of XYZ Pty Ltd, and he explains that as a result of current economic conditions, he is facing a cash flow crunch. It appears to you that Mr X is doing everything he can to keep his business afloat while he waits for new projects to bear fruit. You know that XYZ Pty Ltd's trading account has been slipping for months and it now sits at $60,000.00. This is the limit of what your company will allow. Mr X doesn't want you to close his account and commence enforcement action against him, so he offers to provide a mortgage over an investment apartment he owns on the Gold Coast. Your General Manager has known Mr X for over ten years and he is enthusiastic about this idea.

Why is real property good collateral?

Real property is owning land and it is distinct from personal property, such as a motor vehicle. Real property is considered good collateral because it is historically a more stable and valuable asset that tends to hold its value over time. It is also protected by registration from unauthorised transfer and ownership is readily identifiable.

In the scenario, if we assume that the investment property has a first mortgage in favour of a bank, it would be important to ascertain the value of the equity available in the property, i.e. what the bank isn't already entitled to under the first mortgage. If there is no equity in the property there is no point going to the trouble of drawing up a mortgage.

A canny Credit Manager in the scenario would undertake a purchaser's index property search for Mr X and ascertain all of the real properties that he owns. You may expect that Mr X's family home may be a more valuable property than an investment apartment. The Credit Manager finds that Mr X has a free standing property in Mosman in New South Wales and, based upon initial searches, finds that there is a greater amount of equity available in that property because it is unencumbered by any registered mortgages. On this basis, the Credit Manager may inform Mr X that they require a mortgage over the Mosman property because it is a more valuable asset.

What is a mortgage over real property?

Credit generally consists of a debtor providing an undertaking to pay money on certain terms and conditions. This obligation may be secured by a mortgage over real property.

A mortgage over real property is attractive to a creditor because:

- It gives the creditor a certain level of priority over other creditor claims;
- It provides a right to a power of sale in the event that the mortgagor defaults on their obligations.

This means that if a valid mortgage is provided by Mr X over his Mosman property the Credit Manager's company will obtain an actual proprietary interest in that property and upon the debt being paid it will be required to extinguish the mortgage formally.

There are two broad categories of a mortgage:

- a legal mortgage; and
- an equitable mortgage.

A legal mortgage involves the creation of a security interest in real property and this interest is accepted as registrable by the land titles office in the state where the property is situated.

On the other hand, if for some reason the documentation is not accepted as registrable because it doesn't fulfil a formal requirement of the land titles office but there is a valid assignment of an equitable interest in the property (i.e. a good contract), there will still be an equitable right to a mortgage.

a mortgage

The pitfall with an equitable mortgage is that if the mortgaged property was sold and the purchaser was not aware of the mortgage the mortgagee would lose its priority to the purchaser. This would mean the loss of the proprietary interest in the land. The legal principle is that a bona fide purchaser for value without notice of an interest in the property has priority over an unregistered equitable interest.

A registrable mortgage and an equitable mortgage both have similar enforcement rights including the power of foreclosure, power of sale and the power to appoint a receiver over the property.

What do you do if you don't have a registrable mortgage?

If the Credit Manager in the scenario obtained a valid equitable mortgage over the property they should then take steps to protect that right by registration. The usual course would be to file a caveat over the property to provide a warning to any potential purchases or other mortgagees of the Credit Manager's right to the property.

Getting first priority is what you need to do

The Credit Manager in the scenario should understand that obtaining the mortgage is a form of conveyance and it should be referred to a solicitor. Under legislation across Australia, there is a requirement that the transfer of an interest in land must be made in writing. This means that a verbal promise by Mr X is not sufficient to create a caveatable interest in the property. Property legislation across Australia only permits the registration of dealings, such as a mortgage, provided they are in a form that is accepted by the Registry (i.e. registrable form). In the State of NSW, the current form can be downloaded in PDF format at Form 05M at:

http://www.lands.nsw.gov.au
under Dealing forms

This form is generally referred to as the "front page" and it identifies the mortgagor, mortgagee, land and includes for the annexure of further terms and conditions.

One issue that has come up in the past is the use of a mortgage contract to further a collateral purpose. For example, the Credit manager in the scenario might decide to include a covenant that requires Mr X to use his company as a supplier for all future purchases. This form of covenant is prohibited by section 47 of the Trade Practices Act as it is an anti-competitive covenant.

Can you include a charging clause in your credit application?

A charge is a fixed security over property. This is a more vague security interest than a mortgage but it is useful for credit managers.

It is important for a credit manager to consider the difference between a charge and a mortgage over real property because it has become accepted that suppliers may include a clause providing a right to a charge over any real property owned by customers as part of normal contractual documentation, i.e. a credit application. Credit managers should therefore include a charging clause in contract documentation to give their company a security over a customer's real property holdings. For example, the following clause may be included in a director's guarantee document:

"For the purpose of securing payment the Guarantor hereby charges all of their real and personal property (including all property acquired after the date of this agreement) whatsoever in favour the Creditor with all sums of money, whether present, future or contingent, to which the Guarantor may be liable to pay"

The reason that a credit manager would be wise to include a charging clause in a credit application or director's guarantee is that a mortgage will not include any property that doesn't presently exist. A charge is capable of existing over present and future property therefore including future real property purchases by your customers.

If the Credit Manager in the scenario had a credit process in place which included the entry of a director's personal guarantee for the opening of a credit account and the guarantee provided a charge of all the real property owned by the director the necessity of obtaining a mortgage may be avoided. The Credit Manager may then be able to lodge a caveat over both the Mosman and Gold Coast properties to protect this interest.

Credit Manager's Checklist

- Undertake a purchaser's index search for the customer
- Assess the value of real property owned by any person offering a mortgage through a valuer
- Include a charging clause in your credit application and director's guarantee
- Upon default register a caveat under your charging clause upon all of the customer's real properties
- If you want to obtain a mortgage over a customer's property consult a solicitor
- Consult a solicitor regarding whether any stamp duty is payable on the mortgage transaction ■

Real property is considered good collateral because it is historically a more stable and valuable asset that tends to hold its value over time.

Ben Sewell of Sewell Lawyers is a Sydney-based lawyer who specialises in debt recovery.
www.sewell.com.au