

DISCUSSION PAPER ON HERITABLE SECURITIES: DEFAULT AND POST DEFAULT

EXECUTIVE SUMMARY

Introduction

1. The Scottish Law Commission has published a new discussion paper as part of its review of the law of heritable securities.
2. A heritable security is a right in security held over land or buildings. In Scotland, the only form of heritable security which can be granted is known as a standard security. In England and Wales, the equivalent form of security is known as a mortgage.
3. The Discussion Paper on Heritable Securities: Default and Post-Default (Scot Law Com DP No 173, 2021) is the second of three consultation papers planned for this project. The first paper, published in June 2019 (Scot Law Com DP No 168, 2019), focused on pre-default issues including creation and assignment of standard securities. The third paper, due for publication in early 2023, will deal with two complex, technical issues in the law of heritable securities, namely sub-security arrangements and securities over non-monetary obligations. The results of all three papers will be drawn together in a final Report including a draft Bill, intended for publication in 2025.

Background to the project

4. The use of land and buildings to secure debt is essential to the Scottish economy. Without heritable securities, many people could not afford to buy their homes or grow their businesses.
5. The purpose of a heritable security is to ensure performance of the obligation secured by it. Typically, performance will involve repayment of a loan. Where the debtor defaults on repayments, a standard security allows the holder to exercise certain remedies, typically to sell the property in which the security is held and recoup the amount outstanding on the loan from the sale proceeds.
6. The main work of this Discussion Paper is a systematic review of the process by which a standard security is exercised. The law in this area has been criticised at the highest level for various reasons including its complexity. The key piece of legislation, the Conveyancing and Feudal Reform (Scotland) Act 1970, has been subject to a patchwork of amendments over time, leaving it in an unsatisfactory state. The paper seeks views from consultees on 69 questions about how to achieve a streamlined process for exercising a security, fit for modern practice, which strikes the appropriate balance between the interests of debtors and creditors.
7. Responses to the consultation should be provided by **1 April 2022**. Information on how to respond can be found at the end of this summary.

Issues for consideration

8. The paper is divided into 16 chapters. The introductory chapter provides an overview, and the final chapter contains a list of the consultation questions asked earlier in the paper. We summarise the key issues covered in the other 14 chapters below.

Chapter 2 – Preliminary issues

9. This chapter sets out the key components of a standard security and explains some of the terminology we employ. It provides an outline of the revised scheme for exercise of a standard security on which we consult in the remainder of the paper.

10. It also seeks views on three preliminary matters. First, should a security holder be subject to a general duty to conform with reasonable standards of commercial practice when exercising a standard security? Second, should a debtor have the right to repay the debt owed in full and obtain a discharge of the security at any point up until the security holder has concluded missives for the sale of the security property? Finally, we ask for the views of consultees on whether any reform is required to the law in relation to enforcement of an older form of heritable security, the *ex-facie* absolute disposition, of which very few continue to exist.

Chapter 3 - Ranking

11. It is possible for more than one standard security to be held in the same property. The law sets out default rules on where one security ranks in relation to the other, determining each security's "place in the queue" for enforcement. The law on ranking of standard securities is relatively established but certain ambiguities are discussed.

12. We ask if the principle *prior tempore, potior jure* ("earlier by time, stronger by right") should be restated in statute insofar as it applies to standard securities.

13. The law currently permits a subsequent security holder to restrict the priority of an earlier security by giving notice. In practice, parties often seek to avoid this outcome. We ask whether a subsequent security holder should continue to have this power, and if so, whether voluntary advances by a prior security holder after it has received such a notice should be considered unsecured.

14. Parties to security arrangements can enter into ranking agreements to set out how their securities will rank as against one another. We ask whether consultees agree with our proposals that parties should remain free to enter into such an agreement, that new legislation should require such agreements to be in writing, and that registration of such an agreement in the Land Register is necessary to give it real (not purely contractual) effect.

Chapter 4 - Default

15. A standard security can be exercised following default by the debtor. The meaning of default in the Conveyancing and Feudal Reform (Scotland) Act 1970 ("the 1970 Act") has caused difficulties, most notably that a failure to make agreed repayments on a loan is not, in itself, a default as defined by the Act. This conflicts with the usual understanding of the term.

16. We propose that the security holder should be entitled to exercise remedies where there is a failure to perform the secured obligation, or in other circumstances as agreed between the parties to the security arrangement. We seek views on whether there are other circumstances which should be defined as default in any new legislation rather than left to parties to decide.

Chapter 5 - Notices

17. Under the 1970 Act, a security holder who wishes to exercise a standard security may (or in some cases, must) serve one of two notices: a calling-up notice or a notice of default. We review the difficulties these two notice procedures have given rise to in practice, including difficulties with service.

18. We seek views on a streamlined notice procedure, in which a new “default notice” must always be served by any security holder seeking to exercise its security.

19. We ask a number of questions about the form and content of the default notice and methods by which the notice can be served. We also ask whether there should be a bespoke route to challenge a default notice in court.

20. We seek views on how long a debtor should be given to comply with a default notice, and where they do not comply, for how long a security holder should be entitled to rely on an expired notice as a basis to exercise the security. We also ask about the effect on an expired notice where the default is later purged by the debtor.

Chapter 6 - Court orders

21. The circumstances in which the current law requires a security holder to obtain warrant of the court to exercise remedies are complex, depending on the nature of the default, the form of notice procedure employed and the remedy the security holder seeks to use, amongst other factors.

22. We seek views on a simplified scheme whereby a court order is not required, except in cases to which the enhanced debtor protection measures apply, and/or where a security holder seeks to eject occupants from a property or to foreclose (meaning to take ownership of the property for itself).

23. We ask if security holders should be able to apply to the court for relevant orders in relation to exercise of remedies even where not required by law.

24. We seek views on the appropriate court procedure for such actions and the prescriptive period that should apply to any order obtained.

Chapter 7 - Enhanced debtor protection measures: application

25. Current legislation provides enhanced debtor protection in cases where the security property “is used to any extent for residential purposes”. Our review of the policy background, case law and commentary suggests this application criterion does not effectively capture the persons intended to benefit from the enhanced protections, namely owner-occupiers and their families at risk of homelessness as a result of a security being exercised.

26. We seek views on the provisional proposal that enhanced protection measures should apply in future when two criteria are fulfilled:

(a) the debtor or owner is a natural person (“the person criterion”)

(b) the security property is a dwelling house (“the property criterion”).

Chapter 8 - Enhanced debtor protection measures: content

27. Enhanced protection is provided to debtors under the current law via two key measures: the security holder must comply with a number of pre-action requirements aimed at resolving default before it takes steps towards exercising its security; and a court order is required for the exercise of any remedy, which the court will grant only where it is reasonable to do so in all the circumstances of the case.

28. We do not suggest any changes to these “headline” requirements, which reflect relatively recent Government policy, but seek views on some changes designed to remove

ambiguities in the current legislative drafting, and ask whether any additions or deletions are required in relation to the list of pre-action requirements, or the factors to which the court is directed to have regard when determining the reasonableness of an application.

29. We also seek views on a slightly modified waiver procedure to replace the current “voluntary surrender” procedure where a debtor who benefits from the enhanced measures wishes to co-operate with the security holder in the sale of the property.

Chapter 9 - Remedies: general principles

30. The remedies available to a standard security holder under the current legislation are:

- Ejection of the debtor
- Entry into possession of the security property
- Grant and administration of leases of the security property, with collection of rents
- Sale of the security property
- Foreclosure (meaning direct acquisition of the security property by the security holder).

31. We ask whether the same remedies should be available under new legislation, and seek views on whether any additions are required, considering specifically the remedy of receivership available to mortgage holders in England and Wales.

32. We seek views on whether any restrictions should be placed on a security holder's choice between remedies, and about whether or when consent should be sought from other security holders to the exercise of remedies where more than one standard security is held in the same property.

33. We also ask about how the proceeds of the exercise of a remedy should be applied, suggesting little change may be required from the position under the current law.

Chapter 10 - Ejection

34. A security holder will normally require vacant possession to sell or let the security property, and if the debtor or owner will not flit voluntarily, a court order will be required to dispossess them. The current law in relation to this remedy is antiquated and unnecessarily complex.

35. We seek views on the suggestion that new legislation should allow a security holder to eject any person in natural possession of the security property where that person has no legal basis to occupy.

36. We explore the position of private residential tenants and ask whether an order for possession under tenancy legislation should be required for their removal.

37. We ask whether the law should provide guidance on how the security holder's duty of care in relation to moveables left behind in the security property may be discharged.

Chapter 11 - Possession

38. Confusion arises under the current law as to whether a security holder is “in lawful possession” of the security property only where it takes possession through a tenant, or also where it changes the locks or otherwise controls the boundaries of an unoccupied property, usually as a prelude to sale. Following a review of relevant case law and connected legislation, we suggest new standard securities legislation should define possession to include the latter as well as the former, and ask for views.

39. We discuss a security holder's rights and liabilities on entering into possession and ask, among other things, to what extent a security holder should assume the obligations of the owner (or registered tenant) in relation to the management and maintenance of the security property.

Chapter 12 - Rents and Leases

40. It is possible for a security holder to use rents generated from the security property to pay off the secured obligation. The security holder may also let the security property.

41. We ask if a security holder's right to collect rents, and grant and administer leases, should follow automatically from taking possession of the security property as under the current law. We seek information on current use of the remedy of granting leases, and ask whether any changes are required in new legislation, particularly in relation to the duration of lease a security holder may grant without a court order. We also ask whether the right to collect rents should include rent arrears.

42. We seek views on the suggestion that, as under the current law, a security holder in possession should be entitled to exercise the rights, and should also assume the obligations, of the owner or registered tenant relating to any lease or sub-lease of the security property.

Chapter 13 - Sale

43. The power to sell the security property is perhaps the most important remedy available to the security holder. We discuss how that power becomes available to the security holder, and ask if a court order should be required for sale even where the enhanced debtor protection measures do not apply.

44. We ask whether the security holder should continue to have a choice between selling the security property by private bargain or public auction.

45. We ask about the security holder's duty to obtain the best price for the security subjects and if legislation should provide a list of non-exhaustive factors which could be considered by a court to determine whether that duty has been discharged.

46. We discuss the position of purchasers who buy the security property from a standard security holder exercising their right to sell. We seek views about the conditions that need to be met before such a purchaser's title will be protected against challenge on the basis of irregularities in the sale process.

Chapter 14 - Foreclosure

47. Foreclosure refers to the remedy by which the security holder acquires the security property. It is seldom used in practice. A court decree is required before a standard security holder can foreclose.

48. We seek views as to whether any reform of the foreclosure process is needed, and if so what such reforms should be.

Chapter 15 - Expenses

49. The current law provides that the debtor is liable for the expenses incurred by the security holder in exercising the security. Although this is generally accepted as appropriate in principle, there are ambiguities in the drafting of the relevant legislative provisions.

50. We suggest that, under any new legislation, the debtor will be required to pay expenses which are “reasonably occurred” by the security holder. This will relate to both the reasonableness of incurring the expense and the reasonableness of the amount of the expense.

51. We also suggest that the expenses of litigation incurred in exercising the security should be recoverable only insofar as agreed between the parties or awarded by the court.

52. We seek consultees’ views on both these provisional proposals and ask if any alternatives would be preferred.

Consultation period

53. The Commission is very keen to hear from everyone with an interest in the issues raised in the Discussion Paper. Comments on all or some of the questions raised can be made until 1 April 2022, and will help shape the recommendations to be made in our final Report. A response form can be found on our current consultations webpage available at: <https://www.scotlawcom.gov.uk/law-reform/consultations/>.

54. Further information can be obtained by contacting the project manager Stephen Crilly, Scottish Law Commission, 140 Causewayside, Edinburgh EH9 1PR; Tel: 0131 668 2131; email info@scotlawcom.gov.uk.