

DISCUSSION PAPER ON HERITABLE SECURITIES: NON-MONETARY SECURITIES AND SUB-SECURITIES

EXECUTIVE SUMMARY

Introduction

1. The Scottish Law Commission has published its third Discussion Paper on Heritable Securities, exploring issues around non-monetary securities and sub-securities.
2. The Commission project on Heritable Securities, which started in 2018, is the first broad review of the law in this area since the Conveyancing and Feudal Reform (Scotland) Act 1970 (“the 1970 Act”). The first Discussion Paper in the project (Scot Law Com DP No 168, 2019) addressed a number of pre-default issues, including the creation and assignation of standard securities. The second Discussion Paper (Scot Law Com DP No 173, 2021) sought views on default and post-default issues, including the process of exercising a security to enforce payment of the underlying debt.
3. Consultation on the third paper runs until **29 September 2023**, and information on how to respond can be found at the end of this summary. The results of consultation on all three Discussion Papers will be drawn together in a final Report and draft Bill, anticipated in 2025.

Background to the Discussion Paper

4. 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. The purpose of a standard security, as with any right in security, is to ensure performance of an underlying obligation. Exercising the security allows the holder to raise money from the security property, usually by selling it, and then to apply the money in satisfaction of the secured obligation. This is an appropriate remedy where the secured obligation is the payment of money, as is most commonly the case. However, the 1970 Act also permits standard securities to be taken in respect of non-monetary obligations (or obligations *ad facta praestanda*). One example of a situation where this commonly occurs is where a land owner enters an option agreement in which they undertake to transfer their land to a developer at a future date if particular conditions are met. The developer may seek the grant of a security in respect of that obligation to transfer land.
5. Where the secured obligation is non-monetary, there is an obvious mismatch between the purpose of the right in security (to ensure performance of the non-monetary obligation) and the remedies that the security makes available (which primarily operate to generate money from the security property). In this Discussion Paper, we consult on options for reform to clarify how standard securities for non-monetary obligations should operate.
6. A sub-security arrangement describes the situation where a standard security is taken over an existing standard security. Unlike a more conventional arrangement, where the security property is land or the tenant’s interest in a lease, the security property in this arrangement is itself a standard security. Sub-securities are used in securitisation and debt warehousing transactions in the commercial finance sector as well as in certain complex land transactions.

7. It is unclear how a standard security taken over another standard security can be exercised to enforce the secured obligation. This limits the practical utility of sub-securities and calls into question their conceptual soundness. We tentatively propose that the competence of such securities be discontinued.

Issues for consideration

8. The Discussion Paper is made up of eight Chapters. The first is an introductory Chapter. The final Chapter is a list of the questions asked throughout the Discussion Paper. We summarise the content of the six substantive Chapters below.

Chapter 2 – Development and current law

9. In this Chapter, we explore the background to securities for non-monetary obligations in Scots law, with particular reference to developments in the law of real burdens in the 19th century. We examine archival materials contemporaneous with the Bill which became the 1970 Act, finding that no clear picture emerges of how non-monetary securities were intended to be exercised. We also consider the modern commentary on non-monetary securities.

10. We set out a number of examples of non-monetary obligations for which standard securities are often provided in current practice. These examples can be divided into two broad categories. The first category concerns obligations where the purpose of taking the security is to ensure payment of money to the creditor, either because the obligation itself has a financial element or because the creditor would be satisfied with payment of damages where the obligation itself is not performed. We consider how this first category of obligations can be catered for within a reformed law of standard securities in Chapter 3.

11. The second category concerns obligations to transfer land or grant a subordinate real right – an example being obligations found in option agreements. We consider whether, and how, such obligations should be protected beyond the usual contractual remedies in Chapter 4.

Chapter 3 – Securing non-monetary obligations

12. We ask consultees to consider two options for reform in relation to non-monetary obligations which fall into the first category discussed above. Option (1) is that a standard security should no longer be capable of securing non-monetary obligations, but should continue to be capable of securing substitutionary monetary claims. Option (2) is that a standard security should be capable of securing non-monetary obligations, but with legislation providing that the security holder is entitled only to damages for non-performance of the secured obligation.

13. We also consider how non-monetary securities ought to be ranked in insolvency or on default, and ask whether specific provision under any new legislation is required to deal with the ranking of non-monetary securities.

Chapter 4 – Protecting obligations to transfer land

14. The purpose of taking security in respect of an obligation to transfer land (or to grant a subordinate real right in land) is to give a form of third-party effect to the secured obligation by

making it visible on the Land Register. This publicity will discourage other parties from buying or otherwise dealing with the land without contacting the security holder first. It may also, in some circumstances, allow for a transfer of land (or grant of a subordinate real right) in breach of the obligation to be reduced by the creditor under the so-called rule against offside goals.

15. We ask whether the law should provide a means by which contractual obligations to transfer land can be protected beyond the usual contractual remedies. If so, we ask whether such protection should continue to be afforded by the grant of a standard security and reliance on the offside goals rule, or whether the law should provide a bespoke mechanism for protecting obligations to transfer land.

16. Our provisional view is that a bespoke mechanism for protecting obligations to transfer land is desirable, and we suggest that a modified version of the advance notice scheme found in Part 4 of the Land Registration etc. (Scotland) Act 2012 is the most appropriate way to achieve this goal. We tentatively refer to this proposed new scheme as the 'conditional advance notice' scheme, and seek input on this name.

17. Broadly speaking, the conditional advance notice scheme would operate so as to protect the priority of a deed and performance of the obligation to deliver that deed against the grant of competing deeds during a particular time frame. Detailed proposals for the scheme are discussed. We ask a number of questions in relation to its operation, covering matters such as:

- what the content of the conditional advance notice should be;
- who should be capable of making an application for a conditional advance notice;
- where the conditional advance notice should appear on the Land Register;
- what the length of the protected period should be and whether it should be possible to extend that period;
- whether the scheme should protect against involuntary competing deeds and inhibitions as well as voluntary competing deeds;
- whether provision should be made to deal with the situation where a claim protected by a conditional advance notice is assigned;
- when and in what circumstances a conditional advance notice should be discharged; and
- whether there should be an exception to the conditional advance notice scheme in relation to purchase options held by tenants in respect of leased property.

Chapter 5 – Alternative mechanisms for protecting obligations to transfer land

18. The proposed conditional advance notice scheme is, of course, not the only possible mechanism for protecting obligations to transfer land. In this Chapter, we briefly consider three further options for reform: alternative provision within the law of standard securities, a new form of personal real burden, and a "personal charge" which could operate as a future or conditional inhibition. We ask if consultees consider that any of these mechanisms ought to be explored further.

Chapter 6 – Sub-securities: development and current law

19. This Chapter discusses the development of the law in relation to heritable sub-security arrangements and identifies some situations in which these arrangements are used in practice. We note that sub-security arrangements are most commonly employed in securitisations and debt warehousing transactions. A detailed explanation of a basic mortgage securitisation structure is provided. We ask if consultees are aware of other examples of the use of sub-securities in practice.

Chapter 7 – Sub-securities: reform options

20. In this Chapter, we seek views on our provisional proposals for reform of the law in relation to sub-securities. A standard security is an accessory right. Its purpose is to ensure the performance of the claim it secures. It does this by allowing for funds to be realised through (usually) the sale of the property in which the security is held. The funds are applied in satisfaction of the secured claim. The market value of the claim is enhanced by the existence of the security, since it increases the likelihood that the claim will be satisfied. But the security has no market value independent of the claim, since it has no purpose independent of the claim. A property with no market value cannot be sold or otherwise used to generate funds. It follows that a standard security is an unsatisfactory security property.

21. We set out our provisional view that it should cease to be competent to grant a standard security over a standard security under any new legislation. We ask for the views of consultees on this issue.

22. We then consider assignments in security of standard securities, which are incompetent under the 1970 Act. The Moveable Transactions (Scotland) Act 2023 places on a statutory footing the general principle that accessory security rights follow the primary claim which they secure. Where a claim is assigned, the assignee is therefore entitled to acquire any standard security held in respect of it. This principle will apply where a claim is assigned outright, and also where a claim is assigned for the purposes of security. Where an assignee in security of claim acquires an accessory standard security, can such an assignment appropriately be characterised as an “assignment in security” of that standard security? The paper explores this question. It also addresses the question of how such an assignment may operate where the standard security is for all sums due or to become due. Views are sought on whether it should be possible to assign in security a standard security and, if so, what consequences should flow from this.

Consultation period

23. 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 29 September 2023, and will help shape our final recommendations and Report. A response form can be found at: <https://www.scotlawcom.gov.uk/law-reform/consultations/>.

24. Further information can be obtained by contacting the project manager Stephen Crilly, Scottish Law Commission, Parliament House, 11 Parliament Square, Edinburgh EH1 1RQ; Tel: 0131 244 6605; email: info@scotlawcom.gov.uk.