

DISCUSSION PAPER ON HERITABLE SECURITIES: PRE-DEFAULT

SUMMARY

Introduction

1. The Scottish Law Commission has published proposals for the reform of the law of heritable securities. They are set out in the Discussion Paper on Heritable Securities: Pre-default (Scot Law Com DP 168, 2019).

2. The Discussion Paper is the first of two such papers planned for this Project. The Commission intends to publish a second paper on post-default (enforcement) in late 2020.

What is heritable security law?

3. In Scotland the technical term for security over land and buildings is “heritable security”. The background is that “heritable property” is, broadly, the term for immoveable property.

4. The principal legislation on heritable securities is the Conveyancing and Feudal Reform (Scotland) Act 1970, now almost fifty years old. It replaced the older forms of heritable security with a new single type: the “standard security”. The equivalent security in England is known as a “mortgage”.

5. The use of property to secure debt is of crucial importance to the economy and society. It allows individuals to obtain loan finance to buy homes in which to live. Finance secured on land is also of great importance in the context of agricultural and commercial property, with businesses commonly granting security over their land and buildings to banks and other financial institutions.

6. In the event of the borrower failing to repay the loan, the lender will seek to recover the debt by selling the property. If the borrower becomes insolvent the effect of holding a security is to give the lender priority over unsecured creditors. Equally, if the borrower transfers the property to a third party the security is unaffected. The lender is thus protected.

Problems with the current law

7. The 1970 Act is generally considered to have been a major improvement on the previous law. The legislation has a number of merits, which have stood the test of time. It greatly simplified the law, made it possible to grant multiple securities over the same property, and is flexible in relation to the debt that can be secured.

8. Even so, it is now clear that despite its broad success there are a number of areas of difficulty. This is to be expected given significant changes in market conditions, in society and in technology. The case for reform as summarised here is strong, but this should be evolutionary rather than revolutionary.

Uncertainty

9. Court decisions have shown uncertainty about essential parts of the enforcement process (to be dealt with in the second discussion paper). The law is also unclear on how to transfer (assign) a standard security, and on the effect of a transfer. It is uncertain how a security in respect of a non-monetary obligation, such as an option to require a conveyance of land, is to operate. In particular, it is not clear how such a security is to be enforced.

Complexity

10. The 1970 Act is still more complex than seems necessary. Professors Gretton and Reid have for example described the forms for security deeds that must be used as “fussy and over-prescriptive” (see Gretton and Reid, *Conveyancing* 5th Ed. 2018 para 23-13).

Inaccessibility

11. While much of the law is to be found in the 1970 Act, there are numerous other relevant provisions scattered across legislation elsewhere including enactments from over 150 years ago.

Agedness

12. The mere fact that law is old does not make it bad. The 1970 Act was however prepared at a time before conveyancing work had become divided into today’s specialisms. The standard conditions in Schedule 3 were developed from 1960s styles used by banks and building societies. The 1970 Act also reflects an era which pre-dates digital technology.

Proposals for reform

13. The Discussion Paper sets out 61 proposals or questions. Consultation on the paper will close on 30 September 2019. Here we summarise the main issues considered in the Paper.

Evolution, not revolution

14. We propose that the Conveyancing and Feudal Reform (Scotland) Act 1970 is repealed and replaced with a new statute regulating heritable securities. A standard security would continue to be made real – that is, good against third parties - by registration in the Land Register of Scotland.

15. The term “standard security” should be retained.

16. We propose that the standard security should continue to be the only form of heritable security which can be granted, and that it should remain incompetent to transfer land to a creditor in security.

17. We ask in particular if old pre-1970 *ex facie* absolute disposition arrangements should be brought to an end, and if so how? The 1970 Act prohibited new securities by transfer, but a small number of old securities of that type still survive.

18. We ask if the existing statutory provisions on all the pre-1970 forms of heritable security, including for example the bond and disposition in security, should be repealed and replaced so far as still relevant.

Parties to the security

19. We propose that the grantor of a standard security need not be the same person as the debtor, and nor should the grantee need to be the creditor. This would clarify that third and fourth party securities are lawful. We ask, however, for comments on the use of security trustee or nominee arrangements.

Non-monetary obligations

20. A standard security can secure an obligation *ad factum praestandum* (a positive obligation to perform an act), but the 1970 Act does not provide an effective remedy for any default in such an obligation. It does however enable the sale of land to settle any consequential monetary claim such as damages for breach of contract.

21. We consider that it should continue to be possible to grant a standard security in respect of a positive non-monetary obligation. We ask whether that should be on the basis that:

- (a) only an express claim for damages on breach of the obligation can be secured, or
- (b) the obligation is secured, but on default it is only damages for breach of the obligation that can be recovered by enforcement.

22. It may be that there are other ways to enforce or secure non-monetary obligations relating to land, and we propose that there should be a separate reform project in relation to making options and similar agreements enforceable against third parties by means of registration (as is already possible in other jurisdictions including England and Wales).

Encumbered property

23. We propose that it should continue to be permissible to grant a standard security over a long lease (more than 20 years in duration).

24. We ask whether it should be permissible to create a servitude in a standard security deed.

25. We ask whether there are other types of immovable property over which it should be possible to grant a standard security.

26. We propose that it should continue to be impermissible to grant a standard security over a real burden, a proper liferent, or a short lease.

27. It is permissible to grant a standard security over a standard security, but we ask whether that should continue to be the case, or whether it would be preferable to permit standard securities to be assigned in security. We also ask for comments on enforcement in either of those cases.

Constituting the standard security

28. We propose that matters relating wholly to the obligation between the parties (typically an obligation to repay money) should be for the parties, subject to the general law on, for example, unfair terms in consumer contracts.

29. We propose that there should no longer be a prescribed form of standard security, and in particular that the current Forms A and B should be abolished.

30. We propose that instead the constitutive document of a standard security should require to:

- (a) be signed by the debtor,
- (b) identify the property which is to be the encumbered property,
- (c) identify the secured obligation, and
- (d) use the words "standard security".

31. We ask whether legislation should provide a non-obligatory model form of a standard security document.

32. We ask for comments in relation to identification of the encumbered property or of the secured obligation.

33. We propose that the power under section 893 of the Companies Act 2006 should be used by the Secretary of State so that standard securities granted by companies do not require to be registered in both the property and companies registers ('double registration').

Standard conditions

34. The 1970 Act provides a set of conditions which are incorporated into every standard security (the "standard conditions"), most of which are variable by the parties.

35. We propose that rules on enforcement (including the recovery of expenses by the creditor) and redemption in relation to a standard security should not be dealt with in standard conditions, but in the substantive provisions of the new legislation.

36. We ask whether statute should provide for a freely variable default set of standard conditions in relation to preservation of the value of the encumbered property and expenses (other than in relation to enforcement). If consultees agree then we ask:

- (a) whether these conditions should be set out in primary or secondary legislation, and
- (b) what default conditions should be included.

37. Alternatively, we ask whether the standard conditions should be abolished, and that the new Act should set out:

- (a) a broad rule requiring the debtor to preserve the value of the encumbered property,
- (b) a default rule that the debtor should be liable for the creditor's reasonable expenses (with enforcement expenses being dealt with separately in terms of the rules on enforcement), and

- (c) a default rule allowing the creditor either to (i) require the debtor to insure the property for reinstatement value or to (ii) insure the property directly.

38. We ask whether there should be any additional 'standard' rules.

Leases

39. We propose that, where a lease is granted over land encumbered by a standard security without the secured creditor's consent, the creditor should be entitled to remove the tenant if the security is enforced.

40. We ask whether the creditor should be entitled to remove such a tenant if express provision is made in the security prohibiting the grant of a lease, and whether if so that provision requires to be made public on the face of the Land Register.

41. We ask if the Private Housing (Tenancies) (Scotland) Act 2016 should be amended to make it clear that a heritable creditor cannot evict a residential tenant whose lease was granted before the security. The 2016 Act is uncertain in that respect, unlike the previous law which protected the tenant from later secured creditors.

42. We propose that the holder of a private residential tenancy should be unaffected by a prohibition on leasing in a standard security encumbering the property unless that person knows of the prohibition at the date of entry under the lease.

43. We ask in general for comments on the situation where a heritable creditor is enforcing a security, and there is a residential tenant whose lease was granted after the security.

44. We ask for comments on the interaction of standard securities with agricultural leases.

Juridical acts

45. A juridical act is an act by a person which has, or is intended to have, legal effect. A grant of a lease is a juridical act but so equally is the grant of a servitude or the creation of a real burden on land.

46. We propose that where property is encumbered by a standard security, and the debtor carries out a juridical act without the creditor's consent, the creditor should be entitled to reduce the debtor's act if the security is enforced.

47. We ask whether the creditor should be entitled to reduce any juridical act by the debtor prior to enforcement which is prohibited in the security documentation.

Variation

48. We propose that it should continue to be possible to vary a standard security as under the 1970 Act, except that there should be no mandatory form of deed.

49. We propose that it should continue to be impermissible to vary a standard security to increase the encumbered property.

50. We propose that it should continue to be possible to restrict a standard security either:
- (a) as in the 1970 Act, except that there should be no mandatory form of deed, or
 - (b) by means of a consent by the creditor in a disposition transferring the property.

Assignment

51. We propose that it should continue to be possible to assign a standard security, except that there should be no mandatory form of deed, and that it should be made clear that it is possible to assign multiple securities in the same deed.

52. We ask whether the assignment of the secured debt alone (that is, the transfer of the personal obligation) should be sufficient to transfer the standard security, or whether registration of a document assigning the standard security should continue to be required.

53. We ask, if registration is still required, whether the effect of registration should be to transfer the debt without any need for intimation to the debtor.

54. We ask, if registration is still required, whether on such registration the assignment should give the assignee the benefit of any corroborative and substitutional obligations, such as the right to recover expenses from the debtor, and the right to rely on any notices sent or enforcement procedure started by the assignor.

55. We propose that the effect of an assignment should not be to limit the standard security to the amount due at the time of the assignment, so that future advances made by the assignee may be secured depending on the terms of the security contract.

56. We ask whether there should be any restrictions on what an “all sums” standard security may secure, and in particular whether the security should cover:

- (a) pre-assignment debts owed to the assignee, or
- (b) debts originally owed to other parties.

Discharge and extinction

57. We propose that it should continue to be possible to discharge a standard security in whole or in part:

- (a) as in the 1970 Act, except that there should be no mandatory form of deed, or
- (b) by means of a consent by the creditor in a disposition transferring the property.

58. We ask whether the law should require creditors to discharge standard securities where there is no outstanding debt, and if so:

- (a) whether such a rule should be restricted to residential cases, and
- (b) what the sanction should be for non-compliance.

59. We propose that, where the secured creditor acquires the encumbered property, the doctrine of *confusio* should not extinguish the standard security.

60. We ask whether there should be a sunset rule for standard securities so that any old security is extinguished after a specified period, and if so what the period should be.

Redemption

61. We ask whether the rules on repayment of the secured debt (“redemption”) should be replaced with a general rule entitling the debtor to a discharge on the debt being repaid in terms of the contractual arrangements between the parties, and a court procedure for discharge where the creditor has disappeared or refuses to grant a discharge.

62. We ask for comments on whether the owner of the encumbered property - where that person is not the debtor - should have the right to have the security discharged by paying the creditor an amount equivalent to the value of the property. That amount may be less than the sum due by the debtor.

63. We propose that section 11 of the Land Tenure Reform (Scotland) Act 1974, which gives the debtor the right to redeem a security over a private dwelling-house after 20 years, should be repealed. Section 11 is an anti-avoidance measure whose purpose was to prevent parties avoiding the restriction on long residential leases. It appears that it is no longer needed.