Getting your house in order

A practical look at mortgages of residential property, by Daniel Priestley, Counsel and Christopher Russell, senior counsel and Head of Litigation at Ogier.

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Introduction

Happily, the Cayman Islands enjoy a buoyant property market and, indeed, what has been characterised on a number of recent occasions as a construction "boom". If anyone were to doubt the present boom, one need only look out to see all of the tower cranes dotting the skyline. In order to succeed, a robust property market must, generally speaking, be supported by a robust lending industry and, just from wondering around down town George Town, one can see that we are lucky to have that here as well. In the majority of cases, neither a developer of land will have adequate resources to fund his development at the outset nor will the purchaser of his product have the independent means to acquire it. Developers and purchasers must therefore look to our lending industry to enable them to achieve their respective goals.

For the person of average means, a property purchase will be the single largest transaction of his lifetime - the numbers tend to be large in any first world country and the Cayman Islands are certainly no exception. The consequences of default by borrowers carry considerable risks for the lender which, if not managed properly, can lead or contribute to the demise of the lender. When structuring loans in general, therefore, lending institutions are principally concerned to ensure that the risk being undertaken is priced correctly and is mitigated adequately. The purpose of the taking of security, such as a mortgage, is to mitigate the consequences of default to a point where the lender can still emerge from the termination of a non performing loan in profit and remain in business.

A lender will look to his security to obtain total or partial repayment of the loan where the borrower's assets prove to be inadequate to meet the claims of his creditors. An essential feature of security is that the lender must have first priority over the proceeds of the disposition of the asset secured to discharge the borrower's outstanding obligations. Another feature of security is that it will usually confer a degree of control by the lender over the secured asset, which in turn usually gives the lender the ability to exercise influence or even control over certain events affecting the secured asset. In addition, the taking of the security by the lender will provide the borrower with the greatest incentive possible to observe and perform his obligations in connection with the loan because, if the borrower does not perform, he risks losing the secured asset. All of these features provide opportunities to mitigate risk and ensure that the lender always comes out on top.

These issues and more will be explored in greater detail in further issues of The Journal the coming months.

History and development of the Law of Mortgage

The practice of giving rights over land as security for a debt is of great antiquity, perhaps as old as the practice of commercial lending. It should also be noted that the form and effect of a mortgage as we know it today is the culmination of hundreds of years of legal evolution and, indeed, the evolution of the mortgage gives important insights as to why a mortgage takes its present form and the meaning and effect of a number of provisions within it, which may seem a little shrouded in mystery to the lay man.

At the outset, the mortgage was a very different creature from what it is today. Until the end of the twelfth century, the transaction was by way of lease by the borrower to the lender, and was either a vivum vadium (live pledge, "vifgage") or a mortuum vadium (dead pledge, "mortgage", i.e. mort (dead), gage (pledge)). This depended on whether the income from the land was (the former), or was not (the latter), used in discharge of the debt. Medieval usury laws influenced the development of the forms of mortgage as a means of securing lending of money. Lending at a fixed rate of interest to a borrower was rendered illegal by such laws and methods were developed to avoid these restrictions - hence the concept of the borrower granting a lease of his property in favour of the lender. In default of repayment either on the appointed day, or, following an order of the court, after a reasonable time, the mortgage took the fee simple or absolute ownership rights.

Such transactions were not wholly satisfactory to the lender since the seisina ut de vadio (or, very roughly translated, the interest acquired by the lender) was not protected by law, and it was doubtful, as a matter of law, whether a term of years could be enlarged into a fee simple (or what we would refer to as absolute title). Mortgages of freehold land were therefore made by conveyance of the fee simple, subject to the mortgagor's right to re-enter and determine the lender's estate if the money was repaid on the stipulated date. This was very onerous for the borrower, who would lose his land and yet remain liable for the debt if he did not repay it on the due date.

By the early 20th Century, a further evolution had occurred, by which the mortgage was characterized as a conveyance or transfer of the fee simple or absolute title subject to a condition that the conveyance would be avoided if the debt was repaid on time. Although perhaps somewhat of a subtle and legalistic distinction, it is nevertheless important to highlight this development, because with this change, the critical right of the lender arose not by virtue of the grant of a lease and the operation of a condition precedent (by which I mean prior to, or contemporaneously with, the loan being made), but instead by virtue of a grant of a right and the operation of a condition subsequent. Therefore, although the lender still went into possession, under the later form of mortgage, his protection was no longer based on possession but instead upon the title to the land derived from the grant of the mortgage. Thus, the modern pre-1926 form of mortgage was by way of conveyance of the fee simple or "absolute" title, defeasible by a condition subsequent on a date fixed by the parties.

In these circumstances, the lender enjoyed the following protections:

- absolute priority, in the absence of fraud, misrepresentation or gross negligence, over all later incumbrances, by virtue of his legal title which gave him a right in rem (which basically means that the right acquired was against the property itself and not the person of the borrower);
- the right to custody of the title deeds;
- the power to convey the legal estate to a third party, in exercising his express or implied power of sale, without applying to court;
- the right to protect his security by going into possession; and
- the right to apply to court for a decree of foreclosure which, if granted, would destroy the borrower's equity of redemption and immediately vest fee simple in the lender.

By 1925, other changes had come about, principally by the scrapping of the usury laws which prevented lenders from charging interest and the imposition of equitable principles of conduct by the courts. Under the rule in Thornborough -v- Baker in 1675, the English courts took the view that a mortgage should be a security only. It would no longer permit the lender to profit from the fee simple, and the courts now confined the lender's benefit to the interest he was permitted to earn by statute. Occupation, likewise, would yield no advantage to the lender since he would be liable to the borrower for the full rent, should he go into possession. Thus arose the modern type of mortgage under which the borrower remains in possession of the land and the conveyance of the fee simple is by way of security only.

In 1625, in the case of Emanuel College, Cambridge -v- Evans, the courts, which had for many years relieved the borrower against forfeiture in special cases, established the rule that the borrower must be permitted to redeem his fee simple even though he paid earlier than the due date. By this new law, the borrower had vested in him, as soon as mortgage was made, an equitable interest whose measure was the difference between the value of the land and the amount of the debt, and one which was generally enforceable against anyone. This is generally referred to as the borrower's "equity of redemption". Since an unfettered right to redeem would have nullified the intended effect of the mortgage transaction, that is, to enable the lender to recover his capital, it was necessary to limit that right. Under the rule created in the 1628 case of How -v- Vigures, the courts achieved this by the requirement for a decree of forfeiture, for which the lender had to apply. The effect of such a decree was to destroy the equity of redemption, including, of course, the right to redeem the loan. The court, however, guarded against oppressive foreclosures by ordering a sale of the property when the property was much more valuable than the debt, and the lender therefore received only the balance due to him following such sale. The equity of redemption is likewise destroyed if the lender, acting under his statutory power, makes a binding contract for the sale of the mortgaged property and the exercise of an express power of sale has the same effect.

You will note in this discussion that I refer to a mortgage in the generic sense, by which I mean in the way in which the average man-on-the-street would, whereas, in fact, the instrument we use has the title first legal charge. As a matter of technicality, the essential feature of the distinction between a mortgage and a first legal charge is that a mortgage is a security accompanied by the transfer of property rights, whilst a first legal charge is an appropriation of property to the satisfaction of an obligation without any such transfer of title. The chargee only has certain rights over the property charged. It should therefore follow as a matter of principle that a mortgagee but not a chargee, should have the right to foreclose or go into possession, while both should have the right to appoint a receiver or to realise the security by sale. The fact of the matter is that at this point in the evolution of our laws, the strict distinction between a mortgage and a first legal charge has become blurred and so, in this day and age, I would suggest that the expressions can be used interchangeably.

Next month, we will discuss the nature of a mortgage as a form of security