

THE PROFILE OF THE CREATION AND ESTABLISHMENT OF SECURITY INTEREST: FORMS AND FORMAT IN COMMERCIAL TRANSACTIONS*

Abstract

Secured transactions are mostly obscure; access to finance plays a very important role in business transaction, most businesses require funding and to obtain funding, assurances such as security inform of property is required by the lender. The basic reason for security is to limit the risk on the part of the lender by mitigating and providing alternative source of income for repayment should there be a problem in the repayment arrangement. Many businesses all over the world survive on funding and funding are provided because security for such lending is provided.

Keywords: Security Interest, Creation and Establishment, Forms and Format, Commercial Transactions

1. Introduction

Creation of security interest in any form of transaction can take the form of mortgage, debenture and charge, the above terminologies all relate to the same concept of lending and borrowing money. Sometimes, parties give the transaction a different name like loan or facility agreement etc. The most important thing to know is that this aspect of the law is governed by the general law of contract and legislation on conveyance and borrowing. Therefore, parties, particularly the borrower, must carefully read and seek professional advice before signing any document(s). The most common form of lending and borrowing is the mortgage agreement; so, the discussion in this work will be focused on the mortgage knowing that in appropriate cases, the law on mortgage applies mutatis mutandis to debenture, charge and other forms of loan or facility agreements. Black's Law Dictionary¹ defines a 'Mortgage' as an interest created by a written instrument providing security for the performance of a duty or the payment of a debt. This definition is too restrictive for two reasons: firstly, apart from land, there are other assets, like shares, life insurance policy, etc. that are accepted by banks as security for loan. Secondly, equitable mortgage may or may not be in writing. The Court of Appeal in *Suberu V. Limited*² gave a better definition of a mortgage according to the Court:

A mortgage is a conveyance of land, interest or an assignment of chattels as a security for the payment of a debt or discharge of some other obligation for which it is given. The security is redeemable on payment or discharge of such debt or obligation, any provision to the contrary notwithstanding.

In a mortgage transaction the borrower is called the mortgage and the lender/bank is the 'mortgage'. The foregoing nomenclature is confusing so it is permitted to use the more common words 'borrower' 'lender'. Whichever nomenclature is adopted, it is important to remain consistent. A mortgage may be legal or equitable and in either case, the sole object of the mortgage as against other legal transactions is that in a mortgage the interest in the property is transferred by the borrower to the lender subject to a proviso for redemption upon repayment of the loan.

2. Types of Collateral Security

Land, Chose in action, Chattel, Mere charge, Shares, Other property like ship, aircraft and Insurance policy, the above list is not exhaustive. The type of collateral security accepted by banks depends on the amount of the loan, the nature of the facility being sought, the duration of the loan and the integrity and financial strength of the borrower.

In Nigeria, banks prefer landed property as collateral. The reference for landed property as security for loan is based on the following reasons: Land is a more stable asset than other types of collateral, the value of land is more likely to appreciate than other types of collateral and it is easier to enforce the mortgage's right against land than other types of security³.

3. Negotiating Finance (Mortgage) to Purchase Property

Let us assume that prospective purchaser of a building seeks advice on the implication of obtaining loan from a commercial bank or other financial institutions to purchase a building and to use the building as collateral security for the loan. It is important to state from the onset that in the foregoing scenario, the lenders will require

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¹ H.C. Black's Law Dictionary 6th Edition (St Paul, Minn, 1990) 1009

² (2007) 10 NWLR (Part 1043) 590

³ 11 Encyclopedia of forms and Precedents, 4th Edition 498

the prospective borrower (purchaser) to contribute part of the money for the purchase of the building. The purchaser /borrower negotiate simultaneously with the vendor to sign a contract of sale and with the lender for the loan. After concluding negotiation for the purchase, the purchaser pays deposit to the vendor or a stakeholder and proceeds to obtain the balance as loan from the bank for payment at completion. The legal consequences of the foregoing scenario could put the deposit paid at risk of forfeiture if the purchaser /borrower is unable to secure approval for the loan from the bank to pay the balance of the purchaser money at completion. The law is that payment of deposit is beneficial to both the vendor and purchaser. From the purchaser's perspective, it is evidence of commitment and creates by the fear of its forfeiture a motive to pay the balance at completion; from the vendor's perspective, it binds him or her to the contract unless a breach occurs on the part of the purchaser, for example, if the purchaser is unable to pay the balance at completion. To assuage the fear of forfeiting the deposit paid to the vendor, the prospective purchaser should negotiate with the vendor that the contract of sale is made subject to a condition precedent – that the purchaser /borrower secure approval for the loan to pay the balance purchase money at completion. The legal effect of a contract of sale of land made subject to a condition precedent is that although there is a binding contract between the parties, it is not effective until the condition precedent is fulfilled. A clause should be inserted in the contract of sale to state that if the loan is not approved, the purchaser /borrower is discharged from the contract of sale and the vendor shall return to the purchaser deposit paid at contract stage. This clause is very effective; the law is that parties cannot waive a condition precedent in a contract because the entire contract depends on its performance. A clause in a contract of sale that makes approval of the loan a condition precedent must be drafted carefully because a badly drafted clause may be void for uncertainty which means that the entire contract is void ab initio. The essential requirements of the clause are the source and amount of the loan, terms of payment and interest paid on the loan. In *Lee-Parker v Izzet*⁴ the purchaser entered into a written contract of sale with the vendor to purchase a property. The contract contained a special condition which provided, 'This sale is subject to the purchaser obtaining a satisfactory mortgage'. The purchaser was unable to obtain the loan and could not complete payment of the balance. Goulding J. held that the special condition contained in the contract of sale vendor's obligation to sell and the purchaser's obligation to buy dependent on obtaining a satisfactory mortgage. Until that condition had been fulfilled there was no binding contract of sale. The condition was, however void for uncertainty since the concept of satisfactory mortgage was too indefinite for the court to give it practical meaning; it left at large not only matters such as the rate of interest and ancillary obligations but the two most essential points, that is amount of the loan and the terms of repayment. Accordingly, since the uncertainty avoided the entire contract, the purchaser was not entitled to rely on the contract.

4. Mortgage Institutions in Nigeria

Housing finance is multi-disciplinary; so, a solicitor engaged to advice on it should consult other professionals in the sector⁵. There are several arrangements by which a prospective purchaser of property can obtain loan to finance the purchase. It is the responsibility of the solicitor to advice the client on the advantages or otherwise of the various kinds of arrangements.

Federal Mortgage Bank

The Federal Mortgage Bank (the bank) is established by Section 1 of the Federal Mortgage Bank of Nigeria Act⁶. The Bank is engaged in the business of wholesale banking. Section 5 of the Act establishing the bank provides that the functions of the Bank shall be to provide long-term credit facilities to Primary Mortgage Institutions (PMI) in Nigeria, license, control and encourage the growth of secondary mortgage institutions; the Bank also collect, manage and administer the National Housing Fund⁷. The Bank gives the PMIs loan at the rate of four percent (4%). To qualify for loan from a PMI, the applicant is required to save up to sixty-six percent (66%) of the cost of the property. the loan from the PMI is given on a long-term (sometimes up to 30 years) with interest as low as 6%. The Federal Mortgage Bank has its head office located in the Central Business District, Abuja with branches in the State capitals of the Federation. The main complaint by PMIs is that the conditions for accessing funds of the Bank are harsh. On the part of the Bank, the main challenge facing the bank is how to recover the huge sums owed to it and the lack sufficient funds to perform its statutory functions.

⁴ *Lee-Parker v Izzet* No.2 (1972) 2 All ER 800; (1972)1 WLR 775

⁵ See the curriculum of University of Ibadan MSc degree (Housing)

⁶ Cap F16 LFN 2004

⁷ *FMBN v Lagos State Government* (2010) 5 NWLR (Part 1188) 570, 594

Housing Corporations

The most prominent of these corporations is the Federal Housing Authority (FHA) established by the Federal Housing Authority Act⁸. The function of FHA includes recommending to government a National Housing Programme and the execution of such programmes. The FESTAC Housing Estate in Lagos and Gwarimpa Housing Estate along the Abuja-Suleja Expressway are major projects executed by FHA. At the State level, the Lagos State Mortgage Board, Kogi Investment and Property Ltd, provides funds for building and at times they build houses and offer them for sale to the public. The main advantage of sourcing loan from these corporations is that they offer their loan at very reasonable interest. The root of title of property purchased from the corporations is very good because they build on state land with the certificate of occupancy ready for collection. The corporations have the same challenges as the Federal Mortgage Bank, inadequate funds.

Housing Schemes

The Employee Housing Scheme (Special Provisions) Act, Cap E8 LFN 2004 makes it obligatory for every employer of labour so designated by order to establish, execute and maintain a housing scheme for its employees where its establishment is not less than five hundred employees. The purpose of the scheme is to benefit employees to enable them acquire their own houses. The employer gives loan on the security of the property. The practice is that the employee is required to deposit the title document with the employer until the loan is fully paid. The interest rate is as low as two percent (2%). Repayment of the loan is deducted directly from the employee's salary. Only few organizations are still able to operate this scheme because of lack of funds. The military authorities still provide housing scheme for its men and officers, for example, Navy Housing Estate, Karshi, Nasarawa State. To revitalize the implementation of the Act, it is suggested that the President should exercise his powers under section 14 of the Act to make regulations that will revive the Scheme. Also the Minister of Labour should liaise with Corporate Affairs Commission and other relevant bodies to ensure that the Audited Annual Report of companies to which the Act applies contain information on compliance with the Act.

Commercial Banks

Most banks in Nigeria now have subsidiaries or sister companies that are engaged in Mortgage banking, for example, Union Homes, GTHomes, etc. The customer is expected to save between twenty to forty percent (20% - 40%) of the price of the property while the bank provides the balance. The period of repayment is between 5 to 10 years and interest rate is negotiated; unfortunately, interest in the commercial banks is not as reasonable as FMBN and the Housing Corporations. So, loan from commercial banks is not the best option for the prospective borrower.

Private Property Developers

In Abuja, Lagos, Port Harcourt and other major cities in Nigeria private property developers develop estates for sale to the public on a mortgage basis. A very successful example is Crown Estate in Lekki Peninsular, Lagos and Crown Estate in Mabushi, Abuja both developed by Crown Realities Plc for sale to the public. A prospective buyer is expected to pay only fifty percent (50%) to take possession and the balance is payable over a long period of time up to fifteen years (15 years) at an interest of about fifteen percent (15%) yearly upon delivery.

Securitization of Real Estate Investment Markets

Securities are investment instruments that convey private ownerships (stocks) or establish debt obligations (bonds) by dividing a pool of properties into a series of ownerships through partnership, corporation, or trust entities, real estate securities create opportunity and allow more investors to be involved. Because risks can be diffused through a greater number of smaller investments, securitization reduces the risk to individual investors. Securitization ensures professional portfolio management as well as professional management of the assets that are securitized. Securitization also expands liquidity, which may not otherwise exist for the investments. Securitization is spreading rapidly to real estate equity investments but it is virtually absent in Nigeria⁹. It is expected that with the establishment of Real Estate Investment Schemes under Rule 250 of the Consolidated Rules and Regulations of Securities and Exchange Commission in Nigeria, the ability to invest in commercial real estate will become available to a much larger group of Nigerian. Federal Mortgage Bank in conjunctions with Securities and Exchange Commission and financial institutions in Nigeria should develop a strong securitization of real estate investment market in Nigeria to provide solution to the chronic housing challenges in the country. Securities will open the world of commercial and mortgage properties to the investing and general public. This will allow property to be more actively traded in, with increased turnover, income and investment pull. Securitization will help overcome the intrinsic negative perception of property as poor

⁸ Cap F14 LFN 2004

⁹ The Appraisal of Real Estate (US) 2001, 12th Edition, 91, 131

inefficient investment medium. A restructuring of real estate finance through securitization will benefit all the parties in the real estate finance market investors, banks, etc. furthermore, real property needs to be depersonalized and this is what securitization is and by this, it makes home mortgage to become a bond (security)¹⁰.

Mortgage Protection Insurance

A borrower who has taken loan to buy a building should be advised to take our mortgage protection insurance, a policy. The policy guarantees the lender the balance of the loan outstanding on the death of the borrower. The policy lasts for the period of repayment of the loan. The main advantage of the mortgage protection policy is that the security is coming directly from a financial institution which is a better guarantee for repayment of the loan.

Title Insurance

Title Insurance is another form of guarantee that is popular in other jurisdictions especially in the United States of America. The policy taken is a guarantee against any loss arising from defective titles. Title insurance would provide all mortgage lenders protection for an amount equal to the loan. The policy will last until the loan is repaid. If the business of securing land titles by taking title insurance is developed in Nigeria, it would provide incentive for more mortgage lenders in Nigeria to do business with customers, and it will enhance the success of the National Housing Policy¹¹.

Investigation of Land Titles by the Mortgage

It is the responsibility of the bank to ensure that the root of title of an instrument offered as security is sound. There are similarities in the way a purchaser investigates the vendor's title and the way the bank investigates the title of the mortgagor. For example, the bank will still have to rely on the process for conducting searches at the lands registry, company registry, probate registry, physical visit to the property, etc. There are two main issues that should bother the bank before property is accepted as collateral for loan. They are: The title of the borrower; and the value of the property. It is not sufficient that the borrower's title is sound; the value of the property must accommodate the amount of the loan. The object of investigating the title of the borrower or the person who offers the property as collateral is to ensure that the title to the property is sound and that there are no encumbrances on the property. The practice is that the legal department of the bank engages external solicitors to conduct searches on the property. The Solicitor should be thorough in investigating the root of title of the property offered as collateral using all known conveyancing techniques as prescribed by law. After the search, the solicitor writes a Report that is sent to the bank of consideration whether or not to accept the property as security for the loan. The solicitor's report should also contain comment on the type and condition of property.

States applying the Property and Conveyancing Law 1959 and Mortgage and Property Law 2012 of Lagos State

Section 109 of the Property and Conveyancing Law 1959¹² provides that a mortgage for a term of years absolute shall only be capable of being effected at law either by:

1. Sub-demise for a term of years absolute, less by one day at least than the term vested in the mortgagor, and subject to a provision for cesser on redemption; or
2. A charge by deed expressed to be by way of legal mortgage.

Registration of Titles Law applicable in Lagos State

The mortgage of a registered title is by way of a charge. A charge means the appropriation of a property to the discharge of debt or other obligations. In law and equity, the charge of a property does not change the ownership of the property but the charge has the right to apply to court for an order of sale or appointment of a receiver.

Section 18 of the Registration of Titles Law, Lagos provides that the registered owner of land may in the prescribed manner charge the land or lease with the payment of money to the like extent as if the land was not registered land. The charge is completed by entry in the register of the particulars of the mortgage and the registration of the charge in the Land Registry Form 5. The summary is that there are four ways of creating legal mortgage in Nigeria:

1. Assignment, only in the States that apply the Conveyancing Act 1881¹³.

¹⁰David-Adesua, Opinions for improved Housing financing in Nigeria (November – December, 2012) Property Digest, Conventant Media and Publishing Ltd, 22

¹¹Theron R. Nelson & Thomas A. Potter, *Real Estate Law: Concept and Applications* (West Publishing Company, 1993) 271

¹² Section 15 of Mortgage and Property Law 2012 of Lagos State

¹³ Section 68 of Property and Mortgage Law 2012 of Lagos State

2. Sub-demise in all the States of Nigeria except the part of Lagos that applies the Registration of Title Law.
3. Charge by deed expressed to be by way of legal mortgage in the States that apply the Property and Conveyancing Law 1959.
4. Registered charge under the Registration of Titles Law Lagos.

The solicitor in a mortgage transaction is expected to advise the parties on the legal consequences of each of the four ways of creating legal mortgage. There are four issues that arise frequently when advising parties to a mortgage transaction.

5. Distinction between Legal Mortgage by Assignment and Legal Mortgage by Sub-Demise

A legal mortgage by assignment is created when the mortgagor conveys to the mortgagee the entire unexpired interest in the property and the mortgagor has no reversionary interest in the property. On the other hand, a legal mortgage by sub-demise is created when the mortgagor conveys to the mortgagee a term of years absolute, so the mortgagor retains the nominal reversionary interest in the property. The legal mortgage by sub-demise is better than legal mortgage by assignment. There are two reasons in support of this position:

Privity: Privity is a principle of law that deals with the relationship between the parties to a contract, in this case the mortgage. In a legal mortgage by assignment there is privity of estate between the bank and the Governor being the head-lessor of the certificate of occupancy issued under the Land Use Act to the mortgagor. So under the rule in *Tulk v. Moxhay*¹⁴, the burden of restrictive covenants run with the land; so an equity, the bank is bound to observe and perform such restrictive covenants in the instrument used as collateral for the loan. The legal consequence of the foregoing is that the bank is open to liability for breach of negative covenants in the certificate of occupancy. But if the legal mortgage is created by sub-demise, there is no privity between the Governor and the bank, so the rule in *Tulk v Moxhay* does not apply so the bank is not bound to observe covenants in the instrument and suffers no liability for breach of negative covenant(s) in the certificate of occupancy.

Uniformity: Sub-demise is used in the whole of Nigeria in the States that apply the Conveyancing Act 1881 and States that apply Property and Conveyancing Law 1959 except the part of Lagos State that apply the Registration of Titles Law, Lagos. The uniformity offered by creation of legal mortgage by sub-demise has its *dare* legal consequence.

A legal mortgage created by sub-demise suffers a technical deficiency in respect of the power of the bank to enforce its security. The challenge is that since the mortgagor conveyed to the bank only a term of years absolute and retained the nominal reversionary interest in the property, in the event of the mortgagor's default to repay, the bank cannot sell the mortgagor's nominal reversionary interest. This challenge does not exist in a legal mortgage created by assignment of the mortgagor's unexpired interest. This is because the mortgagor has no nominal reversionary interest in the property. The solution to the challenge depends on where the property is located. In the States that apply the Conveyancing Act 1881, the solution is to insert in the mortgage deed the following two clauses:

Trust declaration clause – by his clause the mortgagor declares himself a trustee of the head-term (the nominal reversionary interest) in the property in favour of the bank, subject to the right of redemption. In the declaration, the bank as beneficiary is empowered to remove the mortgagor as trustee and appoint new trustees to replace the mortgagor and to vest the head term in the new trustee.

Power of attorney clause: This clause is in addition to the trust declaration clause. The bank in consideration of the mortgage money is appointed attorney with authority to deal with the mortgagor's nominal reversion in the property. The power of attorney is made irrevocable until the loan is discharged, if the mortgage defaults, the bank as attorney can rely on the clause to sell mortgagor's entire interest in the property.

In the States that apply the Property and Conveyancing Law 1959, there is no need to expressly insert in the mortgage instrument trust declaration and power of attorney clause because they are implied by statute into the legal mortgage by sub-demise. Section 112(1) of the Law provides:

Where a term of years absolute has been mortgaged by the creation of another term of years absolute limited there-out or by a charge by way of a legal mortgage and the mortgagee sells under his statutory or express power of sale:

- a. The conveyance by him shall operate to convey to the purchaser not only the mortgage term, if any, but also (unless expressly excepted with the leave of court) the leasehold reversion affected by the mortgage, subject to any legal mortgage having

¹⁴ 41 ER 1143 *Tulk v Moxhay* decided in 1848 by Lord Cottenham

- priority to the mortgage in the right of which the sale is made and to any money thereby secured; and thereupon;
- b. The mortgage term, or the charge by way of legal mortgage and any subsequent mortgage term or charge, shall merge in such leasehold reversion or be extinguish unless exempted as aforesaid. And such conveyance may, as respects the leasehold reversion, be made in the name of the estate owner in whom it is vested.

By this provision, the mortgagee can sell the mortgagor's unexpired interest because the mortgagor's reversionary interest is merged (or extinguished) with the term granted. The object of section 112(1) of the property and conveyancing Law 1959 is to simply documentation of legal mortgage created by sub-demise.

6. Conclusion

The central reason for a secured credit transaction is to ensure protection of funds, assurances that funds released would be paid back in good time as agreed, ensuring a smooth running of a workable economy and to create indemnification for all transactions. Furthermore, equitable mortgage as it relates to this work is a type of mortgage that confers equitable interest on the mortgagee. Equitable mortgage is the preferred method of creating security for a short-term loan; but it is not as secured as the legal mortgage and it is more susceptible to fraud than the legal mortgage. In practice, equitable mortgagees protect themselves by requesting that the mortgagor at the time of creating the equitable mortgage sign a legal mortgage and the Governor's consent Form, the legal mortgage is not used until the mortgagor is in default of repayment and the mortgagee will perfect the legal mortgage to enable them exercise the statutory power of sale. If the mortgagor is able to pay back the loan, the legal mortgage becomes useless. The mode of creation of equitable mortgage in Nigeria is uniform in the entire country, so the distinction between the states applying the conveyancing Act 1881 and Property and Conveyancing Law 1959 respectively is not necessary. There are several ways of creating equitable mortgage, for example, the deposit of title deeds with the intention to use it as security for loan, the mortgage of an equitable interest, an agreement to create a legal mortgage, or if a mortgage fails to comply with the requirements of a legal mortgage.