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Goods mortgage – key security document provisions

On 23 November 2017, the Law Commission published its report on the Goods Mortgages Bill. The report contains the final version of the Bill and outlines the Law Commission's recommendations in relation to it. Jacqueline Cook, member of the Lexis®PSL Banking & Finance consulting editorial board and senior professional support lawyer, in the finance practice of Stephenson Harwood, LLP, London, provides an overview of some of the key provisions that will need to be included in, or considered when drafting, a goods mortgage in line with the new legislation when it comes into effect.

1. What is the proposed 'goods mortgage'?

'From Bills of Sales to Goods Mortgage' the Law Commission Report No 376 presented to Parliament on 23 November 2017[1] (the "Report") contains the final version of the draft Goods Mortgages Bill (the "Bill") announced in the Queen's Speech on 28 June 2017. The Bill moves away from the Bills of Sales Acts of the late 1800s and introduces a new type of security device, the 'goods mortgage', for individuals to grant security over certain types of moveable assets in a personal and business scenario. For information on the meaning of 'individuals', see Parties to a goods mortgage below.

This Practice Note examines some of the key provisions of a goods mortgage security document.

2. Parties to a goods mortgage

The party granting the security, the 'mortgagor', must be a 'natural person' i.e. an individual[2], a human being, not a corporate body, trust or LLP. An individual, with capacity to contract can either:

- act in his or her own right[3];
- have sole, joint[4](part share) or common (undivided share) ownership[5] in the goods;
- be a partner with other individuals[6], or a partner with a corporate;
- be a sole trader or an unincorporated business[7]; or
- be a high net worth[8] individual[9].

The party having the benefit of the security, the 'mortgagee', can be either:

- a corporate body;
- an individual; or
- other legal person i.e. there is no restriction in the Bill on the nature of the mortgagee.

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[1] The Law Commission started work in this area in September 2014 at the request of HM Treasury
[2] Section 2(1)
[3] Section 2(1)
[4] Section 3(1)
[5] Section 3(2)
[6] Section 3(4)
[7] Section 7(3) where the 'business credit conditions' apply: to secure a loan for the individual's business which is over a prescribed amount, which is currently proposed at £25,000 and will be set out in secondary legislation
[8] Net income totalling at least £150,000 in the preceding financial year or net assets excluding primary residence, life or endowment policies and pension arrangements of at least £500,000, Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI2001, No 544 art 60H
[9] Section 7(2) the 'high net worth conditions' apply so the goods mortgage is an exempt mortgage if it meets the prescribed requirements and the individual agrees to forego protections

3. What type of security can a goods mortgage be used to create?

The Bill does not stipulate how to create a mortgage over goods under English law. It sets out the statutory procedure to create a ***'charge'***[10] over certain 'qualifying goods' by individuals in various capacities. The label 'charge' was chosen intentionally as part of the consultation process with a non-lawyer, rather than a lawyer, in mind. It is important, then, not to rely on this label but to try to understand what is meant by a 'goods mortgage' within the context of the Bill.

4. The charging clause: granting security

The mortgagor will grant a 'goods mortgage' over 'goods', which will have to be clearly defined. It will be a statutory charge rather than a mortgage. While a mortgage under English law requires transfer of title when security is created, a charge does not.

For businesses, unincorporated businesses or sole traders, a goods mortgage is a useful type of security as possession of the asset and ownership remains with the mortgagor. Goods mortgages will be useful for securing vehicles, particularly by so-called 'log book loan' borrowers. A goods mortgage enables vehicles, which are so vital to sole traders and small businesses, to be used and owned by the mortgagor while being used as collateral for secured obligations.[11]

The 'goods' have to be described and defined in the goods mortgage itself. Only 'qualifying goods'[12] can be made subject to a 'goods mortgage'.

Qualifying goods:

- must be tangible, moveable[13] items which exist at the date of creation[14];
- must be located in England or Wales when the goods mortgage is created[15];
- must not be aircraft registered in the UK, not other aircraft items already covered by a mortgage[16]– but could include aircraft parts, engine, or possibly, drones if owned by a relevant mortgagor;
- must not be a ship of any description, including any vessel for navigation purposes[17];
- must not be any currency, notes or legal tender in the UK or elsewhere[18], nor bitcoin and cryptocurrencies which are intangible rights, but could cover antique coins;
- must not be crops;
- must not be fixtures, or goods which become fixtures as the 'goods mortgage' will be extinguished;
- must not be a chose in action e.g. a receivable or a right to an asset;
- must not be an equitable interest in goods; and
- must not be intellectual property. Some examples of goods that could be used as collateral and count as 'qualifying goods' include: vehicles including, cars, vans, lorries, motorcycles, office machinery, equipment which is not a fixture, stock, artworks, antiques, antique coins, jewellery, household items and furniture.

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[10] Section 2(4)
[11] See https://www.fca.org.uk/firms/consumer-credit-research-logbook-loans/key-features-market for key trends and information on the market
[12] Section 4(3)
[13] Section 4(2)
[14] Section 2(2)(a)
[15] Section 4(3)(b)
[16] s86(2)(f) Civil Aviation Act 1982
[17] s313 Merchant Shipping Act 1995
[18] Section 4(4)(d)

All sorts of vehicles for small businesses which are owned by the individual can be subject to a goods mortgage but still driven and used for the business.

It is important to note that any goods to be subject to the goods mortgage must ***exist*** on day one. This is unlike a 'floating charge' granted by a company or LLP where, subject to the drafting of the charging clause, future goods or after-acquired goods can be caught and goods can move in and out of the floating charge assets prior to crystallisation. Future goods that a mortgagee wants to take as collateral will need to be made subject to a separate security document when they exist and are owned by the mortgagor.

For vehicles, remember that in real time, vehicles move. If the vehicle is outside England and Wales at the time when the goods mortgage is created, then there would not be a valid goods mortgage, for example if a van is making a delivery outside England and Wales, by road, sea or tunnel into continental Europe or Ireland. At the time of creating security, a mortgagor will have to have real time information about the ***location*** of the vehicle. This is not insurmountable but is another detail affecting everyday business which has to be checked to make sure the security will be valid.

5. Secured Obligations definition

Any obligation or debt due to the mortgagee by an individual can be secured, but this excludes an obligation under a guarantee; overdraft or revolving credit; or, an obligation as employee, or for the provision of work or services personally[19]. It can include the loan or financing to buy the asset being secured, eg a loan to purchase a vehicle and the security over that vehicle as collateral.

However, obligations can be secured where they are:

- guarantee obligations of an individual if the high net worth conditions are met[20]; and
- overdraft or revolving credit of individual if the high net worth conditions are met or the business credit conditions are met for an unincorporated business[21].

Further advances can also be secured along the same lines as tacking where the goods mortgage[22] has been registered. If there is an obligation on the mortgagee to make a further advance, even if a second goods mortgage has been registered, then the advance will be tacked onto the first goods mortgage.

6. Protection of the mortgagor: Warnings or Declarations

Warnings

All goods mortgages except exempt mortgages must contain, in the security document itself, written 'Warnings' addressed to the mortgagor. Precise drafting will come in Treasury regulations, drafts of which are expected in early 2018, but the Report gives a recommended statement revised from its 2016 consultation, using a vehicle as an example[23].

[19] Section 6
[20] Section 7
[21] Section 7
[22] Section 10
[23] Para. 5.23 of the Law Commission Report C76 p.48

YOU MAY BE PROSECUTED FOR FRAUD[24] IF YOU SELL THE VEHICLE OR TAKE OUT ANOTHER LOAN ON IT WITHOUT DECLARING THIS MORTGAGE[25]

If this statement is not included a court cannot enforce the goods mortgage.

The Bill refers to a 'disposition of the goods', which it defines narrowly as a contract for sale or a transfer of ownership[26]. This is another example of a specific interpretation within the Bill. 'Disposition' or to 'dispose' here relates to a 'transfer of ownership', not a disposition by granting a security interest, nor by granting any lease of the item or right or licence to use the item.

A mortgagor of a non-exempt goods mortgage (being an individual, other than a high net worth individual, or where the business credit conditions apply)[27] will have the new statutory 'right to terminate'[28] the goods mortgage by informing the mortgagee of its intention and delivering the goods to the mortgagee as set out in the Bill. As the right will be statutory there is no requirement to include a reference to it in the security document.

Considering the thrust of the legislation is to provide a clear, understandable, useful regime, it would not be surprising if secondary legislation or good practice guidance from trade bodies or regulators, suggested or indeed required that the rights of the mortgagor in relation to the goods which are secured, have to be set out in a clear, precise way in the security document like this.

[You have a right to terminate this goods mortgage. You can exercise this right by (i) [informing the mortgagee of your intention to terminate,] and (ii) [delivering the goods to the mortgagee]. There are some situations where this may not be possible. See [the guidance from [ ] for details of your statutory rights and the conditions applying to them.][29]

Notification of the right to terminate, however, will be in a 'possession notice'[30] in relation to all goods mortgages, except exempt goods mortgages[31]. As a protection to mortgagors, the mortgagee's right to take possession of the goods is restricted. It cannot do so without first issuing a possession notice to the mortgagor in a prescribed form with prescribed information, including the grounds for action, the remedies available to cure the breach and the right to terminate the goods mortgage[32]. That said, a mortgagee can take possession without giving a possession notice for an exempt goods mortgage, or where less than one third of the amount due has been paid for a payment obligation determinable when the security was created.[33] Further mortgagor protection lies in the Bill, which requires that once the mortgagee has taken possession of the goods, it must wait 5 working days before it can sell those goods under the statutory right of sale[34]. A mortgagor will have time to remedy or could seek to restrain the mortgagee from removing or selling the goods.

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[24] Fraud Act 2006
[25] Section 5(2)
[26] Section 32(1)
[27] Section 7
[28] Section 23
[29] This is sample drafting by the author not provided by the Law Commission
[30] Section 20
[31] Section 15
[32] Section 15
[33] Section 19
[34] Section 18

Declarations

To allow the mortgagee to enforce without the mortgagor protections in sections 18, 19 and 23 of the Bill for exempt goods mortgages (where the high net worth or the business credit conditions are met) the mortgagor has to make certain declarations in relation to its rights as mortgagor. The individual must declare along these lines, more particular wording could be provided in secondary legislation.

I, as mortgagor, in this Goods Mortgage agree to forego (i) the protection of section 18 (*Goods seized not to be sold until five days have passed*), (ii) the protection remedies of section 19(1) (*Possession notice required while goods are owned by mortgagor*) and (iii) the protection remedies of section 23(2) (*Mortgagor's right to terminate*), each of the Goods Mortgages Act 2017.[35]

In drafting terms, exempt goods mortgages will include the Declarations. Non-exempt goods mortgages will include Warnings but not Declarations.

7. Governing law and jurisdiction clause

The governing law will be English law. A separate programme of reform has been going through in Scotland and is wider dealing with tangible and intangible moveables within specific Scots law definitions of 'corporeal and incorporeal movables'[36]. HM Treasury is consulting at the moment on whether the English law Goods Mortgages Bill should also cover Northern Ireland.

The jurisdiction is presumed to be with the English courts.

8. Execution of a Goods Mortgage

After discussion with stakeholders and comparing consumer credit transactions, the Report recommends that the 'goods mortgage' is signed by the mortgagor in its relevant capacity as an individual. For joint and common owners who are individuals, both should sign. A witness is not required.[37] However, as this is an English law agreement creating a statutory charge, the mortgagee should also sign the document. It can sign under hand and does not have to execute it as a deed. For a financial institution or retail bank, its normal method of execution for an agreement should suffice, taking care to comply with any internal compliance requirements. Immediately prior to execution a check should be conducted to confirm that the relevant assets are in England or Wales at the time of execution of the security document and creation of the 'goods mortgage'.

That said, secondary legislation is expected to come through on the 'prescribed manner' for executing goods mortgages. Electronic execution is also expected to be possible.

[35] This is sample drafting by the author not provided by the Law Commission
[36] See Scottish Law Commission papers on draft Moveable Transactions (Scotland) Bill 2017. https://www.scotlawcom.gov.uk/law-reform/law-reform-projects/security-over-corporeal-and-incorporeal-moveable-property/
[37] See Report Law Com No 376 para 5.14

9. Registration and after execution of the Goods Mortgage

Once signed and dated with the date of creation the race will be on to register details of the security document on what will be the new register at the High Court in England, the Register of Goods Mortgages. Having rejected an advance notice filing system for priority, the time of day of registration will be critical and will regulate priority between two or more goods mortgages. Registration will be made in order of receipt of the information through the electronic filing and payment of the fee. The filing will last for 10 years[38] and if it is needed after that the filing will have to be renewed, but a new goods mortgage would not be needed over the same goods again. Failure to register can affect the right of the mortgagee in relation to the goods secured and can affect the rights in priority where there are competing goods mortgagees.

Unlike other systems there is no deadline for registration. Without registration the goods mortgage is invalid against third parties and trustee in bankruptcy. Remember, we are in the realms of individuals here so the relevant insolvency procedure would be bankruptcy. In practical terms, perfecting the security interest by registration is vital, so why delay? Although other methods could have been adopted we still seem to have a race, an electronic race this time, to the new electronic register to perfect the security and protect the goods.

10. Timing of reform

With the statement in the Queen's Speech, the Bill is definitely on the parliamentary agenda. The Bill has now been drafted and secondary legislation by way of draft Treasury regulations are expected in early 2018. The Bill can travel through the expedited route for 'uncontroversial Law Commission bills, subject to availability of Parliamentary time'[39]. No detailed timetable for implementation has been published at the date of writing.

Sole traders and unincorporated businesses and the lenders to them, should welcome the reforms, which provide simpler and clearer documentation. With (i) protection and additional options for more vulnerable individuals and small businesses, (ii) the expectation that the new 'goods mortgage' will result in reduced costs, and (iii) the introduction of the new electronic Register of Goods Mortgages we hope to see the demise of the forlorn Bills of Sale this year.

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[38] Section 9(5)
[39] See Report Law Com No 376 para.1.9

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How we can help?

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