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The state of play for second mortgagees

A buoyant property market has brought with it a rise in second mortgages. Two recent court judgments clarify where things stand when the borrower defaults.

When reward becomes risk

Second mortgages have become increasingly common. It appears they have lost the stigma of high risk given the rising property market and booming economy over recent years. However, with signs of the market and economy slowing down, and the ever-increasing interest rates, second mortgagees are now facing an increased exposure to shortfalls.

A second mortgagee who has a defaulting borrower faces some difficult decisions as to what to do. Should it wait, hoping that the first mortgagee will sell? Should it sell, hoping that its security is sufficient? Should it take over the first mortgage, so as to maximise control and options?

The options

Waiting for the first mortgagee to sell may achieve nothing more than a further depletion of an already limited equity in the security. A first mortgagee may be perfectly happy to wait patiently, comfortable with a generous default interest rate and a sufficiently high priority sum. And if the first mortgagee does choose to sell, then it may very well be less rigorous in its sale process or more willing to accept a lower price (still acting within the bounds of its obligation of reasonableness) than a second mortgagee,

simply because the price achieved is more than enough to clear that first mortgage – even if not the second.

Faced with those risks, the second mortgagee may decide to take action. A second mortgagee can exercise a power of sale (subject of course to any specific contractual arrangements it might have with the first mortgagee).

But that too requires some careful consideration. Either the second mortgagee will need to sell the land subject to the first mortgage – which might make it hard to find a purchaser willing to pay a good price – or it will need to make arrangements for the first mortgagee to provide a discharge on settlement of the second mortgagee's sale.

The case: Strategic Finance Limited v Ellington East Limited

One problem which can arise is that the first mortgagee also exercises its power of sale – perhaps even after the second mortgagee's agreement is signed up.

This was the situation which recently came before Associate Judge Christiansen and then Justice Panckhurst in the High Court in *Strategic Finance Limited v Ellington East Limited*.

“A second mortgagee who has a defaulting borrower faces some difficult decisions as to what to do.”

“Many first mortgagees do not take future interest payments into account, yet it can amount to a substantial amount of money.”

The first mortgagee entered into agreements to sell the mortgaged land under its power of sale, but not until *after* the second mortgagee had itself entered into agreements also under its power of sale (and the first mortgagee had not consented to the second mortgagee's sales). The purchaser in the second mortgagee's agreements had subsequently lodged caveats which prevented the first mortgagee from being able to pass clear title under its sales.

In dealing with the first mortgagee's application to remove those caveats, Associate Judge Christiansen held that even if the second mortgagee had sold land which was unsold by the first mortgagee, any such sale had to be subject to that first mortgage – and the second mortgagee was not at liberty to deal with the mortgaged land without taking into account the first mortgage. The second mortgagee would therefore need to:

- Sell the property subject to the first mortgage; or
- Arrange for the first mortgage to be discharged out of the proceeds of sale – but this could only happen with the first mortgagee's concurrence; or
- Redeem the first mortgage.

None of those applied, so the Associate Judge ordered that the caveats be removed upon registration of transfers under the first mortgagee's sales.

Caveats and appeal

The purchaser then sought that the caveats remain pending an appeal of the Associate Judge's decision. The Associate Judge refused, and the purchaser sought to review that refusal before Justice Panckhurst who agreed with the Associate Judge's reasoning in the judgment removing the caveats.

He declined to overturn the Associate Judge's refusal. His judgment also confirmed that:

- A first mortgagee in exercising the power of sale has a prior right to do so; and
- that power cannot be defeated by another sale, even one prior in time, unless the first mortgagee has consented to the sale.

What this means for second mortgagees

When it comes to settle the second mortgagee's sale, the second mortgagee will need to either sell the land subject to the first mortgage (which will probably result in a reduced price) or arrange to have the first mortgage discharged.

If the latter, then a second mortgagee should seek the first mortgagee's consent to the sale. If consent is obtained, then the first mortgagee cannot assert priority over the sale. If consent is not forthcoming, then the second mortgagee could seek the first mortgagee's agreement that – on repayment of the first mortgagee's secured debt – a discharge of the first mortgage will be provided. That way, the second mortgagee will be able to give clear title to its purchaser.

But if neither consent to the sale, nor agreement to provide a discharge is forthcoming, that may leave the second mortgagee with having to itself redeem the mortgaged land. Although the right of redemption is usually thought of as belonging to the mortgagor, a subsequent mortgagee can also exercise it – so long as the first mortgagee has not already entered into a binding sale itself.

Redeeming mortgagees

A redeeming mortgagee is entitled to either a discharge of the first mortgage or a transfer of that mortgage to it, whichever it prefers. If there are a number of subsequent mortgagees wishing to redeem a prior mortgage, then (according to the Court of Appeal's 1999 judgment in *McGaveston v NZ Perpetual Trustees Limited*) the priority between those mortgagees determines who is entitled to redeem.

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Note however that the first mortgagee may be entitled to require, as part of that redemption, either:

- If the time for redemption under the mortgage has not yet been reached – payment of the interest which would have accrued for that unexpired period; or
- If the time for redemption has been reached – either three months' notice of redemption or interest in lieu.

The advantage to a second mortgagee of exercising the right of redemption is that it will no longer have to worry about the first mortgagee's actions.

The second mortgagee would then be in entire control of the sale process, and any accruing interest (which would otherwise deplete proceeds available to the second mortgagee) would be to the benefit of the second mortgagee, not the first. And so long as the priority sum under the first mortgage is less than the likely net proceeds of a mortgagee sale, the second mortgagee's additional investment by redeeming the first mortgage should normally be relatively safe.

What this means for first mortgagees

The *Strategic Finance Limited v Ellington East Limited* judgments reconfirm first mortgagees' priority and ability to control the sale process – not just against the mortgagor (and any sales that the mortgagor may enter into) but also against subsequent mortgagees.

As priority can be lost by consenting to sales by mortgagors or subsequent mortgagees, then a first mortgagee should be careful either not to consent or to only give consent on terms which protect the first mortgagee.

And finally, the redemption provisions of the Property Law Act 1952 potentially give a first mortgagee the ability to insist on a payment of additional interest which would have been earned in the future. Many first mortgagees do not take that into account, yet it can amount to a substantial amount of money.