

Loan Agreements and Security Documentation

An essential consideration for a lender when entering into a loan agreement is “What happens if the borrower doesn’t pay?”

It is critical that both parties turn their minds to this question before a loan is made. It is important that both parties know what their exit strategy might be. This can avoid difficulties with enforcement if the borrower defaults, and give the best possible chance that the lender will be repaid for their investment.

Important questions a lender should ask before a loan is made include the following:

1. How long is the loan for?
2. What is the amount of the loan?
3. What will the interest rate be?
4. Should the borrower give security for the loan? If so, what type of security? Examples might include personal guarantees, a registered mortgage over real property, or a registered Personal Property Security Register charge (“PPSR charge”) over the borrower’s non-real estate assets.
5. Should the borrower obtain independent legal and financial advice as to the meaning and effect of the loan documents before I make the loan?
6. Are the terms of the loan fair and reasonable, and necessary for the protection of the lender’s legitimate business interests?
7. What capacity does the borrower have to repay the loan? What is the borrower’s Plan B if the borrower’s circumstances change?

It is essential that a lender holds sufficient security to cover the amount owed by the borrower to the lender, if the borrower defaults under the loan. A very simple example of this would be if a lender, **A**, was to lend \$100,000 to the borrower, **B**. If **B** owns a real property worth \$500,000 with no mortgage registered on the title, **B** might offer a registered mortgage over their property in favour of **A**, to secure the performance of **B**’s obligations under the loan. If **B** were to default at some point in the future, **A** could issue a Notice of Exercise of Power of Sale pursuant to section 84 of the *Property Law Act 1974* (Qld) (“the Act”). To satisfy that notice, **B** must pay

to **A** the amount demanded within 30 days of receipt of the notice in order to avoid further action by **A**. If **B** fails to satisfy the notice within 30 days, **A** may sell the property as mortgagee exercising power of sale in accordance with the Act.

If **A exercises its power of sale, the sale proceeds are to be applied as follows:**

1. Firstly in payment outstanding rates, land tax and other statutory charges owing in relation to the security property;
2. Secondly, in payment of the sum owing by **B** to **A** under the loan agreement. If permitted by the loan agreement terms, this amount will include default interest and **A**’s costs of sale including legal fees, valuation fees, real estate fees and commission, and other costs incurred by **A** as a consequence of **B**’s default;
3. Finally, any sale proceeds left over after payment of 1 and 2 above will be paid to **B**.

Complications can arise when there is not enough equity in the security property to satisfy the amount owing by **B** to **A** under the loan agreement. This may occur if there is already a first mortgage registered over the security property. Generally speaking, the amount owing to the holder of a first registered mortgage must be paid in full before a later mortgagee can be paid anything. To illustrate this point, let’s revisit the above example with the same facts, but where there is an existing first mortgage to a bank, **C**, registered on the title to **B**’s property. This mortgage secures a loan from **C** to **B** for \$400,000.

If B were to default under their loan agreement with either A or C, the loan proceeds would be applied as follows:

1. Firstly in payment outstanding rates, land tax and other statutory charges owing in relation to the security property;
2. Secondly, in payment of the sum owing by **B** to **C** under the first loan agreement, including default interest and **C**'s costs of sale including legal fees, valuation fees, real estate fees and commission, and other costs incurred by **C** as a consequence of **B**'s default;
3. Thirdly, in payment of the sum owing by **B** to **A** under the second loan agreement, including default interest and any costs incurred by **A** as a consequence of **B**'s default
4. Finally, any sale proceeds left over after payment of 1, 2 and 3 above will be paid to **B**.

In the above scenario, if **B** owes the first mortgagee, **C**, \$400,000 under the loan agreement, it is likely that significant further amounts will also be owed by the time **C** exercises its power of sale. Default interest, agent's commission and legal fees would reasonably be expected to amount to tens of thousands of dollars. Further, **C** is not obliged to obtain the best possible price for the property. A distressed sale of a property by a mortgagee exercising power of sale will rarely obtain the best possible price for the property. It is likely in this scenario that **A** will not be able to recover the whole amount owing to it under its loan agreement after **C** has received its share of the sale proceeds. This leaves **A** as an unsecured creditor of **B**, who may not have sufficient funds to satisfy the debt.

At Delaney & Delaney, we encourage careful planning at the outset, to make sure that your interests are protected if things don't go according to plan. Risks to the lender can be minimised by conducting due diligence before making the loan, and taking legal advice to ensure that the loan agreement complies with all applicable state and federal legislation, including the Australian Consumer Law.

There is no "one size fits all" approach and different considerations will apply, depending on the facts of each individual case.

Brisbane

Level 7 Northpoint
231 North Quay
Brisbane QLD 4000

Wilston

131 Kedron Brook Road
Wilston QLD 4051

Postal

P.O. Box 13125
George Street 4003

delaneyanddelaney.com.au

Brisbane ☎ (07) 3236 2604
Wilston ☎ (07) 3856 5600