



Careful Lending

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Just before Shakespeare has one of his fathers say to his son, “To thine own self be true”, the father gave the advice “ Neither a borrower or lender be!”

Take great care when lending money.

Banks spread the risk of default across many loans. Can you afford to rely on your loan?

If you are lending like a bank - think like a bank. What happens if it goes wrong?

WHAT IS THE DEAL?

The key issues on a loan are:

- the amount of the loan;
- what interest is payable, if any;
- when is the interest payable; monthly, quarterly, or the end of the loan;
- when is the capital repaid? It is repaid as a lump sum at the end of the loan or by instalments;
- what happens if the borrower doesn't pay as agreed; and
- will you be repaid?

You need to assess carefully the borrower's financial position, the extent of security for the loan and the general economics of the loan. There are matters that require your careful assessment. Your lawyer is not in a position to assess such financial matters. You may need to take independent financial advice

Be careful to assess not only the borrower's means to answer your loan but your needs for the loan to be repaid. Is the agreed timetable for repayment satisfactory? Will you be able to cope if that time table is not met?

WHAT IF THE BORROWER DOES NOT PAY?

Like any other agreement, if someone defaults on a loan agreement the other party can take court proceedings to enforce the agreement. If those Court proceedings are successful the Court can enforce a judgement against the person found responsible or his assets.

Often lenders are not satisfied with having to take Court proceedings. Often they want to have the loans secured directly against assets.

If the loan is secured, the lender can take action directly against the assets rather than by court proceedings.

Do you need the safety of assets available to secure the loan? A lender is in a stronger position and it is easier to enforce the loan if they can take action directly against property. Consider carefully what security is necessary.

It is no surprise that banks usually insist on having a loan secured.

WHAT SORT OF SECURITY IS AVAILABLE?

There are many different ways in which assets can be bound with debt. A borrower may leave the lender in control of some asset while the loan is outstanding. This is how pawn brokers work, for instance.

One of the best forms of security is a registered first mortgage over real estate. This is the security usually insisted by the bank.

Mortgages are good security because real estate not only can't be taken away, but also it is possible to register the mortgage against the title deeds. By contrast, taking a mortgage over goods is not as reliable because the goods can be destroyed or dealt with contrary to the mortgage.

If you have a mortgage, if the loan is not repaid you have the power to sell property to recover the debt. There can be no dealings with that property contrary to your interest and right to do so.

If there is already a mortgage over the property you could take a second mortgage where your rights would be subject to the claim on the property by the previous mortgage.

If you need more information on mortgages ask for our booklet on that topic.

It is possible to have a mortgage of assets other than land. Cars and household goods can be mortgaged. Land is a good asset to use for security because it has registered ownership and cannot be moved, lost or stolen. It is less susceptible to damage, wear and tear than goods.

WHAT DOES IT COST TO HAVE A LOAN SECURED?

The cost of securing a loan vary according to a number of circumstances.

Mortgages or charges over property are no longer subject to stamp duty of but there will be registration expenses recording the mortgage or the charge of approximately \$100.00. There will also be legal expenses which will vary according to many circumstances that are likely to be at least \$300.00 in the case of a mortgage and \$200.00 in the case of a charge.

There will be the costs of any lawyer involved which will vary according to how the transaction proceeds and how much time is required.

It is impossible to give accurate estimates of the lawyers likely charges in the abstract so you will need to take specific advice on what the costs will be before proceeding with any loan.

IS SECURITY ENFORCED ONLY AGAINST THE BORROWER?

Securing a loan protects the lender against other people claiming against the borrower.

In financial crisis the borrower may want to pay but be unable.

Creditors compete to get paid and secured creditors have the advantage over the unsecured. More than one creditor may have security against an asset. In such a case creditors take it in turns to claim from the proceeds of sale. Secured creditors get priority. The creditor with priority may get paid first, the asset sold not leaving enough funds to clear the loans of later creditors.

HOW MUCH SECURITY DO I NEED?

You need enough security to make sure you get paid. That is a matter for judgment.

There is always some risk you will not be repaid.

Securing a loan is an insurance and risk management exercise. You need to make your own judgement how much risk you want to take and how much trouble and expense you wish taken to get security.

IS THE EXPENSE OF SECURITY JUSTIFIED?

Securing a loan is an insurance and risk management exercise. You need to make assess the extent to which money spent on security is cost effective. Often the borrower will pay the costs of providing the security.

Your loan is as safe as the borrower's ability to pay and your ability to force payment if you have to.

IS THE EXPENSE OF REGISTERING A MORTGAGE JUSTIFIED?

Sometimes to save the cost of registering a mortgage, the parties have it prepared but left unregistered. This binds only the parties who have knowledge of it. People without knowledge of the unregistered mortgage may claim against the property.

IS THERE A CHEAPER ALTERNATIVE TO A MORTGAGE?

If a mortgage is not possible or practical, the Borrower could charge his property with the loan. A charge would allow you to prevent dealings with his property without repayment of your loan. You would be able to apply to the court for an order that the property be sold, but you cannot immediately proceed to sell his property without court proceedings.

To secure the charge you would be wise to register your interest in his property under the loan agreement against his title by way of a caveat. This would prevent dealings with the property contrary to your interest. Please let me know if you would like to register a caveat.

The value of any security is dependant on the extent of the Borrower's interest in the property. If he had other encumbrances against the property which equalled or exceeded the value of the property on sale, your charge over the property would be of no value.

DO YOU NEED TO HAVE SOMEONE GUARANTEE THE BORROWER?

If you are unsatisfied with what the borrower offers by way of security and the prospects of repayment, you may require another person to guarantee the debts are paid. That in turn may involve security over that other person's property. If the borrower defaults, you can take action against the person giving the guarantee or his property.

HOW DO WE KNOW WHAT IS REPAYED?

Take great care to make sure there is a comprehensive record of payments. It is all too easy over the years to lose track of what payments were made and for what purpose and when.

A duplicate receipt book kept by the lender is a simple and easy way. The borrower keeps the signed receipts as issued by the lender and the lender has the duplicates contained within the book. Another alternative is a designated bank account which is

available for deposits by the borrower.

CAN I BORROW YOUR UMBRELLA?

They say that if you lend your friend an umbrella, you will lose both the umbrella and the friend.

Be extra careful where family or friends are involved with money transactions.

Many people say that because it is a family matter or a matter with friends that they need not be concerned with formalities and legalities. In some ways, it is more important to be careful with friends and family because you have more to lose than the loan.

Think beyond reliance on the relationship as friend or family. The person you are now dealing with may lose control of their affairs. You may not end up dealing with the person with whom you now have the relationship. You may end up dealing with their executors after their death or their creditors after their financial disaster.

WHAT IF THE LOAN IS IN THE COURSE OF MY BUSINESS?

If, as part of your business, you make loans that the borrower applies to personal and domestic purposes, you will need to make sure the lending complies with the provisions of the Consumer Credit Code.

The Consumer Credit Code picks up not only whose principal business is lending, but also covers some transactions where a loan is a subsidiary to the major transaction. For instance, if there was a line of credit made available to purchase goods or arrangements were made for payment of the goods over time on the basis of interest being paid.

There is a comprehensive set of requirements under the Consumer Credit Code and the consequence of breach is serious. If the lending is related to your business and is for personal and domestic use to the borrower please take our specific instructions on that.

WHAT IS VENDOR FINANCE?

Sometimes vendors lend to their purchasers.

Vendor Finance may be to win a sale or may just be a happy coincidence of the vendor wanting a loan investment and the purchaser wanting to borrow.

Apart from the coincidence of the vendor being the lender and the purchaser the borrower the same loan issues as discussed above apply.

Vendor finance can be secured by property other than that sold.

If the sale agreement is predicated on vendor finance the contract should deal with the loan terms in sufficient detail.

In the following a sample clause for instance, where the vendor lends a modest amount of money and has only modest security. Different provision would be needed for tighter security:

1. Vendor Finance

- 1.1. *On settlement the Vendor will loan the Purchaser \$15,000.00.*
- 1.2. *The loan shall be repayable within three years from the date of this agreement.*
- 1.3. *The loan shall bear interest at the rate of 8% per annum from the date of this agreement, that interest payable monthly in arrears.*
- 1.4. *Payments in arrears by more than fourteen days shall bear interest at the rate of 10% per annum from the date of due.*
- 1.5. *If payments of interest are in arrears by more than 14 days, the whole of the loan becomes immediately due.*
- 1.6. *The Purchaser may make early repayment of the principal in whole or in part.*
- 1.7. *All monies received by the Vendor on account of this loan shall be applied first in reduction of arrears of interest, then in reduction of any default interest, then in payment of current interest and then in repayment of principal.*
- 1.8. *The Purchaser charges all his real estate with repayment of this debt.*
- 1.9. *The Vendor may caveat to record the existence of this charge.*
- 1.10. *To support that charge the Purchasers will instruct the solicitors of the Vendor to hold the deeds to the property as stakeholder for both parties under this agreement.*
- 1.11. *On demand by the Vendor, the Purchaser will give the Vendor a registered mortgage over any real estate owned by the Purchaser on such terms and conditions and in such form as certified as typical for such transactions by the solicitor for the Vendor.*
- 1.12. *The Purchaser appoints the Vendor as Attorney to execute any mortgage and take any further action necessary to fulfil the provisions of this deed and*

that appointment shall be irrevocable until all monies secured by this agreement are paid to the Vendor in full.

1.13. The Purchaser will pay to the Vendor all stamp duties, registration fees and solicitors costs of and incidental to the vendor finance.

WHAT IF I STILL WANT TO GO AHEAD?

There are risks in loans.

Sometimes the risk is worth taking.

Assess and minimise the risk.

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This booklet is not a complete statement of the law. It does not deal comprehensively with your particular situation. This booklet is to provide general information to supplement our specific advice to you. Do not act in reliance on this booklet without our specific advice.

We are responsible only if you give us specific instructions and for the specific advice we give.

This booklet was originally prepared in 1995 and has been updated as at March 2008. It does not reflect changes to the law after that date. You need to take specific advice on the possibility or effect of any such changes.