Subject: **<u>MORTGAGE: CERTAIN LEGAL ISSUES</u>**

1. Before discussing mortgages, it might be useful to refer to certain aspects of the law relating to security.

a) Where a third person assures a creditor that if the debtor does not pay off the debt, then the third party shall discharge the same, such security is called a **guarantee**. A guarantee is only a **personal promise** to discharge another person's debt, but the promise is not supported by any tangible security. The guarantee creates no right in favour of the creditor relating to the guarantor's property.

b) Where a tangible security is provided to the creditor, such security may have two forms:

i. The debtor or some other person may make a **personal promise** to the creditor that a certain specified property would be available to discharge a debt if it was not settled to the satisfaction of the creditor. In this kind of security the promisor **does not transfer** the relevant property to the creditor but only makes a promise relating to it. This kind of security is called a "**charge**".

ii. Where property in the security is **not transferred** to the creditor but the property is placed in the possession of the creditor with the right to sell it if there was a default to discharge the secured obligations, such security is called a "**pledge**".

iii. Where the possession remains with the debtor, in Pakistan such security is called a "**hypothecation charge**".

iv. A distinctive feature of pledge and hypothecation is that **ownership** of the security remains with the promisor although in one case the **possession** may remain with the promisor and in the other case, the possession may be handed over to the creditor.

c) The other kind of interest relating to tangible security would be where the promisor **transfers** the relevant property to the creditor on the understanding that if the obligations secured on the property were satisfied, the creditor would **re-transfer** the property to the promisor, and if there was a failure to discharge the obligations then the creditor may have the property sold and apply the proceeds towards the debt. This kind of security is called a **mortgage**. The main thing to keep in mind in the case of mortgages is that the relevant property becomes the **property of the creditor**. Once a security has been created the promisor is **no more the owner** of the property. The only interest that he has relating to the property is the right to redeem the property (what, in legal parlance, is called, the "**equity of redemption**").

2. **a)** After having discussed the legal instances of certain kinds of securities it would also be useful to discuss two very important concepts relating to security viz. "**attachment**" and "**perfection**".

i) **Attachment** involves the question whether an effective security has been created between the person creating the security and the person in whose favour the security has been created (the transacting parties) e.g. a mortgage for Rs.10M on immovable property created through a written registered instrument which does not bear signatures of **two witnesses** would not be a mortgage at law. It is a mandatory requirement that a mortgage must be witnessed by two persons (section 59, Transfer of Property Act, 1908). In such a case the security would **not attach**. Similarly, where a pledge is purportedly created but the possession of the pledged goods is never taken away from the pledgor, a security interest would **not attach**.

ii) The other term "**perfection**" involves the question whether **third parties** would also be bound by the security even where the security has come to be attached between the transacting parties e.g. if a mortgage created over the assets of a limited liability company is not reported to the Registrar Joint Stock Companies within 21 days of its creation, another creditor creating security on the same property **despite knowledge** of the earlier security would not be bound by it since the mandatory provisions of the Companies Ordinance, 1984 (Section 121) regarding recordation of a charge on the assets of company have not been satisfied, and such security does not bind other creditors. In this case the flaw in the security would be that although the security has "attached", it has not been "perfected" in accordance with the statutory process for perfecting the security.

b) The principle difference between a **charge** and a **mortgage** discussed above is that when an **effective mortgage** has been created the **attachment** and **perfection** of the security takes place at the same time and the security is binding on all other persons whether they actually know about the mortgage or not. As far as a charge is concerned, it becomes perfected against only those who know about the charge.

c) In the above context, section 100 of the Transfer of Properties Act lays down:

"No charge shall be enforced against any property in the hands of a person to whom such property has been transferred for consideration and **without notice** of the charge".

Therefore, as far as a charge is concerned, the **question of notice** assumes great importance. The concept of notice is very elaborately discussed in section 3 of the Transfer of Property Act, 1908. The relevant part is being reproduced below:

"A person is said to have notice of a fact when he actually knows that fact, or when, but for willful abstention from an inquiry or search which he ought to have made, or gross negligence, he would have known it.

Explanation I – Where any transaction in relation to immovable property is required by law to be and has been effected by a registered instrument, any person acquiring such property or any part of, or share or interest, in such property **shall be deemed to have notice of such instrument as from the date of registration** or, where the property is not all situated in one sub-district, or where the registered instrument has been registered under sub-section (2) of section 30 of the Registration Act, 1908, from the earliest date on which any memorandum of such registered instrument has been filed by any sub-registrar within whose sub-district any part of the property which is being acquired, or of the property wherein a share or interest is being acquired, is situated:

Provided that:-

i) The instrument has been registered and its registration completed in the manner prescribed by the Registration Act, 1908, and the rules made thereunder;

ii) The instrument or memorandum has been duly entered or filed, as the case may be, in books kept under section 51 of the Act; and

iii) The particulars regarding the transaction to which the instrument relates has been correctly entered in the indexes kept under section 55 of the Act.

Explanation II – Any person acquiring any immovable property, or any share or interest in any such property shall be deemed to have notice of the title, if any, of any person who is for the time being in **actual possession thereof**.

Explanation III – A person shall be deemed to have had notice of any fact if his **agent** acquires notice thereof whilst acting on his behalf in the course of business to which that fact is material:
Provided that, if the agent fraudulently conceals the fact, the principal shall not be charged which notice thereof as against any person who was a party to or otherwise cognizant of the fraud.

d) Here it may be kept in mind that where a mortgage is created by deposit of title deeds, the legal consequences of such mortgage are the same as would follow if a mortgage had been created under a registered deed. In areas where the Transfer of Property Act applies, this position stands affirmed u/s 96 of the Transfer of Property Act:

> "96. **Mortgage by deposit of title deeds.—**The provisions hereinbefore contained which apply to a simple mortgage shall, so far as may be, apply to a mortgage by deposit of title deeds."

In Punjab there is a chain of judicial authorities upholding the same principle although Section 96 does not formally apply to Punjab.

3. In light of the above discussion, the following principles follow:

i) The most important matter for a creditor to ensure is whether the security has **attached**. An unattached security cannot be **perfected**.

ii) In case of a "**mortgage**" the security gets attached as well as perfected at the time when the mortgage is created except in the cases of mortgages on the assets of companies incorporated under the Companies Ordinance, 1984. In such cases the mortgage must be reported to the RJSC within 21 days of the creation. Where a company is not involved nothing further is required to perfect the security after it has come to be attached unless some special law requires certain formalities to be fulfilled. In cases where a mortgage has been effectively created it is deemed by the law that everybody has notice even where a particular person might be ignorant about it.

iii) As far as "**charges**" are concerned, they become perfected only against those persons who have knowledge of the charge. Those who do not have knowledge are not bound by it, if they can establish that they acquired the property bonafide without notice of the charge and for valuable consideration. Therefore, in cases of a charge it becomes important to ensure that there is adequate notice of the charge.

4) In the light of the above discussion, it would be useful to discuss certain other relevant matters also.

a) In cases of registered mortgages or equitable mortgages created by deposit of title deeds (and not documents that do not constitute title deeds) there is no requirement whatsoever that such mortgages be incorporated either in revenue record or in the Excise & Taxation Office to become bind on third parties.

b) There is no reporting requirement whatsoever for achieving perfection except where there is a specific provision requiring formal reporting e.g. provision of Companies Ordinance discussed above. There are similar requirements regarding security on the assets of Modarabas relating to recordation of the security with the Registrar of Modarabas.

c) Under Section 42 of the Land Revenue Act it is required that a person acquiring any rights in "estate" as a "land owner" etc. should report such acquisition to the Patwari of the estate for entry of such report in the register of mutations. The purpose of such mutation is to facilitate updating of the periodical record of rights. A mutation is not presumed to be true, while entries in the records-of-rights and periodical records create only a rebuttable presumption of truth. None of these entries "create" a right in property – they merely provide some evidence of such right. A valid mortgage reported or unreported would remain a mortgage while a void "mortgage**"** even reported would not operate as a mortgage.

d) The principle purpose of revenue entries is revenue administration in accordance with the Land Revenue Act, 1967. In urban areas where no land revenue is being assessed or collected maintenance of revenue records is quite an anomaly. The practice continues despite expansion of cities since there has been no denotification of surrounding village "estates" regarding the change of actual status of the land. An "Estate" for Land Revenue Act purposes is essentially a defined area of land for which there is separate land revenue assessment.

e) There is also a reporting requirement (when there is a change of ownership) where the assessing authority so requires under Section 9 of the Urban Immovable Property Tax Act, 1958 but, again, such reporting is only for tax purposes and not for "attaching" or "perfection" of rights..

5. a) From the above it can be seen that reporting a mortgage to the Property Tax Department or the Revenue Authorities adds nothing to the validity of the mortgage. If a person buys a mortgaged property, he acquires no "title" to the property (since the property "belongs" to the mortgagee) but only acquires the "equity of redemption", whether he knows about the mortgage or not. The mortgagor does not "own" title to the property mortgaged by him. He can convey no better title than he would if he sold the property of his neighbor, or a tenant sold his landlords property, or having sold his property once a seller sold it again. Reporting of a mortgage to the Revenue authorities might serve only the "practical purpose" of reducing the possibility of another person buying the property and then getting involved in time consuming litigation with the secured creditor, although the litigant would end up as the loser at the end.

b) Here it may be pointed out that it happens sometimes that in cases where a person not knowing about a mortgage has purchased the relevant property and has entered into its possession, the banks commit the mistake of filing a foreclosure suit without making such person a party to the suit. In such a case a bank may face a frustrating situation that despite having got a decree relating to the mortgaged property against the mortgagor, it might not be enforceable against the purchaser of the mortgaged property since such purchaser was not a party to the suit. A decree cannot be enforced against a non-party (unless such non-party had purchased the property after commencement of the litigation).

6. **a)** The above discussion deals with cases where mortgages are created by persons who are **owners** of the relevant property and not cases where the security creator holds only **allotment letters**. Unless an allotment letter has been registered and clearly states that the relevant property has been transferred to the allottee as an owner, such letters are not instruments of conveyance/transfer of title but are merely evidence of a contract between the allotting authority and the allottee. The title to the property as an "owner" continues to vest in the allotting authority. The situation is somewhat similar to the case of a landlord and a tenant. Any mortgage created by the allottee would actually operate only as an "assignment by way of security" of his "**contractual rights**" as the allottee. There can be no mortgage in the sense that he should be in a position to transfer "**title**" to the property by way of mortgage. In practical terms, where the security is desired over such interest, the real question would be what are the **terms of the grant** under which an allotment is held. If the allotment/transfer/allocation letter states that the interest of the allottee may be "mortgaged" only with the permission of the allotting authority then all that would be required for creating a security in the "contract rights" would be to seek permission of the allotting authority to create security interest in the contract rights of the allottee and ensure that the allotting authority has effectively noted this fact in its records. In fact such transaction would create a security by way of "novation" of the original contract for the purpose of establishing a security interest. In cases of allotment rights, the revenue authorities or Excise & Taxation Offices refuses to enter any information relating to the security on their records for the reason that the property continues to belong to the allotting authority as far as the property records are concerned. The allottees etc. are strangers to this record.

b) From the discussion above, it can be seen that except for practical utility purposes discussed above (preventing of frustrating litigation) there is no requirement whatsoever that for "perfecting" the security the mortgage must be recorded with the revenue authorities or the excise & taxation authorities. As regards charges, the matter is discussed below.

7. Where a security is operative only as a charge, the question of putting other to notice assumes critical importance. Whether effective notice has been made or not would depend on the circumstances of the case. Recordation of a "charge" on assets of a company, with the SECP would be conclusive. In agricultural properties, it is a common practice that any person desiring to acquire an agricultural property would, as a prudent man, examine the revenue record. If the record contains information relating to a charge on the property, it would be difficult for such purchaser to assert that he was a bonafide purchaser without notice. The same cannot be said about the excise & taxation record. It is not at all a practice regarding urban properties that people, as a matter of normal routine, also examine the excise & taxation records. Assuming that the security was only in the nature of a charge and not a mortgage, it should be possible for a purchaser to reasonably assert that he was not even aware of any security interest recorded with the ETO. Nevertheless such entry would serve the purpose of putting to notice such person who may actually happen to examine the record.

8. Here it may be useful to reiterate the fundamental purpose of revenue record or excise and taxation records. Both these records are essentially maintained for determining as to who should bear the tax liability. Section 42 of the Land Revenue Act, 1967 only states that transfer of interest in a property must be recorded with the revenue authorities but it must be remembered that making of the entry does not "create" an interest. At best, it is only an evidence of the interest. As far as the record of ETO maintained under the urban Immovable Property Tax Act, it does not even carry a "presumption" of being evidence of some interest relating to the relevant property. Here a question arises whether, after having created a mortgage the bank should insist that there should also be an entry with Land Revenue authorities. As a matter of law West Pakistan Land Revenue Act, 1967 deals only with land revenue matters pertaining to agricultural land assessed to land revenue and not urban lands not subject to land revenue. Even where agricultural land is involved, the trend of the revenue authorities is that they make entries only on the basis of registered mortgages. It is perhaps for this reason that the practice of token registered mortgages has evolved to create some kind of public notice, even in cases where it is not really required. Where an effective equitable mortgage has been created, the token mortgage adds nothing to the security. Where the equitable mortgage is ineffective, the token mortgage would be the "only" security effective "only" for the "token" money. Therefore, the ultimate issue always remains, whether effective security for the entire exposure has been created or not.

9. It may be kept in view that the legal structure regarding recordation of rights relating to immovable properties is not the same in the Province of Punjab as in the Province of Sindh In Sindh the entire transfer of Property Act applies. In the Punjab only a few of the provisions (basically those dealing with transfer of property through registered instruments) are applicable. In Karachi it is a common practice that properties are held under a lease. In Lahore, and other urban centres, property in case of developing areas is often held only under some kind of allotment letter or even a "transfer of allotment" letter, with nothing more to evidence the rights of the relevant person. Since the TPA applies to the Province of Sindh, therefore, by virtue of an amendment made in Section 58(f) where no "title documents" exist "mortgage by deposit of title deeds", can be created in Sindh by making an entry to that effect in the Revenue record. Since this provision does not apply to the Province of Punjab, its benefit cannot be taken in Punjab.