

# Lending to Individuals

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# Lending to individuals

## Introduction

Few areas of business are more highly regulated than the business of lending to individuals. Anyone lending or providing credit to an individual borrower, or seeking to obtain security from an individual, must consider numerous regulatory aspects, and should take advice from a suitably experienced lawyer.

This briefing paper sets out some of the relevant legislation, issues and other factors that a lender should consider in financing transactions involving individuals. This paper is aimed at lenders in the private wealth sphere. It does not consider all the legislation and regulations and other factors to be taken into account by lenders offering retail banking services to individual customers or in relation to consumer hire.

## Consumer Credit

### The legislative framework

Since 2014 (when the Financial Conduct Authority (**FCA**) took over responsibility from the Office of Fair Trading for the regulation of consumer credit), the regulatory framework for consumer credit activities within the UK is based primarily on two sources:

- *Parts of the Consumer Credit Act 1974 (CCA)*. This Act, that grandfather of consumer protection legislation, remains in force to govern, with secondary legislation under that Act governing many aspects of consumer lending transactions including the form and content of regulated agreements and pre-contract disclosure, rights of borrowers and the powers of the court.
- *The Financial Services and Markets Act 2000 (the FSMA)*. This Act, and secondary legislation under it sets out the licensing regime for different types of lending businesses and in addition, provides for the regulation of a number of intermediary and ancillary activities relating to consumer lending, mortgage lending, and operating peer-to-peer lending platforms. Regulated firms are obliged to follow rules made by the FCA which has consolidated its rules and guidance into the FCA Handbook which includes a number of specifically relevant Sourcebooks including the FCA's Consumer Credit Sourcebook (**CONC**) and the Mortgage and Home Finance Conduct of Business Sourcebook (**MCOB**) as well as its helpful Perimeter

Guidance Sourcebook (**PERG**). The scheme of regulation under the FSMA governs the need for authorisation; and identifies agreements that are exempted from this regime as well as providing for the regulation of advertising; and obligations on lenders including assessing creditworthiness, arrears handling and fair business practices.

The UK law reflects and embodies the UK's implementation of European law (principally the EU Consumer Credit Directive (**CCD**) and Mortgage Credit Directive (**MCD**) which generally remains applicable notwithstanding Brexit, subject to minor and technical amendments including those under the Consumer Credit (Amendment) (EU Exit) Regulations 2018 (SI 2018/1038).

### What business is regulated?

Certain activities relating to lending (when carried out by way of business) are regulated under the FSMA. These are specified in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (as amended from time to time) (**RAO**).

Any firm or person undertaking any of these specified consumer credit services by way of business (including some types of peer-to-peer lending) must be authorised by the FCA to be permitted to provide such services.

In determining whether an activity is being undertaken by way of business, the FCA will consider:

- whether the activity is continuous;
- the existence of any commercial element; and
- the scale of the activity and its proportion to non-regulated activities.

Lending is not of itself a regulated activity but where lending is undertaken by way of business and amounts to consumer credit lending or regulated mortgage lending, unless an exemption or exclusion applies it will fall into scope.

### Consumer credit lending

A lender carrying on a consumer credit business (i.e. "*any business being carried on by a person so far as it comprises or relates to the provision of credit by him ... under regulated consumer credit agreements*") in the UK must be authorised under the FSMA.

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The regime also regulates a number of activities relating to consumer credit including such items as acting as a lender in relation to a regulated consumer credit agreement, exercising the rights of a lender under such an agreement and certain other ancillary activities relating more generally to credit agreements, such as credit broking, debt administration, debt adjusting, debt counselling, debt collection, as well as lending and hiring itself. It also applies to the provision of credit information services and acting as a credit reference agency. Some of these activities can apply even when the agreements being are not regulated agreements.

It is a criminal offence for a person who is not authorised or exempt to carry on any regulated consumer credit activities (Section 19 of FSMA). In addition, any regulated consumer credit agreement would be unenforceable (without a court order), any money paid under it may have to be returned and compensation payable, unless the creditor applies for dispensation to the FCA and the FCA grants it.

The regulated activities that apply to consumer credit apply in relation to "consumer credit agreements" between a "creditor" and an "individual" or "a relevant recipient of credit". This means that it applies to credit arrangements of any value entered into by a lender with:

- individuals (including trustees);
- sole traders;
- partnerships of two or three partners (unless all partners are bodies corporate); or
- other unincorporated bodies, such as clubs (again, unless they consist entirely of bodies corporate).

The definition of what constitutes a "credit agreement" for the purposes of the CCA and CONC is broad. "Credit" is defined as "*any form of financial accommodation*". Therefore "*credit agreement*" extends to cover (without limitation) loan agreements, overdrafts, hire purchase agreements, conditional sale agreements, pawn agreements, credit card agreements and other agreements where goods or services are supplied, but payment for which is deferred or credit provided.

Not all credit agreements fall within the definition of a regulated credit agreement (so as to bring the FSMA requirements for authorisation into scope). However, care needs to be taken as certain aspects of the consumer credit regime do still apply to a credit agreement that is

not a regulated credit agreement.

A "consumer credit agreement" under section 8 of the CCA :

- a. is an agreement between an individual (the debtor) and any other person (the creditor);
- b. under which the creditor provides the debtor with credit of any amount;
- c. is not an exempt agreement under the RAO; and
- d. is not secured on a home or to acquire an interest in land.

It should be noted that it is irrelevant, for these purposes, whether or not interest is charged in relation to any of these arrangements; the requirement for authorisation, the CCA and CONC may equally apply to, for example, an interest-free loan.

Before 6 April 2007 (and applicable to agreements made prior to this date) credit agreements of a value in excess of £25,000 fell outside the definition of "regulated agreement" under the CCA. This financial limit was removed by the Consumer Credit Act 2006 and there is currently no general exclusion for agreements above a certain value (save for those to which the "business purposes" exemption outlined below would apply).

The territorial aspects of the consumer credit regime are not straightforward. Situations where the individual debtor is resident in England or where the creditor is resident in England and the credit agreement is governed by English law should all be considered with care and specific advice sought.

The consumer credit regime also applies to hire agreements with individuals. However, the focus of this note is in relation to credit agreements.

When a lender has established that the relevant credit arrangement is itself one that meets the above criteria, the next question to ask is whether the arrangement amounts to a "regulated agreement", or whether an exemption applies.

## What exemptions could apply?

A consumer credit agreement, when entered into by way of business, will be regulated unless an exemption applies. Not all exemptions are addressed in this paper; the

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focus is on those most commonly used by lenders, particularly in the private wealth sector. In each case, care must be always taken to fall within the precise terms of the relevant exemption.

- *"High Net Worth Individual" exemption*

An exemption at Article 60(H) of the RAO may apply if the *borrower* is a natural person (oddly it does not clearly cover loans to "relevant recipients of credit such as partnerships or unincorporated associations) with an income (net of National Insurance contributions and income tax) of not less than £150,000 and/or net assets (excluding items such as the value of their primary residence and any pension benefits) of not less than £500,000 in the "previous financial year" (i.e. the financial year ending on 31 March).

In addition, the agreement must either:

- be secured on land; or
- provide credit of over £60,260 for purposes other than the 'renovation of a residential property' or 'to acquire or retain property rights in land or in an existing or projected building'.

The exact requirements of Article 60H of the RAO must be observed. A declaration of high net worth in the prescribed form must be included in the credit agreement and a statement of high net worth in the prescribed form must be obtained in respect of the debtor and each duly completed. The statement of high net worth must be completed by an accountant (who is a member of a listed professional body) or the lender (if it is a bank authorised to accept deposits). A copy of the statement must be provided to the borrower before the credit agreement is entered into. The statement must be made within one year ending on the date on which the credit agreement was made. If there is more than one individual debtor under a credit agreement, each of them must qualify in order for the exemption to apply. The relevant declarations relating to the HNW exemption are set out at CONC App 1.4.6R and 1.4.7R.

- *"Business purposes" exemption for agreements above £25,000*

A credit agreement which **exceeds** £25,000 will not be a regulated agreement if it is entered into by a debtor wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by him/her (Article 60C(3), RAO). If the borrower makes a declara-

tion to that effect in the form prescribed in the credit agreement itself, it will be presumed that this is the case (Article 60C(5), RAO), but note that unlike the "High Net Worth Individual" exception above, the declaration is not compulsory though of plain evidential value in the presumption conferred by it.

Acting in the course of business means in the course of a business regularly carried on by the **borrower or hirer**. Please note that if the lender or hirer (i.e. the creditor) (or anyone acting on their behalf) knows, or has reason to suspect that the agreement is not, in fact, being entered into wholly or predominantly for business purposes of the debtor, they cannot rely on this exemption. The statutory wording for the business purposes declaration is set out at CONC App 1.4.8R.

Applying the business purpose exemption can be tricky in practice. For example, if a loan is being made to an employee to purchase shares in his employer company, can this be regarded as a business purpose? The answer is probably "no" given that the loan is not being made to the employee for the purposes of a business carried on by him/her.

- *Exemption for transactions relating to financial instruments*

A credit agreement is exempt if: (i) the lender is an investment firm or credit institution; and (ii) the agreement is entered into for the purpose of allowing the borrower to carry out a transaction relating to one or more financial instruments.

- *Exemption for regulated mortgages*

"Regulated Mortgage Contracts" (as described in the "Regulated Mortgages" section below) are outside the regime for consumer credit (as they are subject to their own regulatory regime). It should be noted, however, that loans secured by a second (and not first) charge over such property will be regulated by the CCA unless one of the other exemptions applies.

- *Exemption for certain agreements secured on land*

In addition to the exemption for FCA-regulated mortgages, certain other types of credit agreements secured on land will be exempt. There is an exemption (the "buy-to-let" exemption), which applies to secured loans used to purchase property or land, less than 40% of which is to be used as or in connection with a dwelling by the borrower or the borrower's family (or where the credit is provided

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to, trustees, by a beneficiary or related persons). This is on the basis that such lending is expected to fall within the scope of regulation for mortgage lending, and will not apply if the credit agreement does not meet the basic conditions to fall within the definition of a regulated mortgage contract, as explained below.

There are also other exemptions relating to loans secured on land which can only be relied upon by deposit-takers (i.e. banks or building societies), insurers and certain other bodies (such as local authorities) listed in article 60E, RAO.

The exemptions are for: (i) credit agreements secured by a land mortgage where the credit is used to purchase non-residential land, a dwelling or business premises; (ii) credit used for land or home improvement where the lender holds a mortgage over the land or property being improved; and (iii) credit used to refinance debt which falls within one of the two of the above mentioned categories.

- *Small number of payments exemption*

This exemption can apply if, under a credit agreement (involving a borrower, lender **and** supplier) for fixed sum credit, the credit is repayable by the debtor in twelve or fewer payments over a period not exceeding 12 months and the credit is secured on land or free of any interest or charges. There are certain other limitations in relation to the nature of the loan.

- *Low total charge for credit of credit exemption*

There is also an exemption for certain low interest rate agreements offered to a limited class of individuals (such as employees), but the technicalities which are to be met before this exemption can be relied on mean that the scope for the application of this exemption is very limited.

- *Exemption for loans entered under the Bounce Back Loan Scheme*

From 4 May 2020 new exemptions were introduced by the Financial Services and Markets Act 2000 (Regulated Activities) (Coronavirus) (Amendment) Order 2020. The Order amends article 60C of the RAO to create a new type of exempt agreement applicable to a credit agreement where a lender provides a borrower with credit of £25,000 or less for the purposes of a business carried on, or intended to be carried on, by the borrower and where the agreement is entered into under the Bounce Back

Loan Scheme (BBSL). However, as a result of an amendment made to the Order to Article 39H of the RAO the activity of debt collecting in relation to BBSL loans, is a specified activity notwithstanding this exemption.

## What if none of the exemptions apply?

If the credit agreement in question meets the criteria for regulation under the RAO and none of the exemptions apply, the lender must be authorised under Part 4A FSMA by the FCA before it can undertake that business and it must comply with the procedures of the relevant secondary legislation, CCA and FCA Handbook.

This means that the lender must comply with the pre-contractual requirements of the CCA, the form, content and format of agreements prescribed by the CCA, the post-contractual information provision requirements and the procedures prescribed by the CCA for steps to be taken in the event that things go wrong, and upon enforcement.

Failure to comply with the requirements of the CCA when entering into a credit agreement can render the agreement unenforceable without a court order.

It should be noted that there is a "light touch" regime that would apply to certain types of agreements which are technically covered by and regulated by the CCA, but to which only certain of the provisions of and formalities required by the CCA would apply. These include non-commercial agreements, overdrafts and small value agreements. However, the rules around these arrangements are not straightforward to apply.

## "Unfair relationships" and the CCA

It is important for any lender involved in lending to individuals to bear in mind and consider the "unfair relationships" provisions in sections 140A to 140C of the CCA, which apply to *all* agreements entered into with individual debtors. They apply to regulated, exempt and completely unregulated agreements originated after 6 April 2007 and apply retrospectively to agreements entered into prior to that date if they had not been fully completed by that time. The provisions can apply even after the agreement has ended.

If a borrower alleges that the relationship between the lender and the borrower is unfair to the borrower, it is

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for the lender to prove to the contrary. If the courts consider that there was an unfair relationship between the borrower and the lender, the provisions of the CCA give the courts the power to "re-open" and vary credit agreements, to discharge any obligation under it, order the repayment of money to the borrower, cancel or return security, reduce or cancel interest or require the lender to do anything else that the court considers necessary.

The term "unfair" itself has not been defined, but, in the assessment of fairness, certain relevant factors will be considered by the courts, including: (i) the way in which the agreement is drafted; (ii) whether the lender engaged in unfair commercial practices, such as making misleading statements; (iii) whether the lender checked the credit-worthiness of the borrower or that the financial product in question was suitable in light of the borrower's circumstances; and (iv) the manner in which the creditor has dealt with the borrower, including the manner in which it enforced or sought to enforce its rights.

## Regulated mortgages

### When are activities relating to mortgages regulated?

The restriction mentioned above in section 19 of the FSMA prohibiting unauthorised persons from undertaking regulated activities applies also to various activities connected to regulated mortgage contracts. These activities include:

- *advising* in connection with a regulated mortgage contract,
- *arranging* for a person to enter in to a regulated mortgage contract as a borrower (including making arrangements and making arrangements with a view for a person to enter in to as a borrower),
- *administering* regulated mortgage contract, or
- *entering* into as a lender under regulated mortgage contract

where the activity is being undertaken by way of business in the UK.

### What is a "regulated mortgage contract"?

In addition to residential mortgages, the term "regulated mortgage contracts" can extend to cover a wide range of loans where security is taken over residential property, such as loans for home improvements, lending for debt consolidation, business lending to sole traders and partnerships in England and Wales, secured overdrafts, secured credit cards and bridging loans.

Except where an exemption or exclusion applies, a regulated mortgage contract is one where at the time it is entered into:

- a. the lender provides credit (which includes any form of financial accommodation) to an individual or trustee (i.e. including a corporate trustee);
- b. the obligation to repay is secured by a mortgage over land in the EEA; and
- c. at least 40% of the land by area is used or intended to be used in connection with a dwelling, which in the case of loan to a trustee who is not an individual is to be occupied by a beneficiary of the trust or a member of the beneficiary's immediate family. In assessing whether the required area is used in connection with a dwelling, reference is made to all associated land area and the aggregate floor areas of each storey within a building. Where a single mortgage is being taken over a portfolio of properties, the assessment is made by reference to the total area of the entire portfolio.

However, a contract is not a regulated mortgage contract if it falls within a number of exclusions set out in detail in the RAO. These include exclusions for a **regulated home purchase plan**, a **limited payment second charge bridging loan**, an **investment property loan**, an **exempt consumer buy-to-let mortgage**, a **second charge business loan**, an **exempt equitable mortgage bridging loan**, an **exempt housing authority loan** or a **limited interest second charge credit union loan** within the meaning of article 61A(1) or (2), RAO.

Also, there are special rules if the contract was entered into before 21 March 2016. In this case a contract will be a regulated mortgage contract only if :

- a. at the time the mortgage was entered into, entering into the contract constituted the regulated activity of entering into a regulated mortgage contract as lender; or

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- b. the contract is a consumer credit back book mortgage contract within article 2 of the Mortgage Consolidation Directive Order 2015.

## Exclusions for Investment Property Loans

The exclusion for investment property loans is an important one. A contract which otherwise would be regarded as a regulated mortgage contract because it meets the three conditions in the definition of a regulated mortgage contract above, is **excluded** from the definition of a regulated mortgage as an "investment property loan" if, at the time it is entered into it meets the following conditions:

- less than 40% of the land secured by the mortgage is used, or intended to be used, as or in connection with a dwelling by the borrower or related person or (in the case of credit provided to trustees) by an individual who is the beneficiary of the trust or related person; and
- the borrower enters the agreement *wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by such borrower.*

For these purposes, a borrower is regarded as entering into an agreement for the purpose of a business carried on, or intended to be carried on, by such borrower if the agreement is **a buy-to-let mortgage contract** (the definition of which requires the agreement to exclude the property from being occupied by the borrower or a related person and that the property is to be occupied under a rental agreement) and one or the other of two sets of further conditions apply.

The first set of conditions is that:

- the borrower previously purchased, or is entering into a contract to finance the purchase by the borrower of, the land subject to the mortgage;
- at the time of the purchase (or if earlier at the time of the contract) the borrower intended that the land would be occupied as a dwelling on the basis of a rental agreement and would not at any time be occupied as a dwelling by the borrower or by a related person; and
- since the time of purchase the land has not at any time been occupied as a dwelling by the borrower or a related person.

The other set of conditions is that:

- the borrower is the owner of land, other than the land subject to the mortgage, that is:
- occupied as a dwelling on the basis of a rental agreement and is not occupied as a dwelling by the borrower or by a related person;
- secured by a mortgage under a buy-to-let mortgage contract;
- it meets the three conditions in the definition of a regulated mortgage contract above;
- the lender provides the borrower with credit exceeding £25,000;
- the mortgage ranks in priority behind one or more other mortgages affecting the subject land; and
- the agreement is entered into wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower (Article 61(A)(6), RAO).

## Consumer buy-to-let contracts

The Mortgage Order 2015 (MCDO) introduces a special regime for the regulation of consumer buy-to-let contracts that a lender can opt into by becoming registered as a consumer buy-to-let mortgage firm. Firms that have registered under this regime (which is less onerous than regulation under the FSMA) enjoy an exemption under article 72L so that their lending for the purposes of a consumer buy-to-let mortgages is not counted as regulated mortgage lending.

The definition of "consumer buy-to-let mortgage business" is given in article 4 MCDO, and its characteristics are similar to the RAO definition of a buy-to-let mortgage contract so there may be an overlap between a consumer buy to let contract and an investment property loan. If the investment property loan definition is being relied upon, however, lenders will want to rely on a declaration made by the borrower that the loan is for investment purposes in the form mandated by article 61A(3) so that it includes a statement that the borrower understands that he or she will not have the benefit of the protection of remedies available under FSMA and should seek independent legal advice if in any doubt in any doubt as to the consequences.

There are some categories of "exempt consumer buy-to-let mortgages" that are exempted from both the FSMA

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authorisation regime and that under the MCDO. These apply to consumer buy-to-let loans in certain specialised circumstances listed in the EU Mortgage Credit Directive and where the consumer-buy-to-let loan is a bridging loan.

## The consequences of breach

There are various penalties if an unauthorised person (who is not an "exempt person" for the purposes of FSMA) has been carrying out regulated activities or that might apply to an authorised person who has not complied with FSMA or rules in the FCA Handbook. These include:

- criminal sanctions (including imprisonment of up to 2 years) and/or a fine;
- any agreement made or security granted by a person who has been carrying on a regulated activity without permission may be unenforceable against the borrower;
- private persons (including the borrower) may in certain cases bring an action for damages for losses arising as a result of a breach by an authorised person of the FCA's Handbook rules;
- the FCA investigating and taking enforcement action (including, in some cases, by initiating criminal prosecution), levying fines and/or taking disciplinary action against firms and approved persons, including restricting activities or removing their permission; and
- the Financial Ombudsman Service finding against the lender/intermediary following a complaint made by the borrower.
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Compensation may be paid under the Financial Services Compensation Scheme to borrowers if an authorised firm becomes insolvent or ceases to trade after a claim made against it.

## Taking security and guarantees

## from individuals

### Issues to consider when taking security from an individual

Lenders taking security from individuals should consider the following issues:

#### CCA security

Security for credit regulated by the CCA is subject to additional requirements. It must be in writing, adopt the prescribed form, and embody the prescribed contents. If it is provided by the borrower, the terms of the security must be set out in the credit agreement, or a document it refers to. Unless these and numerous other formalities are observed, the security document is not properly executed, and would only be enforceable with a Court order.

If the credit is not regulated by the CCA (for example because it is provided to a limited company), these requirements do not apply to security provided by an individual in respect of that credit (i.e. third party security).

#### Registration

Subject to what is said below about the Bills of Sale Acts, there is no public registration system for most security given by individuals, although registration may be required in an "asset registry" such as the Land Registry. As a result, such security from individuals can be more vulnerable to the legitimate competing interests of third parties.

#### Bills of Sale Acts

A mortgage or charge by an individual or a partnership (other than a limited liability partnership) over "personal chattels" is subject to the Bills of Sale Acts 1878-1882 ("**Bills of Sale Acts**"). Most goods are personal chattels for these purposes, but the Bills of Sale Acts do not apply to boats or aircraft. "Personal chattels" also exclude shares or interest in the stock, funds or securities of any government, or in the capital or property of incorporated or joint stock companies, and choses in action.

Unless it falls within one of a number of statutory exemp-



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tions (including goods at sea or abroad), the security will be void if it is not in the form required by, and registered under, the Bills of Sale Acts. In practice, these formalities are cumbersome and unattractive to lenders, such that taking a mortgage or charge over personal chattels from an individual is seldom practicable. Having said that, the use of bills of sale especially for log book loans on vehicles has surged in recent years. However, from a borrower's standpoint problems arise from the ability of the lender to seize the secured goods upon default without the need for a court order notwithstanding that almost the whole of the loan has been repaid.

From a lender's standpoint, the Bills of Sale Acts requirements make the process very rigid, complex, costly and dangerous as a small deviation from the statutory template renders the security void. In addition, the bill of sale has to be registered at the High Court within 7 days (which in itself is a complex procedure involving the attestation by a solicitor and the making of an affidavit) and this has to be renewed every five years otherwise it becomes void.

The Law Commission's Goods Mortgages Bill proposed a complete repeal and simplification of the current Victorian legislation. The Bill included protection for borrowers so goods (especially vehicles the subject of log book loans) cannot be seized too readily and protection for innocent purchasers of goods (especially vehicles the subject of log book loans). An electronic register of goods mortgages was also proposed. The proposed additional protection for purchasers (aimed predominantly at motor vehicles) in turn gave rise to further potential issues for lenders against art as security. After the first attempt to get the Bill through parliament there were two further attempts (both private bills as opposed to public bills originating from the House of Commons) the last of which was shelved as a result of Brexit. The Bill was, however, recently revived and had its first reading in the House of Lords. Given Covid 19, however, it is questionable whether the Bill will make it onto the statute book in the foreseeable future.

It is sometimes possible to avoid the difficulties caused by the Bills of Sale Acts by taking security over personal chattels in the form of a pledge, rather than a mortgage or charge or by the lender acquiring title to the chattel and entering into a hire purchase arrangement with the borrower. A pledge given by an individual falls outside the scope of the Bills of Sale Acts. A pledge gives the lender a proprietary interest in the relevant personal

chattels, and confers a power of sale on the holder of the pledge. It should be noted that a pledge requires the actual or constructive delivery of possession of the chattels, or of documents of title to them, to the lender, with the intention of creating a pledge, although the delivery may be symbolic, for example, the borrower may hand over the keys to the warehouse where the chattels are kept.

There is a degree of "recharacterisation" risk if goods have been purchased in the name of a company, or transferred to a company, in order to enable the company rather than an individual to create security. The purchase or transfer must be a genuine one. The risk is greater where the individual is left in possession of the relevant asset.

## Floating charges

As shares, cash and purely contractual rights are excluded from the definition of "personal chattels" in the Bills of Sale Acts, it is generally accepted that an individual borrower may give a charge over such assets without concerns arising under the Bills of Sale Acts. However, a floating charge over **all of an individual's assets** will include "personal chattels" and will fall foul of the Bills of Sale Acts as not being in the form required by, and registered under, the Bills of Sale Acts. That is why, in practice, a floating charge over **all** assets cannot be taken from an individual.

Despite some judicial commentary apparently to the contrary, it is generally thought that an individual may give a floating charge over assets other than personal chattels (e.g. shares) and, if a fixed charge fails as a result of lack of control by the creditor, it might be re-characterised as a floating charge.

## Financial Collateral Regulations

Lenders should bear in mind that the Financial Collateral Arrangements (No. 2) Regulations 2003 do not apply unless the collateral provider and the collateral taker are non-natural persons meaning that the benefits arising from falling under the purview of these regulations, such as the right to appropriate financial collateral, are not applicable to security given by an individual.

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## General assignments of book debts

If an individual is engaged in business, a "general assignment" of his or her uncollected book debts by way of security or charge will be void as against a trustee in bankruptcy unless the assignment has been registered under the Bills of Sale Acts. This does not apply to an assignment of book debts due at the date of the assignment from specified debtors or under specified contracts.

## Directors

There are detailed provisions in the Companies Act 2006 on loans to company directors, and the provision of guarantees or security for a loan made by any person to a director of a company or its holding company. Shareholder approval would be required in these circumstances.

## Undue influence/ duress

The security granted may be voidable if undue influence or duress is established. The circumstances where this most commonly arises are where a jointly owned matrimonial home is mortgaged to secure the business debts of, or obligations under a guarantee given by, either the husband or wife. Similar issues arise in relation to the waiver or postponement of an occupier's rights. However, the risk arises in relation to all security and not just residential mortgages. The risk of a successful challenge is minimised if the well known "Etridge" procedures are followed, by disclosing sufficient details of the transaction to the person providing security (with the borrower's prior approval), requiring them to take independent legal advice, and obtaining written confirmation from the solicitor providing the advice to that effect.

## Misrepresentation

Like any contract, a mortgage or charge is at risk of being rescinded if there has been misrepresentation. In particular, it may be set aside if it can be shown that a misrepresentation was made by the borrower or that the lender had actual, constructive or implied knowledge of the misrepresentation. Indeed, in many cases where there is undue influence there will also be misrepresentation. The Etridge procedures should again be followed to minimise the risk of a successful challenge of the security.

## Issues to consider when taking a guarantee or third party security from an individual?

### Preference

A guarantee and third party security may be challenged on the grounds of being a preferential transaction. Preference arises when a person voluntarily does something at a "relevant time" that favours one of his or her creditors over others, with the intention of doing so, and is insolvent at the time, or becomes bankrupt as a result. Commercial pressure applied by the lender on the borrower may be sufficient to defeat a preference claim. Simplifying slightly, the "relevant time" is two years prior to the bankruptcy of an individual, except when the transaction is both a preference and at an undervalue, when the period is five years.

### Transactions at an undervalue

A guarantee (including third party security) ("**Guarantee**") given within a "relevant time" may also be challenged on bankruptcy as a transaction at an undervalue: i.e. that the benefit received by the guarantor is significantly less than the benefit conferred on the lender receiving the Guarantee. The difficulty of making the comparison between the likelihood that a Guarantee will be called and the benefit that the guarantor may derive from giving it means that, in normal circumstances, a claim that giving a Guarantee was a transaction at an undervalue is relatively difficult to sustain. Where there is a strong likelihood of default under a facility, the risk is greater. As in the case of preference, the guarantor must be insolvent at the time, or become bankrupt as a result of giving the Guarantee. Again simplifying slightly, the "relevant time" is **five** years prior to the bankruptcy of an individual.

### Undue influence and misrepresentation

The same concerns arise in respect of undue influence and misrepresentation when taking guarantees and third party security, as with taking security from individuals (as outlined above). The prudent course of action for a lender taking a guarantee from an individual is to insist that the guarantor takes independent legal advice on the guarantee and to follow the Etridge procedures.

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## Other factors to consider when contracting with individuals

### Capacity

A further principle to be borne in mind when dealing with individual borrowers, security providers and guarantors is that a contracting party must have capacity to enter into a contract, although there is no "ultra vires" principle as in the case of a corporation. If a party purports to enter into a contract without capacity, the contract may be voidable under common law because it is beyond the powers of the contracting party. In the case of agreements entered into by individuals, it is presumed that individuals have the capacity to enter into the relevant contractual arrangements, although there are three categories of individuals who may lack personal contractual capacity: minors, people lacking the requisite mental capacity and people who are intoxicated.

#### Minors

Anyone below the age of 18 is considered a minor for the purposes of contract law. The general rules are that:

- i) a minor's contracts are voidable at the minor's option;
- ii) a minor can enforce most contracts, but they are not binding on the minor until he or she expressly ratifies them on turning 18;
- iii) a minor cannot acquire or hold a legal estate in land, although a minor may contract to acquire land and the contract will be binding unless and until it is repudiated by the minor; and
- iv) a transfer of a legal estate in land would take effect only in equity and, similarly, a lease granted to a minor would take effect in equity only and would be voidable at the option of a minor; however, if a minor goes into occupation under a lease, he or she will be liable for rent.

A lender dealing with a minor should be aware of the above risks and seek legal advice where relevant.

#### *People lacking the requisite mental capacity.*

The law requires quite a high level of mental incapacity before it will consider an individual lacked contractual

capacity. For example, the following factors would be unlikely to make a contract unenforceable:

- i) The individual not understanding the nature of the transaction. However, in certain cases, undue influence or unconscionable dealing by the other party or potentially, inequality of bargaining power, may permit the transaction to be set aside as being inequitable. For example, in the *Barclays Bank plc v Schwartz* case of 1995, the judge said whilst illiteracy and unfamiliarity with the English language should not be equated with mental incapacity or drunkenness, a person who signed a contract in English without fully understanding it (because their mother tongue is another language) might be able to claim that the contract be set aside as a harsh and unconscionable bargain.
- ii) Immaturity of reason even in an adult.
- iii) Mere absence of skill on the subject of the particular contract.

The law may provide a remedy to the individual in a wide range of circumstances provided that: "one party has been at a serious disadvantage to the other, whether through poverty or ignorance or lack of advice or otherwise so that circumstances existed of which unfair advantage could be taken". Further, if a lender acting in the course of a business takes advantage of the lack of full understanding of the terms of a contract which he or she concludes with a consumer, this may be relevant when considering if the terms are fair or not under the Consumer Rights Act (discussed below).

If an individual is unable to read or understand a document (unless this is due to physical illness or disability, illiteracy or because the document is in a foreign language) the execution clause of a document should be adapted to show how the individual was informed of the contents of the document. In addition, the individual should be asked to obtain independent legal advice and, ideally, a letter from the independent legal adviser to the individual confirming that such advice was given should be obtained by the lender.

A representation could also be included in the relevant agreement that the individual was not of unsound mind or a patient for the purpose of any statute referring to mental health and an additional event of default, enforcement event or termination event could be included

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in the relevant documents, which would be triggered by reason of mental incapacity or the individual becoming incapable of managing his or her own affairs or becoming a patient under any mental health legislation. When including such provisions, a lender should bear in mind that there is a risk that such clauses could be interpreted as being discriminatory.

## Death

When entering into contractual arrangements with an individual, it is important to bear in mind the risk and possibility of the individual's death. In general, personal representatives step into the shoes of a deceased individual in relation to contracts entered into by that individual and claims made by or against that individual during his or her lifetime. However, there are exceptions to the general rule, in particular where the contract provides otherwise or ends on the individual's death.

The fact that the personal representatives of the deceased step into the shoes of the deceased means that: (i) they must meet the liabilities that the deceased incurred before his death out of his or her estate; and (ii) they are entitled to the benefits due to the deceased before his or her death.

When dealing with an individual, it may be appropriate to include an additional event of default, enforcement event or termination right to be triggered by the death of the individual. The notices provisions in the relevant agreements could also be amended to provide that, until the lender receives written notice of the grant of probate of the will or letters of administration in respect of the estate of the deceased, and an address for the executors or personal representatives, the lender can use the address provided in the notices section for the purposes of communications under a given document, and that notices delivered to such address will be sufficient.

## Bankruptcy and similar proceedings

A lender should seek to include in any loan or security documents a repeating representation from the contracting individual that he or she is not bankrupt, insolvent and has not entered into any voluntary arrangements with his or her creditors.

In addition, a lender should seek to include an additional event of default, enforcement event or termination right

triggered by the individual becoming or being adjudicated or found to be, bankrupt or insolvent or suspending payment of his debts or being (or being deemed to be) unable to or admitting his inability to pay his debts as they fall due, or entering into a composition or other arrangement for the benefit of his creditors (generally, or with a specific class of creditors), including voluntary arrangements.

## Consumer Rights Act

When dealing with individuals, lenders should bear in mind the implications of the Consumer Rights Act 2015 ("**CRA**") which applies to consumer contracts in relation to goods, services or digital content that have been entered into after 1 October 2015. The CRA aims to protect consumers from contracts that may be one-sided. The CRA allows consumers to challenge any term which causes a significant imbalance to the parties' rights and obligations and is detrimental to the consumer. The CRA includes a grey list which details terms that may be considered unfair. By way of example, this list includes terms which exclude or limit the liability of the firm in certain circumstances and those terms that allow unilateral alteration of the services without any particular reason.

In contrast to previous legislation, the CRA applies both to contracts that are in standard form and those that have been individually negotiated. It also governs pre-contractual terms and statements, implying these into the contract, if they have been taken into account by the consumer. This is significant and therefore, it is important to ensure that all communication with the consumer is appropriately recorded for recordkeeping purposes.

The CRA has imposed a fairness test which includes an exemption for core terms of the agreement such as those that deal with subject matter and pricing, as long as these core terms are deemed to be prominent and transparent (meaning the terms are written in plain and intelligible language). European case law highlights that exemptions from the fairness test are to be strictly interpreted. It is important to note that the fairness test applies to consumer notices as well as consumer contracts.

The extent to which the CRA applies to contracts is also unrestricted in the context of guarantees and security, but following European case law around the Unfair Con-

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tract Terms Directive (which the CRA implements) it is thought that the scope of the legislation has widened to cover guarantees where the borrower is a non-natural person.

The FCA and the CMA have the power to enforce the provisions in the CRA and can void any terms that they deem to be unfair.

## Standards of Lending Practice

Previously the Lending Code, published in March 2011, set standards of good practice for banks, building societies and credit card providers on dealing with consumers, micro-enterprises (businesses with less than ten employees and with a turnover or annual balance sheet not exceeding €2 million) and small charities. Non-business borrowing secured on land and some other services were excluded. It sat alongside the Banking Conduct of Business sourcebook, but is self-regulatory and voluntary. Compliance was monitored and enforced by the Lending Standards Board (**LSB**). The emphasis in the Lending Code was on consumers and micro-enterprises. The section on guarantees was headed "Guarantees for personal and micro-enterprise lending" (emphasis added). The implication was that it was not directed at, for example, a guarantee of corporate borrowing given by a high net worth individual.

The Lending Code was replaced in relation to personal customers (excluding micro-enterprises) by **The Standards of Lending Practice** on 1 October 2016. It was replaced for smaller business entities from 1 July 2017 by the Standards of Lending Practice for Business Customers (together referred to below as the "**Standards**").

A list of subscribers to the Standards ("**registered firms**") can be found on the LSB's web-site. They include many leading banks active in the UK, or at least their consumer divisions. They apply to lending in *sterling*, but subscribers may choose to apply it to other currencies as well. They also require the use of plain English. The LSB's monitoring role and enforcement powers derive from its contract with each subscribing firm.

The Standards echo some aspects of the Code in containing a commitment by registered firms not to take an unlimited guarantee from an individual. For this purpose "unlimited" refers to the capital amount of the loan, and excludes interest, charges and arrears. The Standards

state that other forms of unlimited third party security may be taken from an individual (such as a third party mortgage or charge or, presumably, an unlimited first party charge taken to support a guarantee), in order to avoid having to take a series of security documents, so long as the limit of the individual's liabilities is explained in a side letter. If such a side letter is required it may need to be counter-signed by the individual, to comply with the Statute of Frauds.

The Standards also apply in relation to small businesses (this replaces the elements of the Lending Code that previously applied to micro-enterprises or charities with an annual income of less than £1 million). The Standards state that: "firms should not accept unlimited guarantees from an individual/business unless it is to support a customer's liabilities under a merchant agreement; however other forms of unlimited third party security may be taken, if available".

The Lending Code previously stated that in the case of limited companies that are part of a group structure, subscribers may continue to take unlimited guarantees from the constituent companies in support of borrowing by other companies in the group. This is not expressly echoed in the Standards.

The Standards provide that: "firms should ensure that where an individual provides a guarantee/indemnity or other security, they have access to regular financial information on their current level of liability". This obligation is subject to normal rules as to customer confidentiality and will require the cooperation of the principal debtor (borrower) as customer.

In general terms the Standards contain overarching principles for lending, and apply to credit card, overdraft and unsecured loan products for personal customers, and to registered firms and any third parties that retail and service any such lending product. Among the key principles is that customers must be provided with clear and understandable documentation along with information which clearly sets out both parties' rights and obligations during the lifetime of the product.

Lenders are reminded that it is important that guarantors receive independent legal advice, and should encourage them to take it as soon as possible. In addition to any separate communication, a recommendation should appear clearly in the guarantee or security. Guarantors must be warned that they may be liable instead of the borrower, and told the extent of their possible liability,

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including interest and charges. It may be assumed that if independent legal advice has been given, the nature of all monies and continuing security will have been explained to the guarantor, if applicable. Lenders may choose to explain these features to a guarantor who has refused independent legal advice.

## Foreign law considerations and formalities

When lending to, taking security or a guarantee from an individual resident in a jurisdiction other than England and Wales, a prudent lender would be advised to instruct counsel in the jurisdiction of residence of the individual to ensure that any local law formalities are complied with when entering into or relying on the relevant documentation. For example, in certain jurisdictions, a lender will not be permitted to enforce its rights under its security documents without first obtaining court approval. There may also be registration requirements or requirements to give notice in order to perfect security, depending on the type of asset being charged. Another example is that in certain jurisdictions (such as Russia), spousal consent is required when obtaining a guarantee.

Counsel in the relevant jurisdiction will be able to advise the lender on any such requirements, as well as any other formalities in relation to execution of the guarantee, such as a requirement for notarisation that must be met under the laws of the relevant jurisdiction.

It is also advisable that a formal legal opinion be obtained covering the main areas that are likely to be of concern to the lender, in particular, the validity and enforceability of the loan and security documentation and execution of judgments under the laws of the relevant jurisdiction.

If the individual is a diplomat or a sovereign, he or she may be able to claim immunity before the foreign courts under local law or before the UK courts under bilateral agreements between the UK and the foreign state. In this situation, a full waiver of immunity will need to be included in the loan and security documents, but the extent to which the foreign courts will give effect to this will need to be checked with local counsel.

When dealing with an individual resident outside of the UK in connection with loan or security documents, the borrower or security provider should be required to ap-

point and maintain an agent in England and Wales to accept service of process issued in the English courts in any proceedings arising out of the documents or in connection with the transaction. This will prevent the lender from being required to apply to court to serve process outside England and Wales. The process agent appointed should be asked to confirm its appointment directly to the lender.

## Searches and due diligence

- **Bankruptcy and insolvency.** To minimise the risks of dealing with a bankrupt individual, which is outlined above, bankruptcy searches should be carried out against the individual prior to and on the day of completion to ascertain that no bankruptcy petitions have been made against the individual. Bankruptcy searches can be made on the Individual Insolvency Register and at the Land Charges Department of the Land Registry. Consideration should also be given to conducting equivalent searches in other relevant jurisdictions.
- **Companies House.** To ascertain whether the individual has ever been disqualified from acting as a director of a company.
- **Register of Bills of Sale at the High Court.** To ascertain (in appropriate cases) *whether* the individual has created security over chattels.
- **Other asset registries.** To ascertain (in appropriate cases) *whether* the individual has created *security* over certain classes of asset, such as registered land, and for possible adverse third party rights.
- **Money laundering.** As part of the lender's "know your client" checks and particularly when *dealing* with a foreign individual that may be a politically exposed person (PEP), care should be taken to ensure that adequate money laundering checks are made and legislation complied with. This becomes even more important when dealing with persons in jurisdictions where money laundering procedures and legislation are not similar to or equivalent to those of the United Kingdom as conducting business with persons in those jurisdictions may necessitate more extensive and thorough checks, which should be conducted at the outset of any transaction.
- **Sanctions.** Searches should be made to ensure that the lender is not contracting with an individual against

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whom UN, US or EU sanctions are imposed, to ensure that it is not illegal for the lender to enter into the relevant arrangements.

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