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A critical examination of the application of the neighborhood principle to mortgagee's duty to third parties in common law legal systems

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Abstract

The power and the right to sell the mortgage property is the most central of all rights and remedies available to a mortgagee particularly to legal mortgage created by deed. The mortgagee's power of sale is the right of a mortgagee to sell property if the mortgagor defaults. In particular, it refers to the method by which a mortgagee use his power under the mortgage deed to sell the property mortgaged as security for the mortgage loan without having to go to court. The mortgagee is obligated to behave in good faith when using his power of sale and same time exercise a "reasonable degree of care" in dealing with the sale. This paper examined the nature of the duty of care to include acting in a trustworthy manner to exercise reasonable prudence to achieve the mortgage property's real market value at the moment of sale and that the sale must be genuine sale by the mortgagee to an impartial buyer for an honest price. The paper also postulated that the mortgagee has a duty of care not just to the mortgagor but also to any mortgage guarantor and the holder of a beneficial interest in the mortgage property since they are all "in very close 'proximity' to those who conduct the sale". This paper brought to the fore the applicability of the neighbourhood principle envisaged under the law of tort to the requirement of a mortgagee owing the mortgagor a duty of care and other persons vitally affected by the mortgagee's power of sale. The paper found among others, that although the neighbourhood concept as originally espoused was limited in terms of tort of negligence, however, due to the 'proximity' of relationship between the mortgagee and the mortgagor, the same neighbourhood level of care can be extended to cover a mortgagee's duty to the mortgagor when executing the mortgagee's power of sale. The paper recommended the inclusion of the neighbourhood concept on the standard of care required with respect to the exercise of the power of sale by a mortgagee in all mortgage documents.

Keywords: Neighborhood principle, mortgages duties, third parties

Introduction

Whenever a mortgage is created, the parties acquire certain rights (and duties) arising from the real right, namely a registered mortgage bond. For a mortgagor, he must be given the opportunity to offer full payment of the amount lent to him at the legal due date and thereafter to exercise his equitable right of redemption. This is because the property used by the mortgagor as collateral is not given out as an outright sale to the mortgagee and therefore must always be redeemable. Consequently, any clause in the mortgage which constitutes a clog against redemption is void ^[1]. On the other hand, the mortgagee's rights and remedies on the mortgaged property include taking possession of the properties, appointment of a receiver, foreclosure action in court to receive the sum of money in default and sale of the property ^[2]. Of all the rights and remedies available to the mortgagee, the power and right to sell the mortgage property is central particularly to legal mortgagees created by deed ^[3]. In the course of exercising the power of sale, the mortgagee owed the mortgagor a duty to exercise reasonable diligence in obtaining a fair price for the property at the period of sale ^[4]. This is because the amount realized on the sale of the property vitally affects the mortgagor in one way or the other. For example, if the proceeds of sale do not cover the mortgage debt, the mortgagor remains liable for the balance, but the mortgagor is entitled to the surplus if the sale revenues exceed the mortgage amount. Therefore, the "proximity" between parties to a mortgage as regards to the exercise of power of sale by the mortgagee was that "they were neighbors". This neighborhood principle applicable to the relationship between parties to a mortgage was further extended to a mortgage guarantor. In *Standard Chartered Bank Ltd v.*

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Walker ^[5], Lord Dennis M.R. held that “a mortgagee also owed a similar duty to a guarantor of the mortgage; the guarantor was vitally affected by the outcome of the sale so that the mortgagee and the guarantor were “neighbors”. According to Lord Dennis, “the duty of care in the above relationship was of the same application of the same application of the principle (of care) established in *Donoghue v. Stevenson* as stated by “Lord Atkin” ^[6].

This paper addresses the mortgagee’s responsibilities when exercising the power of sale over the mortgage property. The paper also considers the nature of the mortgagee’s duty of care when exercising the right to sale, drawing a parallel to Lord Atkin’s neighbourhood concept in *Donoghue v. Stevenson* ^[7].

It finally analyses that the required duty of care is not restricted to mortgagee and mortgagor relationship but relationship between the mortgagee and other third parties to the mortgage who are vitally impacted by the right of sale exercised by the mortgagee.

Power of Sale of a Mortgagee

An important aspect of the remedies and rights of a mortgagee particularly to legal mortgage created by deed is the power to sell the mortgage property ^[8]. In a mortgage deed, the power of sale must be mentioned explicitly and in some circumstances the power of sale has been provided by statute. Therefore, there is no implied power of sale even at common law ^[9].

However, the mortgagee’s right in exercising his power of sale requires that:

- a) The mortgage is by deed
- b) Whether the power of sale has arisen (i.e. whether the mortgage money has become due),
- c) There is no provision in the mortgage deed expressing a contrary intention ^[10].

The power of sale becomes exercisable only if any of these three conditions are met ^[11].

1. The mortgagor or several mortgagors have been served with a notice requesting for the payment of the mortgage money, but after 3 months of such service there has been no payment; or
2. Some mortgage interests are in arrears and have been unpaid for two months after it became due; or
3. Some provisions of the mortgage deed or of that of relevant statutes have been violated ^[12].

The mortgagee’s power of sale is the right to sell the property covered by a mortgage if the mortgagor defaults. It is the power of a person with a right to the revenues of the sale of property held as security for a debt, to replace the property sold with money. In many jurisdictions, ^[13] specifically, the manner in which a mortgagee utilizes his right as provided in the mortgage deed to put up the property for sale as security for the mortgage loan without having to go to court. In general, it refers to the process through which a property is put up for sale while the mortgagor defaults. This is the only way to recover the value of property used as security for a mortgage in many jurisdictions. However, the power of sale of a mortgagee cannot be directly employed in some jurisdictions, instead it must be exercised by a sheriff, a public trustee or other persons who are also legalized.

The power of sale must be absolutely applied in compliance to the loan documentation, including any legislation relating to power of sale specifically relating to the notice sine qua non which must be handed over to the mortgagor or any other affected party. Nonetheless, the approach is usually less formal as compared to a judicial foreclosure.

In the Nigeria case of *B.O.N. v. Aliyu*, ^[14] the court posited that those requirements are mandatory rather than advisory and that any sale of mortgage property without the required notification is invalid ab initio and cannot transfer title to a future buyer ^[15]. The correct position by sections 19 (2) of the CA and 123 (2) PCL is that any of these requirements may be ruled out entirely or be altered depending on the parties’ agreement ^[16]. Thus, the court held in *Bank of the North v. Babatunde*, ^[17] that where the parties agree in a mortgage deed to omit certain section of the law in order for the mortgagee to exercising his right to sale, this is not illegal or against public policy. Even though some of these requirements can be waived by agreement of the parties, the Nigeria Supreme Court has held in *Okonkwo v. Cooperative and Commerce Bank (Nig) Plc*, ^[18] that the provisions of section 19 of the Auctioneers Law cap 12 Laws of Eastern Nigeria still in effect in some States like Imo state cannot be waived since its existence is to safeguard the public rather than the parties. The section provides:

inter alia, “that no sale by auction of any land shall take place until after at least seven days” public notice thereof by print or written documents or beat of drums to uneducated persons is made at the principal town of the district in which the land is situated and also at the place of the intended sale ^[19].

Explaining why the clause cannot be waived, the Nigeria Supreme Court noted that-

Although some aspects of the provisions have become anachronistic owing to socio-political changes, it cannot be denied that the purpose of the provision is for the mortgagee to give adequate notice to the public of the proposed sale. It is not a notice intended to be given to the mortgagor. This is to ensure that a true public auction, where everyone interested in the property may have the opportunity to bid for it, is conducted for a fair deal, devoid of unconscionable bargain through connivance or collusion. This is not a notice which can be waived by the mortgagor. Actually, it does not lie with him to do so as it is not meant for him (but) to ensure that the auction....is not “a fraud upon the sale, and upon the public.” ^[20]

It is a must for a mortgagee to wait for the power of sale to arise and also to become exercisable before any sale. A buyer who buys a property before the power of sale arises will not acquire a good title. Despite this anomaly, a buyer who buys before the authority becomes exercisable will have a good title. Where a conveyance is made while exercising the power of sale, the purchaser’s title is unimpeachable and will not be set aside simply because there has not been a single instance where the sale has been authorized or that appropriate notice was not given or that the power was poorly or irregularly exercised. However, a person who has been harmed by the improper exercise of power of sale may seek damages from the person who exercised the authority ^[21].

Nature of Duty of Care of a Mortgagee

As previously stated, there is no doubt that when exercising the right to sale, the mortgagees owe the mortgagor a duty

of care. But the question that arises is: what is the nature or standard of care expected of the mortgagee? According to Lord Dennis,^[22] the duty of care expected of the mortgagee in this regard cannot be less than what has been laid down as “general duty of care” by Lord Atkins in *Donoghue v. Stevenson*^[23]. As stated by Lord Atkins in the case of *Donoghue v. Stevenson*^[24].

“... The rule that you are to love your neighbour becomes in law, you must not injure your neighbor; and the lawyer’s question, who is my neighbor? Receives a restricted reply. You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbor. Who, then, in law is my neighbour? The answer seems to be persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question. Consequently, when a mortgagee is exercising power of sale, he owes a duty “to take reasonable precautions to obtain the true market value of the mortgaged property at the date on which he decides to sell... and the sale must be a genuine sale by the mortgagee to an independent purchaser at a price honestly arrived at a public auction”^[25]. The obligation to procure the “best possible price that the circumstances permit” as owed to the mortgagor does not exclude any guarantor since they are both in “extremely close ‘proximity’ to the mortgagee”^[26]

By the above dictum of Lord Atkins, the persons who are vitally impacted by the right of sale exercised by the mortgagee in relation to a mortgage are the mortgagor, the mortgagor’s guarantors, holders of beneficial interest in the mortgage property etc. Applying the above dictum of Lord Atkins to the listed persons who are affected by the mortgage, it is almost certain that these persons qualify as “neighbours” to the mortgagee to which the mortgagee must exercise reasonable precaution to avoid any act or omission that he reasonably predict would cause harm.

1.4 Persons affected by mortgagee’s power of sale

We will now consider persons or parties that would be affected by the exercise of power of sale by the mortgagee and the extent to which this may affect them.

The mortgagor

The mortgagee owes the mortgagor an obligation to exercise reasonable diligence in obtaining a fair market value for the property at the moment of sale. This is because the amount realized from the sale vitally affects the mortgagor in that, if the proceeds of sale do not cover the mortgage debt, the mortgagor remain liable for the balance, and if the proceeds of sale exceed the mortgage debt, the mortgagor is entitled to the surplus. As a result, while exercising his power of sale, the mortgagee is obligated to act in good faith. Although there is no requirement on a mortgagee to sell the mortgage property for any particular sum as long as he sells at a proper price and does not sell at gross undervalue^[27].

Undervalue *per se* may not vitiate the exercise of power of sale by a mortgagee, however, it must be demonstrated that the sale was deceptive and grossly undervalued.

In the Nigeria case of *Ibekwoaba v. ACB*^[28], N194, 000.00 (a property of 8 flats) was the estimated worthy of property of 8 flats. The property was sold at the rate of N115, 000.00 in 1987 (ten years after). However, the sale was set aside as prove of fraud by the court of appeal on the bases that there was no evidence that it has depreciated. The Supreme Court,

on the other hand overturn the verdict of the court of appeal^[29]. It was decided that where a party claims fraud in a sale of property due to the fact that it was sold at a very low price, such property must bring forward evidence against such sale of which the standard of proof will be beyond reasonable doubt. To help in discharging the burden, the party making the allegation should produce a valuation report of what the property would have earned

According to the court:-

True enough there was evidence that the property was valued by a valuer at the time the mortgage was being executed at N194, 000.00. But no valuer gave evidence as to the value of the property at the time of sale, a number of factors would have to be taken into consideration in determining whether the value of the property had appreciated or depreciated. This would depend on such factors as the state of repairs of the property at the time of sale and the market value of real property at the time^[30].

It is clear based on the analysis given and the above case, that the mortgagor is a close neighbour of the mortgagee in relation to a mortgage and the neighborhood principle as enunciated by Lord Atkins in *Donoghue v. Stevenson* is applicable to the extent that the mortgagee should exercise reasonable caution in order to avoid any act or omission that would harm the mortgagor (tagged as “mortgagee’s neighbour”) while exercising the power of sale.

Guarantor of the mortgage

Just like the action or omission of the mortgagee in the exercise of his right to sale will affect the mortgagor, in the same vein, the mortgagee is expected to contemplate the effects of his actions on the guarantor of the mortgage. A guarantor of the mortgage is the person who guarantees or responsibly gives security for the mortgage debt^[31]. While the liability of a surety begins with the principal, the liability of a guarantor does not begin until the principal debtor has defaulted^[32]. Although being a guarantor does not necessarily mean that you have to sign your life away. However, if you were to co-sign the mortgage or be a co-applicant, then that means you are on the loan and will be responsible until it’s been fully repaid, which is a big commitment. A mortgage guarantor commits to covering the repayments if the mortgagor fails to keep up with payment. Therefore, the relationship between the mortgagee and the mortgagor, particularly when the mortgagee’s right to sale is exercised, also applies to the mortgage guarantor. In this regard, a mortgagee also owed a similar duty of care to a guarantor who will be vitally affected by the outcome of the sale. If the proceeds of sale do not cover the mortgage debt, the guarantor will still be held liable along with the mortgagor for the balance. Consequently, the “proximity” between the mortgagee and the guarantor was such that they were “neighbours” and as such the mortgagee exercise reasonable care when exercising power of sale to prevent any act or omission that he can reasonable predict as being harmful to the mortgage guarantor.

Holder of a Beneficial Interest in the Mortgaged Property

A beneficial interest is an interest in the economic benefit of a property accruing to the beneficial owner who is entitled to the monetary value of the property notwithstanding that his name is not registered as the legal owner.

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4. Peter B. Mortgagee's Duty to Third Parties, *The Australian Law Journal*, vol. 64, No 4 p. 2009. See also Chuckmere Brick Co. Ltd v. Mutual Finance Ltd. (1971) Ch. 949; Remckean's Caveat (1988) 1Qd R 524, Mckean v. Maloney, 1988, 1QdR628.
5. 1982 1 WLR 1410. See also Downsvie Nominees Ltd v. First City Corp. Ltd., 1993, AC 295.
6. 1932, AC 562.
7. Ibid.
8. Dadeem Y.Y.D op. cit p. 145; Eimunjze, F.O *Real Property Law and Practice in Nigeria*, Malthouse Press Limited, Lagos, Nigeria, 2014, 169.
9. See section 19-22 Conveyancing Act 1881; sections 123-129 Property and Conveyancing Laws 1959. (Western Nigerian)
10. See Section 101-107 Property Act 1925, see also section 122(1) Abia State of Nigeria Property Law, Silver Properties v. Royal Bank of Scotland of Scotland PLC (2003), 50 EG 96, (2004) 1 WLR 997 (CA)- where it was held that once a mortgagee power of sale has arisen, it may be exercised as the mortgagee reasonably chooses but must act in good faith and exercise a reasonable degree of care in dealing with the sale
11. S 20 Conveyancing Act, 1881.
12. Section 20CA 1881, S. 125 PCL; S.O.N. Okafor & Sons Ltd v. Nigeria Housing Development Society (1972) 1 ALL NLR P.362; WEMA Bank Plc v. Abiodun (2006) ALL FWLR, part 317, p. 430. Some provisions of the laws are however exempted and the parties may decide to exclude them-section 19 (2) section 123(2) PCL; section 124 Abia State Law of Property.
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17. FWLR, part 119p. 1452 at, 2002, 1473p.
18. FWLR, part 154 The parties in the mortgage deed under consideration resolved in clause 8 that the borrower "expressly waives his rights to be given notice by bank under section 20 of the Conveyancing Act 1881 or under law or custom in operation in any part of the Federal Republic of Nigeria before the sale of the mortgaged property, 2002, 457pp.
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26. See standard *Chartered Bank v Walker*, supra at 942 (Barclays Bank plc Kingston (2006) EWHC 533, (2006) 1 ALL ER (Comm) 519).
27. See *Kenedy v. De Trafford* (1987) A.C. 180, *Eka-Eteh vs. NHDS Ltd* (1973) All NLR 555
28. (1998) 10 NWLR pt. 571 p. 590 at 608, see also *West African Breweries Ltd. v. Savannal Ventures Limited* SCN, 2002, 269pp.
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