



SPOTLIGHT | CREDIT CRISIS

## Taking back distressed assets

UAE law needs to be updated to allow lenders to reclaim property when borrowers default, without having to litigate, argues Mazen Boustany

ONE OF THE MAJOR ASPECTS OF THE CURRENT credit crisis is the reluctance of banks to lend to borrowers. It cannot be stressed strongly enough the importance for banks to restart lending for the economical cycle.

Lenders need to feel confident so they can start to lend again and thereby get consumer confidence and consumption moving.

To help allay bank fears, it would assist greatly if they were allowed to own directly a distressed asset if a borrower failed to pay back a debt, consequently sparing banks lengthy litigation and then the sale of the mortgaged assets through public auction to recover their rights.

### OLD FRENCH LAW

Currently in the UAE, the case justifying the prohibition on lenders owning directly distressed assets falls under article 1420 of Federal Law No 5 of 1985 related to Civil Transactions, which provides the following:

- If it is a condition of the mortgage agreement that the ownership of the asset be vested in the lender in consideration for his loan in the event that the borrower does not pay at maturity or if there is a condition that the mortgaged asset is to be sold regardless

of the legal procedures, the mortgage shall be valid, but such condition shall be void

- Such condition shall also be void even if it is provided in a subsequent agreement

This prohibition for the lender to own directly the distressed asset is derived from elements of historic French law and is called

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*prohibition du pacte comissoire* (although no texts of law ever prohibited explicitly the *pacte comissoire* in the case of real-estate assets, but such prohibition existed for movable assets).

Furthermore, article 1419 of the 1985 legislation provides that a lender may satisfy its debt out of the mortgaged asset on maturity date in accordance with the rank it holds, after following the procedures pro-

vided for in the code of civil procedures and particular procedures.

The obligation for the lender to have recourse to the courts to satisfy its debt and not to reach out of courts settlement on the security registered on a mortgaged property is called *prohibition de la clause de voie parée*.

These are derived from the French law that influences both Egyptian and UAE laws. The prominent Egyptian scholar Al Sanhoury – and the overwhelming majority of French scholars – reason that such prohibitions are in the public interest because borrowers are in much weaker positions than lenders. The reasoning for the protection is that lenders may impose any conditions they choose on borrowers and as such may unduly deprive them of all their assets.

### RIGHT OVER VALUE

In addition to these prohibitions protecting borrowers, these scholars explain that entitling the lenders to own mortgaged assets would be contrary to the purpose of the mortgage itself, which is to grant the lender a right over the value of the asset and not over the asset itself.

Are such prohibitions still valid? No, because banks and lending institutions are tightly controlled by bodies such as the central bank and other regulatory agencies, so that borrowers are protected and are not anymore in the weak position they were when the prohibition was initially enacted.

In March 2006, French legislators amended the country's civil code to allow lenders to acquire mortgaged real-estate properties (except for the borrowers' main residence and with some other exceptions). This move was designed to encourage consumption by encouraging banks to lend more easily.

All legal systems derived from French law should follow suit and adopt a similar position, especially in these times of tight credit. Doing so will restore bank confidence, assuring them their rights are protected.

Since the prohibitions date back to a historic period when there was no adequate protection for borrowers, they are no longer justifiable. Changing the position would require amending both the UAE Civil Code and Civil Procedures Code to allow the direct acquisition by lenders of distressed assets.

Such a reform could well be the first significant step in the region towards the integration between the common law and civil law systems. ●

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