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United Arab Emirates: Pledge Of A Banking Deposit

11 October 2011

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This article was first published in the In House Lawyer

Under UAE law, the commercial pledge is a possessory pledge, which means that the possession of a pledged asset (but not its ownership) is transferred to a pledgee or to an agreed third party as security for the loan.

This definition was approved by the Dubai Supreme Court (decision no. 154 dated 3 January 1995) when it stated that the pledge restricts the rights of the borrower in disposing of the pledged assets, but keeps the pledged assets under ownership of the borrower[1].

Such possession and security also entails a prohibition by the pledgee to directly acquire the pledged assets in the event of default of the pledgor, except through court proceedings[2].

If this is the case, how does the pledge of a banking deposit qualify? Such a pledge raises the complex issues of ownership of the deposited funds and the acquisition by the pledgee of the funds in the event of default.

Ownership of funds

Under article 371 of Federal Law no.18 of 1993 relating to Commercial Transactions (the Commercial Transactions Code) the banking deposit is defined as follows:

1. *a cash deposit is a contract by virtue of which a person delivers a sum of money by any means of payment to the bank that undertakes to return it upon demand or according to agreed terms.*

3. *The bank acquires the ownership of the deposited sum and shall have the right to dispose of it for its activities with an undertaking to return an equivalent sum to the depositor. The refund shall be in the same currency.*

It is arguable that article 371 of the Commercial Transactions Code by establishing the bank as the owner of the deposit, permits the bank to bypass the prohibition mentioned in article 176 of the same Code, by entitling the bank to directly acquire ownership in the event of a pledge of the deposit.

To clarify, however, ownership of the funds by the bank is clearly restricted by the undertaking to refund an equivalent sum upon demand by the depositor or according to agreed terms.

Thus, ownership of the fund remains with the depositor and is only transferred to the bank under certain conditions. This has been confirmed by court precedents where third parties have been allowed to attach such deposits for a debt due on the depositor, to such third parties[3], meaning that the ownership of the funds remains with the depositor.

In line with the above, article 373 of the Commercial Transactions Code provides as follows:

Except for the deposit dedicated for investment, the cash deposit shall be considered as a debt that may be set-off with the debt that may be due to the bank from the depositor and any agreements to the contrary shall be

void.

This means that the deposit shall remain the depositor's property since it is considered a debt of the bank's, which may be set-off with any debt or loans due to the bank.

Acquisition by the pledgee of pledged funds in the event of default

As we have already established, the pledge of a bank account is a possessory pledge that falls under the provisions of article 164 et seq. of the Commercial Transactions Code. As a result of this, the bank would not be entitled to acquire the pledged funds directly and should apply to the UAE courts to acquire such funds.

In the context of fungible assets however, several articles of the law, and more specifically articles 1499, 368 and 370 of federal law no.5 of 1985 in relation to civil transactions (the Civil Code) come into play to remove the prohibition, allowing the bank to directly acquire the pledged funds due to the nature of the pledged assets.

Article 1499 of the Civil Code states the following:

If the pledged asset and the loan secured by the pledge have come to maturity and the pledgee has not recovered its rights, then it may recover any outstanding due to it from the pledged asset and refund the rest to the pledgor, provided that the loan and the pledged asset are of the same nature, otherwise the pledgee shall be entitled to ask for the sale of the pledged asset or to acquire it in its value to recover its rights.

Article 368 of the Civil Code defines a set-off as follows:

A set-off is the satisfaction of a debt due to a lender with a debt due to its borrower.

Article 370 of the Civil Code provides for a mandatory set-off when both parties are indebted to each other and the obligations of both parties are of the same type and description, equally due and of equal strength and weakness.

In the context of obligations of the same nature, type, description and equal strength and weakness, a mandatory set-off and amicable set-off may be agreed on, disregarding the prohibition under article 176 of the Commercial Transactions Code. Because the pledged asset is a sum of money, it can be evaluated precisely and the lender cannot unduly benefit at the expense of the borrower.

The courts, have thus, ascertained the above direction and, in practice, consider that banks are at liberty to set-off between the deposit and the loan[4].

This means, in conclusion, that if banks want to use the pledge mechanism, they have to mandatorily keep the deposit in the name of the borrower, knowing that this will not put the bank at any risk, since it will be able to recover its debt through the set-off procedure, because the pledged assets and the loan are of the same nature, type and description.

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Footnotes

1. Dubai Supreme Court, no. 154 dated January 3rd, 1995

2. Article 176 of the Commercial Transactions Code

3. Dubai Supreme Court, decision mentioned in1 above.

4. Dubai Supreme Court, decision no. 354 for the year 2003 dated 29 February, 2004

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.