

Abu Dhabi Court Judgment: The Characteristics of a Novation and Extinguishment of a Debt

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Introduction

In a recent Abu Dhabi Court of Cassation judgment (Cassation No. 46-2020 dated 4 May 2020), the court considered whether there had been a novation between the parties of a settlement agreement. It applied an objective test to determine the intent of the parties based on the relevant facts and circumstances, and disregarded the parties' description of the agreement as a settlement agreement. The court held that there was no novation of a debt and that the debt remained outstanding.

Background

A company (the First Defendant/Principal Debtor) obtained facilities from one of the leading banks in the UAE (the Claimant or bank) in the amount of AED1.5 billion. The facilities were secured by a personal guarantee from two individuals, the owner of the company (the Second Defendant or surviving guarantor) and the owner's father. However, one of the individuals (the owner's father) passed away.

The bank filed a lawsuit in 2013 against the defendant company, the surviving guarantor in his personal capacity, and the heirs of the deceased guarantor pursuant to Article 1078 of the Civil Transactions Law, under which the obligee may claim the guaranteed debt from the guarantor or the principal obligor or both of them together.

The bank also obtained a precautionary attachment on the real estate (several properties) that devolved to the heirs, including mortgaged properties that were in favour of the bank as part of the guarantees provided by the Defendants at the time the facilities were granted.

Before the commencement of proceedings, the bank entered into an agreement with the surviving guarantee according to which the parties agreed that bank would take over the management of the mortgaged properties, which were the subject of the facilities agreement. This agreement was entered into before the Conciliation & Settlement Committee, which is a division of the Abu Dhabi courts.

The heirs of the deceased guarantor (who were entitled to a share of his estate) argued that the agreement entered into was a settlement agreement which replaced the original agreement. They argued that the debt was discharged by the settlement agreement and they were no longer obliged to pay the debt amount.

Court of First Instance and Court of Appeal decisions

The Court of First Instance ruled in favour of the heirs. The Court of Appeal upheld the judgment issued by the Court of First Instance.

Court of Cassation decision

The bank had not discharged the guarantor from his liability on the debt

The bank filed an appeal before the Court of Cassation on the basis that the Court of Appeal misapplied the law. The Court of Cassation held that the trial court did not examine the wording of that agreement to establish whether it constituted a settlement or a novation of debt. There was no connection between the purported Settlement Agreement and the dispute, the subject of the cassation petition, in respect of which an action was filed to recover, from the heirs, the deceased guarantor's debt to the bank and his debt as guarantor for the defendant company. Instead, the agreement was concluded between the bank and the Principal Debtor. The bank had not discharged the guarantor from his liability on the debt nor had it discharged the Principal Debtor from their liability on the debt being claimed (whether in the action, subject of the instant cassation petition, or under the so-called Settlement Agreement, whether explicitly or implicitly)

No novation of the debt

The bank also relied on Article 258(1) of the Civil Transaction Law (Federal Law No. 8 of 1985) which states: "The criterion in (the construction of) contracts is intentions and meanings and not words and form." It argued that even though the new agreement was signed before the Conciliation & Settlement Committee, this did not automatically make it a settlement agreement. Thus, the agreement should be interpreted based on its content and not its title. Accordingly, as the guarantor had passed away, this meant his heirs should take on his obligations. The Court accepted these arguments.

The Court held that the purported Settlement Agreement did not provide for a settlement or conciliation in relation to the debt or set a date for payment of same, the Settlement Agreement's title notwithstanding. This is because the agreement did not substitute a new obligation for an existing one whether by changing its subject matter, basis, or source or by changing the debtor and creditor, being the circumstances under which an old debt is extinguished in order to be substituted by the new debt. Instead, the agreement was nothing more than an acknowledgement of the debt by the First Defendant, as the principal debtor, in favor of the bank and an agreement to effectuate the property management agreement previously concluded in 2012.

The Court held that it is settled law that suretyship is a consensual contract whereby one person guarantees the performance of the debtor's obligation by undertaking to the creditor to satisfy that obligation should the debtor fail to do so himself. As a secondary obligation that runs parallel to the primary obligation, a guarantee terminates only when the primary obligation does by being paid or novated by changing one of its elements, unless it is agreed that it continue to secure the new obligation. Suretyship is not to be presumed but must always be express and must be construed narrowly i.e. within the limits of the surety's obligation and in case of doubt, the more lenient interpretation will prevail, as borne out by the wording of the guarantee.

The Court of Cassation thus issued a judgment ordering the heirs, the Second Defendant and the First Defendant to pay the debt amount of AED1.5 billion plus legal interest.

Conclusion

This judgment provides helpful analysis on the objective test applied by the courts when interpreting contracts as well as describe the characteristics of a suretyship. The Court of Cassation emphasised its authority to interpret contracts and to understand the contracting parties' intentions. By interpreting the contract, the court must focus on the meaning of the whole text rather than individual words and not deviate from the apparent meaning of the terms of the contract.

Al Tamimi & Company's litigation team regularly advise on commercial disputes. For further information, please contact [Zafer Oghli](#) or [Ahmed El Shaer](#).