Asset Finance in the UAE Finance Structures and creation of Security

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Asset finance is a form of financing that is applied toward the purchase of tangible and movable assets. The purpose of this type of financing is to facilitate the purchase of capital equipment required for the day to day running of businesses, and on a larger scale, asset financing can also cover larger assets such as aircraft and vessels.

The key components of the asset finance are that the asset being financed is the primary security provided to the lender and the revenue generated from the asset is used to repay the debt and service interest payments. Depending on the structure of the asset financing agreement, the borrowing entity may also be afforded additional flexibility such as having the option to replace or update the equipment at the end of the lease period.
This article sets out the typical financing structures available in the UAE and the possible means by which security over the financed assets may be provided.

Asset Classes

We examine below the different categories of assets which usually form the subject of asset financing in the UAE:

(a) Plant and equipment

This category covers a broad range of assets, including industrial equipment such as machinery, generators, cranes and storage units purchased by the borrowing entity.

(b) Vehicles

This category covers a range of vehicles which are used in the course of the borrowing entity's business, and apart from the normal fleet of cars, trucks and other forms of conventional transportation, can also include tractors, bulldozers, excavators and cranes.

(c) Vessels

This category deals with vessels that are over ten tons and that have been registered at the National Transport Authority in the relevant Emirate.

(d) Aircraft

This category deals with aircraft that are registered by the General Civil Aviation Authority.

Financing Structures

Term Loan

The most common form of financing used is to provide a term loan to the borrower to purchase the asset.

The asset that is being financed will be pledged or mortgaged to the lending bank and the receivables used to repay the outstanding debt.

Lease Finance

Here the asset remains in the name of the bank and leased to the lessee. At the end of the finance period the asset is transferred to the lessee. This type of structure may pose legal issues in the UAE as there is no specific law that governs lease finance and conventional banks and finance companies are restricted from owning assets and carrying out commercial activities such as leasing.

Shari'a Compliant Structures

In both cases above, Shari'a compliant financing alternatives are also available as solutions to their conventional counterparts. A direct financing may be granted by way of Murabaha, where the bank purchases the asset directly from a third party and immediately resells the same asset to the borrowing entity at a profit. It is possible for the bank to enter into a pledge over the assets in question. However, this structure is not popular for medium or long term financing because the profit rate may not be benchmarked to LIBOR or EIBOR and must be a fixed rate.

Alternatively, the bank can purchase the asset and subsequently lease the asset to its client pursuant to an Ijarah structure. Ownership of the leased asset is then transferred to the client upon the termination of the lease.

Creating Security over Assets

The following are the types of security that can be created over the different types of movable assets.

Pledge

In this section of the article, we are referring to movable assets that are not registered with any government authority in the UAE.

A pledge would be relevant in case of unregistered moveable assets, being assets which are not of a permanently fixed nature (i.e. assets which can be removed without damaging or alerting its structure, physical appearance or surroundings). Simply put, moveable assets are assets which do not comprise real property (i.e. land) or any structure permanently affixed to the land. In cases where the asset subject to the asset financing can be specifically defined and ownership interests therein are not capable of being legally mortgaged, the pledge is a more appropriate form of security. The requirements for perfection of the pledge are set out below:

(i) The Pledge should be executed in a written form and time certain.

A pledge over movables is ineffective against non-contracting parties unless an instrument showing the debt and the property held in pledge together with the transfer of possession to a pledgee is made.

Since there is no registration of pledged movable assets in the UAE, the signing of a pledge agreement in a notarised document serves as a document that fixes the time of signature of the pledge agreement and thereby confirms priority over other unsecured and subsequent secured creditors. Notarisation is the recognised and accepted practice to create time certainty.

(ii) The pledged assets must be in existence and be identified.

The Civil Code in general, requires that the subject of a pledge is identifiable at the time of the contract. Therefore, future assets are not able to be captured, nor is a 'floating' pledge possible.

(iii) The secured party must take custody of the pledged assets.

The Civil Code and Commercial Code both require that custody of the pledged assets should either be held jointly or by the creditor or by a neutral third party.

Therefore, if the lenders do not intend to have physical possession over the pledged asset, it would be required that the pledge agreement provides that the custody of the pledged asset should be transferred to a third party "Bailee". If the borrower is a company (as with most financial institutions' facility agreements) the pledge agreement may appoint the general manager of the borrower (in his personal capacity) as a Bailee.

The following are some issues to be considered in the context of a pledge:

- It is not likely that a pledge can be entered over a portion of the relevant asset, unless such portion can be identified separately (for example, by way of a distinct serial number which would distinguish it from the rest of assets to which it is attached).
- A pledge is specific to the assets listed in the pledge document itself. Unlike a commercial mortgage, a pledge is not publicly registrable, and does not embody notification to the world at large. Hence, the bank and the borrowing entity have to weigh their respective objectives in achieving the best solution. It is suggested that a pledge, which is perfected in accordance with applicable formalities, would be more suitable in the context of asset financing.

Commercial Mortgage

This is a mortgage over the tangible and intangible assets of the borrowing entity, and includes tools, machinery (listed in the mortgage agreement) and intangible elements such as goodwill or trade name. The requirements for creation of a business mortgage are as follows:

(i) The mortgage must be notarised in front of a UAE notary public. Generally the notary will require notification prior to notarizing the mortgage.

(ii) A search of the Commercial Register (nominal fee) is undertaken to ensure no prior business mortgage is recorded.

(iii) Once notarization is complete, and the search is obtained, the mortgage must then be registered with the appropriate Commercial Registry. Until now, only four established Commercial Registries exist in the UAE, the Emirates of Dubai, Abu Dhabi, Sharjah and Ras al Khaimah. Thus, the mortgage over commercial business may only be effected in these Emirates (or anywhere else which has a commercial register).

One difference between a pledge and commercial mortgage is that the mortgagor may continue to maintain possession of the commercial business or unit even after mortgaging the commercial business or unit.

Registration with the Commercial Register provides protection for a period of five (5) years from the date of registration. Such registration must be renewed prior to expiry of the five (5) year period; otherwise, it will be automatically cancelled. The registration of a mortgage with the Commercial Registry may not be cancelled except by the consent of both parties or pursuant to a final court order.

Vehicles

Security over vehicles is effected by way of registration of a mortgage with the relevant Traffic Department. There is an absence of clear written law on this topic, however, in general all dispositions and ownership interests over vehicles must be registered. Accordingly, the borrowing party still retains the legal ownership of the vehicles, such ownership being subject to the mortgage.

There may be cases in which the scope of the mortgage is not clear cut. For example, a trailer forming part of the vehicle, and is hence detachable, may arguably fall outside the scope of the mortgage, depending on how the mortgage was registered. Other assets, such as cranes, may not obviously fall into the “Vehicles” category.

Vessels

Vessel mortgages in the UAE are created pursuant to the UAE Commercial Maritime Law No. 26 for the year 1981 and amendments as per law No. 11 for the year 1988 (the “Maritime Law”). The Maritime Law permits the mortgage of a vessel if its total tonnage exceeds ten tons. The vessel being mortgaged in the UAE should be registered with the National Transport Authority, in other words, the vessel should maintain a UAE flag.
A vessel mortgage is only valid if it is made by an official instrument. The practical steps for perfection of a mortgage include the following:

- A notarized vessel mortgage agreement is filed with the National Transport Authority.
- The National Transport Authority will issue a new vessel registration certificate noting the mortgage registered in favour of the mortagee.

The Maritime Law permits the creation of a mortgage over a vessel that is under construction however; the mortgage must be preceded by a declaration from the relevant Maritime Office in the port in its jurisdiction the vessel is being constructed, stating the length and other dimensions of the vessel, its approximate tonnage, and the address of the yard or place in which it is being built. The National Transport Authority is currently putting in place procedures to register mortgages over vessels that are under construction.

Aircraft

Financing the purchase or lease of aircraft is common in the UAE where such aircraft are being acquired or leased by private operators or airlines. In relation to private operators or high net worth individuals acquiring a single aircraft, the financing structure usually includes a term loan coupled with an aircraft mortgage registered at the General Civil Aviation Authority (GCAA). Once the mortgage is perfected, the GCAA will issue a certificate of registration confirming the details of the owner/mortgagor, the operator (if the operator is a separate entity) and the financing bank as mortgagee.

In relation to financing of a fleet of aircraft for airlines or private operators, the structure would include a special purpose company (jointly owned by the financier and the relevant airline) which is the owner of the aircraft and such special purpose vehicle would lease the aircraft to the airline. In certain instances, such leasing structures are also supported by a further layer of financing provided to the special purpose company. Accordingly, the special purpose vehicle would provide a mortgage to its financier.

Banks and financial institutions would in addition to the mortgage registered at the GCAA require an additional registration of a security interest over the aircraft (airframe and engines) at the International Registry pursuant to the Cape Town Convention on International Interests in Mobile Equipment 2001 as adopted under UAE law. Such registration is effected through the GCAA which acts as an Authorized Entry Point in relation to the International Registry for the UAE.