

RAK Court of Cassation Clarifies the Court's Power to Interpret the Parties' Intentions

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Introduction

When a limited liability company goes into liquidation, its creditors are faced with considerable uncertainty, not least over their rights to securities on loans made to the defaulter. In such cases, a number of questions arise, including the following:

- will the loan amount be repaid when repayment of a debt is triggered by a condition that can never materialise?
- will a creditor be entitled to recover the debt amount with immediate effect if a debtor provides securities for the debt that becomes defective?
- will the directors of a limited liability company become personally liable for the company's debts where such debts are due to their wrongdoing or gross negligence?
- does the court have the power to interpret contract terms in order to explore the parties' intentions, when such terms are clear on the face of the agreement?

A recent decision of the Ras Al Khaimah Court of Cassation has provided clarity on these issues.

Background

The Claimant entered into a loan agreement with, inter alia, the First Defendant (a limited liability company), wherein the Claimant agreed to lend the First Defendant AED 12,000,000 ('Loan Amount'). The First Defendant undertook to repay the Loan Amount within seven years starting from June 2016, on the condition that the First Defendant would not start making the payment until the company made profits ('Payment Condition'). The First Defendant provided the Claimant with various forms of security.

A few months after entering into the said agreement the First Defendant became insolvent and failed to meet its financial obligations. One of its shareholders commenced civil proceedings in the Ras Al Khaimah Court of First Instance seeking the appointment of a liquidator as a matter of urgency. As the First Defendant was in a critical financial situation, the court accepted that claim and appointed a receiver to manage the company pending a determination of the liquidation claim.

The Claimant realised the First Defendant had not acted in good faith. It alleged that the First Defendant's directors ('Second Defendants') must have acted with gross negligence whilst managing the firm, as at the time of the loan agreement the First Defendant was in good standing but within a couple of months had incurred substantial and unexplained losses.

The Claimant filed a case against both the First and Second Defendants (together the 'Defendants') (the Second Defendants in their personal capacity) for the recovery of the monies owed to the Claimant. Al Tamimi & Company represented the Claimant in his claim seeking recovery of the Loan Amount from Defendants jointly.

Courts Findings

Ras Al Khaimah Court of First Instance Ruling

The Court of First Instance dismissed the case, saying that the claim was premature. The Court found that the case was filed prior to the fulfillment of the agreed Payment Condition, i.e. repayment of the Loan Amount was not due under the Payment Condition until such time as the company started to make profits. The Court did not make a decision on the claim against the Second Defendants because of the dismissal of the claim against the First Defendant, on which it rested.

Ras Al Khaimah Court of Appeal Ruling

The Claimant lodged an appeal application to set aside the judgment of the Court of First Instance. However, the Court of Appeal did not give permission to appeal. It upheld the judgment by the Court of First Instance without detailing its reasoning.

Ras Al Khaimah Cassation Court Ruling

The Claimant lodged an appeal application before the Cassation Court to set aside the Appeal Court's decision. To substantiate its application, the Claimant argued that the Court of Appeal did not understand the merits of the case properly and had misinterpreted the law.

The Claimant also argued that the First Defendant no longer had the securities of the debt and that it was impossible to satisfy the Payment Condition as the First Defendant had become insolvent. The Claimant submitted that the debt should be repaid immediately. The Claimant relied on Article 431 of the UAE Civil Code No. 5 of 1985 and its amendments which provides:

[T]he right of an obligor to defer shall lapse in the following circumstances... (3) if the obligations in rem for the obligations become defective by his act or through a cause in which he has played no part, unless he takes steps to supplement them.

Alternatively, the Claimant argued that the Second Defendants acted in bad faith, committed gross negligence and mismanaged the First Defendant in ways that caused the First Defendant to become insolvent. Additionally, it maintained that the First Defendant could never have sustained such losses without the fraudulent acts of the Second Defendants. The Claimant relied on Article 84 of UAE Commercial Companies Law No. 5 of 2015 and its amendments which states:

Every manager in a Limited Liability Company shall be liable vis-à-vis the Company, the partners and third parties for any fraudulent acts by such manager and shall also be liable for any losses or expenses incurred due to improper exercise of power or contravention of the provisions of any law in force, the memorandum of association of the Company or the contract appointing the manager or for any gross error by the manager. Any provision in the memorandum of association or the contract appointing the manager in conflict with the provisions of this Clause shall be void.

The Cassation Court held that the Court of First Instance should investigate the merits of the claim

thoroughly and should examine its power to interpret the contract terms in order to arrive at the parties' real intention, pursuant to Article 246 of the Civil Code, which states:

(1) The contract must be performed in accordance with its contents, and in a manner consistent with the requirements of good faith.

(2) The contract shall not be restricted to an obligation upon the contracting party to do that which is (expressly) contained in it, but shall also embrace that which is appurtenant to it by virtue of the law, custom, and the nature of the transaction.

Additionally, the Cassation Court found the Appeal Court did not address the merits of the case diligently as it did not investigate the claims in relation to the loss of the debt securities and that it did not contemplate the impossibility of fulfilling the Payment Condition, as the First Defendant was insolvent.

The Cassation Court ruled that the creditor is entitled to claim the immediate payment of the deferred payments once the creditor lost its securities. Although the Claimant raised such factual arguments before the Courts of First Instance and Appeal, those courts did not consider them thoroughly, according to the Cassation Court.

The Cassation Court further found that the Appeal Court did not apply the law properly, thus its judgment was defective and should be set aside. More particularly, the Appeal court did not apply the provisions of the said Article No. 431 of the Civil Code. Moreover, it did not apply its inherited power to interpret contracts to reach to the parties' real intention (court should look at the substance rather the form).

Consequently, the Cassation Court referred the case back to the Appeal Court (formed by a different panel) to rule on the merits of the case.

The Appeal Court focused on the direction of the Cassation Court. It investigated the financial position of the First Defendant to reach a decision on whether or not the Payment Condition would be satisfied. Further, it considered the fraudulent acts of the Second Defendants in further detail. The Appeal Court then arrived at the conclusion that the Second Defendants had cheated the Claimant and that due to their gross negligence the First Defendant's business had collapsed. It issued its judgment by holding the First Defendant and the Second Defendants jointly liable to repay the Loan Amount to the Claimant.

Conclusion

There is no doubt that this case looks into key legal principles of UAE commercial and civil law and the Cassation Court judgment is a remarkable precedent in the UAE national courts. The three key principles are as follows:

1. The Personal Liability of the Company's Directors

The threshold of evidence for holding a the directors of a limited liability company accountable for the insolvency of a company is very high, as holding directors personally responsible clearly contradicts the corporate veil principle, i.e. that the company bears its liabilities and its directors do not. However, in certain circumstances, the court can look into the actions of the directors and, if it is satisfied that they have acted with gross negligence, they will be held personally liable for the company's debts.

2. The Court has the Power to Interpret the Terms of Agreement in a Manner that Reflects their Real Intent

The courts usually do not look into the intention of the parties if the terms of the agreement are clear. It is difficult to convince the court to examine the parties' real intentions that, on their face, may not be consistent with their express agreement. However, as in this case the Claimant successfully convinced the Court of Cassation to apply its discretion and explore the parties' intentions in accordance with the provisions of the Civil Code.

3. If the Debtor Loses his Securities for the Debt, the Creditor is Entitled to Claim the Payment of the Debt Immediately, even if the Parties Agreed on a Deferred (Re)Payment Plan

In this case the Payment Condition was clear, however the Claimant relied on the relevant provisions of law that preserved the creditor's interests and caused the Appeal Court to rule on the ineffectiveness or impossibility of performing the parties' agreement (more particularly, the Payment Conditions) due to the dramatic change of the financial position of the debtor.

Al Tamimi & Company's [Litigation team](#) regularly advises on civil and contractual liability in connection with commercial and civil transactions. For further information, please contact [Mohamed Abdelsabour \(M.abdelsabour@tamimi.com\)](#).