SECURED TRANSACTIONS AND ISLAMIC FINANCE

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SECURED LENDING IN COMMERCIAL TRANSACTIONS: TRENDS AND PERSPECTIVES
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Topics

- Introduction: Select Issues
- Systemic and Definitional Matters
- Second and Subsequent Liens; Subsequent Debt
- The Secured Debt
- Proceeds
- The Collateral
- Remedies
Implementing Sharīʿah-Compliant Collateral Security Regimes:
Select Issues
This presentation considers a few representative issues encountered in implementation of a collateral security regime that:

- is compliant with Islamic Sharī‘ah, and
- will be enforced by a court, arbitrator or other dispute resolution body that applies the Sharī‘ah.

These are issues that have arisen in practice in OIC jurisdictions.

I use the new Saudi mortgage law as an example, and refer to it in connection with various issues.

- It is typical in many ways.
- It is now being implemented and has been approximately 17 years in the making.

I will use the terms “mortgagor” and “mortgagee” for both real property mortgages and personal property charges.

Exhibit A has other examples that are not included in this presentation.
Systemic and Definitional Matters
Select Issues

- The Sharīʿah is a 1,400 year old legal system.

- Collateral security elements are established and an integral part of the system.

- *Rahn*: a mortgage and pledge that applies to both real property and personal property, immovable and movables, without distinction.
Fundamental *Rahn* Concepts

- **Charitable contract**: a *rahn* is a voluntary charitable contract (*tabarru‘*) because the mortgaged property is given without financial consideration and involves non-fungibles.

- **Delivery and receipt**: as such, a *rahn* is not considered totally binding until the object of the contract is delivered and received by the mortgagee – it must meet the delivery requirements of the applicable *madhhab* (school of Islamic jurisprudence; *madhahib* is the plural).

- **Real and personal property**: *rahn* concepts are applicable to both real property and personal property, without distinction.

  - Any law that makes a distinction risks conflict with the Sharī‘ah.

- **Assurances regarding those distinctions**: will be needed in each jurisdiction to ensure effectiveness in the courts, including courts applying the Sharī‘ah.
Can a Sharīʿah-compliant *rahn* secure an interest-bearing obligation?

What effect will the charge (mortgage/pledge/security interest) law have on instruments that can be secured by it?

Consider both:

- Currently used instruments, and
- Future instruments (e.g., the full range of Sharīʿah-compliant instruments).
Role of Sharīʿah: what is the role of the Sharīʿah in the law of the relevant jurisdiction:

- Paramount? - Saudi Arabia
- An important element? - many MENA
- Unclear? – many OIC, and increasing

Dispute resolution body: What dispute resolution body enforces what actions? Will the dispute resolution body change if Sharīʿah elements are incorporated in the law?

School of jurisprudence: What interpretation of the Sharīʿah will be enforced? Which madhhab (school of Islamic jurisprudence)?

- Ḥanafī, Ḥanbalī, Shāfiʿī, Mālikī, Other
- It makes a difference.
- Rahn concepts are possession-based.

- Will physical possession be required?

- Or will constructive possession concepts (of the Māliki school) be accepted?

- Will recordation be considered to be the equivalent of possession, and accepted as such, under the relevant Sharīʿah principles in the jurisdiction under consideration?

- There will need to be some assurance that Sharīʿah-based determinations will respect these concepts of constructive possession and recordation.
Common, classically, for the debtor to be permitted to hold and operate the mortgaged property during the term of the mortgage.

- With an obligation to produce the mortgaged property for confirmation upon demand by the mortgagee in certain circumstances, such as at the time of repayment.

- Under the applicable madhhab, how do these doctrines interplay with the possession doctrines?

- Easier if the Māliki constructive possession concepts are accepted.
Some laws (Saudi) apply clearly to real estate (residential housing finance was the impetus).

And they apply to some types of personal property. But maybe not all. This is a difficult set of issues in most OIC countries.

Land registration systems – often imperfect.

If the land registration system is not easily monitored, comprehensive, etc, then the mortgage recordation system may not be either; and the constructive possession regime is stressed.

Most jurisdictions have no personal property lien registration system, even if they do have a real property registration system. Might have to build from scratch.

E.g., Saudi seems to apply only to motor vehicles and other assets where a registration system already exists. What of other assets?
Guarantors

- Does the mortgagor have to be the debtor on the debt secured by the mortgage?

- What of guarantors, including a guarantor that provides a mortgage without the consent of the debtor?
  - But law may limit enforcement to only the assets constituting the mortgaged property of the guarantor, not the assets of the debtor. Saudi does that.
Classical *rahn* principles relating to “association of the underlying debt”:

- the underlying secured debt is associated with the entirety of the mortgaged property; and
- the mortgaged property is associated with the entirety of the debt.

Saudi: mortgage law follows this, but allows mortgagor and mortgagee to consent to different arrangements.

(I ignore multiple debtor situations, multiple creditor situations and multiple debt situations – there are special rules here).

Thus, repayment or forgiveness of part of the debt leaves the remaining outstanding unpaid debt associated with the entirety of the mortgaged property and

No portion of the mortgaged property is released until payment in full of the debt even if there are multiple debts or multiple items of mortgaged property.
Second and Subsequent Liens
Subsequent Debt
Permissive second mortgages may invalidate the first mortgage; must consider these Sharīʿah principles in implementing any collateral security regime.

- E.g.: original mortgagor grants charge to a third party with the consent of the original mortgagee – voids initial mortgage and leaves second mortgage as sole valid charge (Majelle).

- E.g.: mortgage by original mortgagee (creditor) to a third party with the consent of the original mortgagor – the original mortgage is void and second mortgage is valid as a mortgage.

- Second mortgages without consent – are void.

- Most laws neglect the rights of bona fide third parties without knowledge of the original mortgage.
Annexures and After-Acquired Property

- If mortgagor is not the owner, when does the mortgage become effective?
- Classically, both annexures and contiguous increases and separate growths are included in the collateral subject to the lien of the *rahn*.
- But, *madhahib* different greatly: Māliki most restrictive, Ḥanbalī quite comprehensive.
- Saudi: only when mortgagor obtains a deed of ownership with respect to the mortgaged property.
  - Implies that one can mortgage property to be acquired in the future.
  - Annexures are covered under Saudi Mortgage Law: mortgage is affective against all annexures to the mortgaged property (*e.g.*, buildings, plants, services, constructions and modifications), expressly including those coming into being subsequent to deed, unless the mortgagor and the mortgagee otherwise agree.
Al-Zuhaylī notes that there are three forms of mortgages:

- those required pursuant to the debt-generating contract, such as a condition in a sale agreement that a mortgage be provided to secure payment of the sale price (consider revolvers and undrawn facilities);
- a mortgage originating after the establishment of the relevant secured debt; and
- a mortgage prior to the establishment of the relevant secured debt, such as a mortgage of property prior to incurrence of any indebtedness (consider revolvers and undrawn facilities).

With respect to (3), the Shāfi`īs and most Ḥanbalīs ruled that such a mortgage is not valid.

The Shāfi`ī's and the Ḥanbalīs established a number of conditions relating to the liability underlying the mortgage, including that liability must be an established and matured fungible debt.

The Ḥanafīs also set forth a number of conditions for the underlying secured debt, including that the underlying right in respect of which an object is mortgaged must be binding and matured.
The Secured Debt
In each case: mortgage secures only debt that is specified in the mortgage deed, including as to its amount and the maximum period for repayment.

Rules regarding degree of specificity of debt are usually applied with rigor. Future advances are a significant issue.

Some madhahib allow increases in debt subsequent to the grant of the rahn.

Others do not

- Shafi‘i and Hanbalī madhahib have disapproved on the grounds that insurance of a legal right may not precede the establishment of the legal right, characterizing a rahn as a derivative of a legal right.

Different madhahib have different positions on the maturity of the secured debt, including distinctions as to “finally established” loans and those that are not “finally established”, and with respect to other underlying debt conditions.
• Saudi law allows waivers of priority by a mortgagee in favor of another mortgagee, but is unclear on consequences of a waiver.
  • Consider the second lien issues under the Shari‘ah, which seem to be overridden by the law. Will the courts enforce this?

• Example:
  • 3 creditors with priority.
  • 1st priority mortgagee creditor waives SAR 500 million mortgagee position in favor a second mortgagee.
  • Does the waiving 1st priority mortgagee then become 2nd or 3rd in respect of the waived priority?
  • What if the waiver is for less than all of the total secured mortgage claim of the waiving mortgagee (e.g., total mortgage in favor of waiving 1st priority mortgagee is SAR 1 billion, but the waiver pertains to only SAR 500 million)?
The Secured Debt: Subordination and Reinstatement

- Saudi: mortgage is subordinate to the debt, terminates upon payment of the debt.

- Saudi: the mortgage is automatically reinstated, subject to intervening rights of *bona fide* third parties, if the debt is lifted and subsequently re-effectuated.

  - Consider revolving credit agreements: interpretation is unclear.

- Consistent with classical rules, including the consequence of the “right of the mortgagee to hold and keep the mortgaged object” until payment in full of the debt.
The Secured Debt: Prepayment

- Saudi mortgage law allows prepayment of debt prior to its maturity date in accordance with the agreement of the parties to the debt and mortgage documents.

- Consistent with the Shari‘ah principle that allows a debtor to prepay his, her or its debt at any time, even if the financing arrangement expressly precludes early payment.

- Will a dispute resolution body (e.g., a court) enforce a restriction on early payment?
  
  - Predominant position: no.
Proceeds
- Are proceeds of a mortgaged (charged) asset subject to the collateral security law?

- Note the Sharī‘ah rule that rent and other proceeds of real property cannot be pledged unless the underlying real estate is pledged.

- Classical principles: the priority will attach to – follow – the proceeds upon sale of the mortgaged asset.
Saudi: the mortgagee may be authorized to collect and receive the proceeds from operation of the mortgaged property prior to foreclosure, but is not allowed to retain those proceeds.

Any provision authorizing the retention of proceeds by the mortgagee is null and void although mortgage deed itself remains valid and binding.

Permits the use of lockbox structures, especially if considered together with Shari‘ah principles pertaining to adl structures.

Should permit use and enforceability of reserve account provisions so long as the funds in those accounts are not applied to the debt except in accordance with the enforcement provisions of the law.
Collection and Application of Proceeds: Classical

- Consistent with classical *rahn* formulations.

- The mortgagee cannot take any benefit from the mortgaged property during the term of the mortgage absent the consent of the mortgagor.

- If consent is obtained, the benefits of the mortgaged property, to the extent of the consent, are retained by the mortgagee and do not constitute a reduction in the secured debt.

  - Saudi law prohibits this mortgagor consent arrangement (the provision is null and void, even with consent), although it does allow for consent to collection, without mortgagee retention, by the mortgagee.
The Collateral
Expenses of Upkeep of Collateral

- Classical Ḥanafī:
  - the debtor mortgagor is responsible for the expenses relating to the benefit and upkeep of the mortgaged property without credit for such expenses against the outstanding debt
  - the creditor mortgagee is responsible for safeguarding the mortgaged property with the limit of the creditor's liability being the amount of the underlying secured debt.

- Other three orthodox Sunnī madhahib: different view (Saudi law also):
  - the debtor mortgagor is responsible for all expenses relating to the benefit and upkeep of the mortgaged property and also for the expenses relating to safeguarding the mortgaged property.
  - basis: the debtor mortgagor is the owner of the mortgaged property and is entitled to its output and is correspondingly responsible for its expenses.
More on this topic in Exhibit A.

Saudi: if decrease in value, loss or defect is the result of the mortgagor's negligence of willful misconduct, the mortgagee may require immediate payment of the debt or demand security that is adequate to that provided by the mortgage.

Classical: the mortgagor must pay an amount of compensation equal to the amount of the loss or defect.

Second: decrease, loss or defect is not the result of the mortgagor's negligence or willful misconduct, the mortgagor is obligated to either provide a sufficient guarantee of the debt or pay the debt.

Not entirely consistent with classical principles: see below.
Defective Collateral: Classical

- Ḥanafī: mortgagee's possession is a trust: reduction in underlying secured debt if the mortgaged property perishes.

- Ḥanafī: Various conditions attach in order to make a diminution, loss or defect compensable while in the possession of the creditor mortgagee:
  - existence of the underlying secured debt at time of event;
  - possession by the creditor mortgagee (and not the debtor mortgagor) at the time of the event; and
  - affected mortgaged property is part of the original underlying mortgaged property, and not an increase.

- The other orthodox Sunnī madhahib view the creditor mortgagee’s possession as one of guaranty:
  - perishing of the mortgaged collateral gives rise to a reduction in the underlying debt
  - unless the creditor mortgagee is responsible by way of transgression or negligence.
Defective Collateral: Classical

- Classical: loss or defect resulting from third party acts that are not attributable to the mortgagor must be compensated by the third party and that compensation then becomes subject to the mortgage.

- If the decrease, loss or defect results from acts or omissions of the mortgagee, the amount of the decrease, loss or defect is struck from the secured debt as it is compensable by the mortgagee.
Remedies
Mortgagee Taking of Ownership

- Saudi: provisions in a mortgage deed or related documents that allow the mortgagee to take ownership of the mortgaged property upon non-payment of the secured debt are null and void, although the mortgage itself will remain valid.

- Entirely consistent with classical *rahn* principles and an oft-quoted *hadīth*, although some Ḥanbalī jurists have sometimes allowed the transfer of ownership of the mortgaged property upon nonpayment.

- The mortgage is cancelled upon payment in full of the secured debt, under the Mortgage Law.
More on foreclosure and remedies in Exhibit A.

Defaults other than payment defaults, such as covenant defaults, allow the mortgagee to foreclose upon the mortgaged property.

Saudi: default entitles the mortgagee to request sale of the mortgaged property upon adequate notice and compliance with the provisions of the law, with the mortgagee having the designated priority with respect to the proceeds of such a sale.

If those proceeds are insufficient to pay the secured debt in full, the mortgagee becomes an unsecured pari passu creditor with respect to the unpaid balance of the secured debt.
Foreclosure and Sale: Classical

- Classical: favor sale of the mortgaged property in default scenarios, including pursuant to judicially ordered sale.
  - Permit the debtor mortgagor to sell the mortgaged property in some situations (often stated as the preferred rule in light of the debtor mortgagor's retention of ownership).
  - The “normal” rule of debtor sale quickly gives way to judicially mandated sale if the debtor refuses to sell or is recalcitrant in effecting a sale of the mortgaged property.
  - Classical principles permit the mortgagor to appoint the mortgagee or another person as attorney for the sale of the mortgaged property.
  - Most contemporary statutory enactments do not make provision for sales by the mortgagor or the mortgagee as attorney for the mortgagor.
The mortgage lien, and rights of the mortgagee, survive any transfer of ownership or possession of the mortgaged property (so long as there is a registration system).

Saudi: possessors of the mortgaged property have a right to make payment of the secured debt upon receipt of notice of default and foreclosure, and, upon any such payment, such possessors succeed to the position of the mortgagee and are entitled to reimbursement of expenses from the mortgagor.

This effects a “right of redemption” in possessors “until the gavel falls” upon foreclosure sale.

The purchaser in foreclosure will acquire the mortgaged property free of the mortgage lien.
Proceeds of Foreclosure Sale

- Saudi: upon a foreclosure sale:
  - a portion of the sale proceeds, equal to installments due and unpaid at the time of the foreclosure sale, is paid to the creditor and
  - the remainder of the proceeds is placed in a bank account (and can be released upon the agreement of the creditor if a bank guarantee is obtained with respect to the payment of future debt payments).

- Gives effect to classical principles that are based upon the theory that the proceeds obtained by sale of the mortgaged property substitute for the original mortgaged property, with continuation of the original transaction arrangements in respect of the underlying debt until maturity of the debt.

- This introduces issues pertaining to a previously unconsidered credit, that of the bank holding the funds until maturity.
Proceeds of Foreclosure Sale

- Classical: the debtor mortgagor continues to own the proceeds as mortgaged property as it is substituted for the original collateral.

- That arrangement exposes the amounts in the bank account to the subsequent bankruptcy of the debtor mortgagor (although it is likely that the creditor mortgagee's priority in those amounts would continue during the bankruptcy).
THANK YOU
Exhibit A

Some Other Examples of Issues in Implementing Shariʿah-Compliant Collateral Security Regimes
A Caution: Specific Types of Property Have Specific Rules

- Rather precise rules have been developed for some specific types of mortgage arrangements and specific types of mortgaged property:
  - indebted estates
  - perishables
  - fruit juices
  - religious books
  - and others.
Who May Grant the Charge

- Must the mortgagor/charger own the property being mortgaged/charged?
  - Generally, no.

- Can grant *rahn* on borrowed property (all *madhahib*); requires consent of owner.

- Can grant a *rahn* on property of others, usually requires consent.

- Must pay careful attention to consent requirements under the Sharīʿah.
Must the Mortgagor be the Debtor?

- Does the mortgagor have to be the debtor on the debt secured by the mortgage?
- Classically, borrower could grant *rahn* on borrowed property, with the consent of the owner.
- Saudi, that may not be permitted.
- Classical rules pertaining to mortgages of previously mortgaged property involve issues pertaining to the comprehensiveness or restrictive nature of the initial mortgage, consents and permissions with respect to subsequent mortgages, and the extent to which the two mortgages contradict one another, among others.
- But the Majelle: subsequent mortgage with consent voids first mortgage.
To comply with the rules of different madhahib, different jurisdictions define the types of debt that may be secured.

Saudi: the debt secured by the mortgage must be:

- of a financial nature
- a specific amount to be acquired in the future
- a secured asset, or
- a debt to be repaid, such as a conditioned debt or a debt to be established in the future or a potential debt.

It is difficult to determine the distinctions between and among the foregoing categories, which are listed as summary statements, without further explication, in the Mortgage Law.

Litigation will define these categories.

But remember, no *stare decisis*; so decisions are very much *de novo* case by case determinations.
May the mortgagor lease the property and will the mortgagee then be able to enforce the lease against the third party lessee?

Saudi: If the property is registered pursuant to the system of real estate registration, leases issued by the mortgagor to third parties may not be enforced in favor of the mortgagee, provided that the property was registered prior to the registration of the mortgage deed, unless the period of the lease is less than five years. (translation problem here).

If the property is not registered pursuant to that law, the mortgagor must disclose, in the mortgage deed, all in-kind original and accessory rights relating to the mortgaged property, and the mortgagor is liable to the mortgagee for any failure to disclose if any such rights affect the rights of the mortgagee.

If a failure to disclose is in bad faith, the mortgagor is subject to criminal actions pursuant to the laws pertaining to forgery.
The Secured Debt: Transfers of Debt and Mortgage

- Saudi: the debt obligation, and related mortgage, may be transferred by the mortgagee to a third party, unless the documentation limits this right.

- Saudi requires registration of the transfer.

- Law is very unclear as to rights of third parties in transfer situations.
The Secured Debt: Multiple Draws

- Saudi law strives for flexibility and responsiveness to modern financing arrangements and is permissively broad in its conception of debt that may be secured by a registered mortgage.

- Saudi law, on its face, applies to multiple draw, revolving and term credit facilities, so long as the amounts and tenors are specifically determinable and stated.

- Enforceability in a Sharī‘ah court remains uncertain.
Corollaries of this principle, and of the consequences, under classical *rahn* principles, of “dealing in and sales of the mortgaged property”, are that:

- the debtor mortgagor may not deal in (sell, lend, lease, mortgage, pledge, gift or place in trust) the mortgaged property without the consent of the creditor mortgagee, and

- the creditor mortgagee may not deal in the mortgaged property without the consent of the debtor mortgagor.

- Ḥanbalī position: either way, if no consent, is invalid *ab initio*, but each is permissible with consent of the other.

- Some *madhahib*: mortgage terminates upon permitted leasing, gifting or sale of the mortgaged property by the debtor or the creditor and noting that the mortgaged property may thereafter be held pursuant to different principles (such as those pertaining to a lease, a gift or a sale).
Who is obligated to guarantee the safety of the mortgaged property prior to repayment of the secured debt obligation?

Saudi: the mortgagor is obligated to guarantee the safety and value of the mortgaged property until repayment of the secured debt obligation.

Obligation extends to all matters that might result in a decrease in the value of the mortgaged property or prevent the mortgagee from recovering due to destruction or defect of the mortgaged property.

The mortgagee may object to matters that would result in such a decrease in value or subject collateral to loss or defect and make take necessary measures to ensure the safety of the mortgaged property, with the mortgagees’ costs being for the account of the mortgagor.

The extent of this right in the mortgagee, and how far it extends into the “self-help” domain, remain unclear, but supports the use of strong preservation and use covenants in the related financing agreements.

Mortgagee may seek a court injunction against actions that might have the effect of exposing the mortgaged property to destruction or damage or that might render it insufficient as collateral for the debt.
Saudi: if a decrease in value or a loss or defect occurs with respect to the mortgaged property or the rights or interests of the mortgagee in such property, there are three situations that must be considered, each of which bears defined consequences.

First: if as a result of the mortgagor's negligence of willful misconduct, the mortgagee may require immediate payment of the debt or demand security that is adequate to that provided by the mortgage.

Classical: the mortgagor must pay an amount of compensation equal to the amount of the loss or defect.

Second: decrease, loss or defect is not the result of the mortgagor's negligence or willful misconduct, the mortgagor is obligated to either provide a sufficient guarantee of the debt or pay the debt.

Not entirely consistent with classical principles: see below.
Third: confusing in Arabic text of Saudi law: the mortgagee may accept a new or substitute mortgage that is equal in value to the decreased, lost or defective mortgage,

- unless the mortgagee has an interest in the decreased, lost of defective mortgage,
- in which case a mortgagee may request immediate payment of the debt.

Upon any damage to or decrease in the value of the mortgaged property, the mortgagee's rights attach to any money that is substituted for the mortgaged property without the consent of the mortgagee and the mortgagee shall have rights, and the mortgagee’s priority, against such money.

- This portion is consistent with classical rahn concepts.
- But most of the third position is not entirely consistent with classical concepts: see below.
Defective Collateral: Classical

- Classical: loss or defect resulting from third party acts that are not attributable to the mortgagor must be compensated by the third party and that compensation then becomes subject to the mortgage.

- If the decrease, loss or defect results from acts or omissions of the mortgagee, the amount of the decrease, loss or defect is struck from the secured debt as it is compensable by the mortgagee.
Defective Collateral: Classical

- The different orthodox Sunnī madhahib treat the guarantee or assurance with respect to the mortgaged property somewhat differently.

- Ḥanafī: characterizes the creditor mortgagee's possession as a possession of trust, allows for a reduction in the amount of the underlying secured debt if the mortgaged property perishes, with the mortgaged property being protected in an amount equal to the lesser of its value and the amount of the underlying secured debt.

- Ḥanafī: Various conditions attach in order to make a diminution, loss or defect compensable while in the possession of the creditor mortgagee:
  - existence of the underlying secured debt at the time of the relevant event;
  - possession by the creditor mortgagee (and not the debtor mortgagor) at the time of the event; and
  - that the affected mortgaged property is part of the original underlying mortgaged property, and not an increase to or output of that property.

- Time of valuation is an issue: at inception of mortgage or time of loss?
The other orthodox Sunnī madhahib view the creditor mortgagee’s possession as one of guaranty:

- perishing of the mortgaged collateral gives rise to a reduction in the underlying debt
- unless the creditor mortgagee is responsible by way of transgression or negligence.

- Saudi conception extends somewhat further than the classical rahn conception.
Second and third situations of Saudi are inconsistent with classical, but do place the burden on the debtor to pursue the compensation from the non-debtor offender, which is an element of the classical Ḥanbalī position based upon the position that the debtor mortgagor is the owner of the mortgaged property.

Saudi also varies from classical by allowing the debtor mortgagor to retain proceeds obtained from the party that is liable, a position that is internally consistent given the requirements that the debtor mortgagor provide increased assurances directly to the creditor mortgagee, including during the pendency of the action against the liable party.

Classical: the debtor would provide adequate security, equal to the value of the decrease, loss or defect, and thus to the full amount of the debt, for the benefit of the mortgagee and separately pursue an action against the third party or mortgagee, as relevant, for the amount of such value.
Termination of Mortgage

- Foreclosure sale terminates the mortgage upon the mortgaged property, as does:
  - repayment of the debt (previously discussed) (explicit classical)
  - expiration of the stated term of the mortgage (implicit classical)
  - a unification of the mortgage and ownership in a single person
  - a waiver by the mortgagee creditor during the term of the debt (explicit classical, all four schools), and
  - pursuant to mortgagor request, expiration of the statute of limitations on the underlying secured debt.

- Presumably, the mortgaged property must then be returned to the debtor mortgagor if it is held by the creditor mortgagee at the time of mortgage termination.
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