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The Security Situation in Afghanistan: Foreign Lenders Beware

Foreign lenders have financed vast sums of money to Afghan businesses in recent years. To secure such financings, they have generally taken security over the borrowers' assets and undertakings including security over land. To date, very few securities have been enforced presumably because borrowers have been meeting their repayment obligations.

The World Bank has predicted a significant slowdown in the Afghan economy leading up to and following the NATO military withdrawal in 2014. In addition, there are widespread concerns of a substantial weakening of the Afghan currency, the Afghani.

The majority of the subject financings, and therefore repayment obligations, are in USD. Borrower earnings are generally in Afghani. A weaker Afghani is, on its own, likely to make it difficult for a large number of borrowers to meet their repayment obligations. Coupled with reduced cash-flows for many borrowers - which is likely to result from any economic slowdown - widespread borrower default may be inevitable.

Therefore, foreign lenders may need to enforce their securities in the not too distant future. Regrettably, many foreign lenders are likely to encounter major difficulties in enforcing their securities. This is because the vast majority of their securities do not create valid security interests under Afghan law. As such, many foreign lenders may not be entitled to priority over other creditors in the event of the borrowers' insolvency and may not have recourse to secured assets that have been transferred to a third party.

Foreign lender can, before any economic slowdown, re-structure their transactions and securities, and enact other measures, to better protect their investments.

Legal Framework

The legal framework for the recognition and enforcement of security interests consists of the: (a) Afghanistan Commercial Code 1955 (**Commercial Code**); (b) Afghanistan Civil Code (**Civil Code**); (c) Afghanistan Law for Secured Transactions on Movable Property in Banking Transactions 2009 (**Moveable Property Law**); and (d) Afghanistan Law for Mortgages on Immoveable Property in Banking Transactions 2009 (**Immoveable Property Law**).

The Moveable Property Law and the Immoveable Property Law were devised and implemented by the former administration of Da Afghanistan Bank (**DAB**). Both laws have been, and continue to be, praised for finally providing lenders with a workable system for the recognition and enforcement of their securities.

The Moveable Property Law and Immoveable Property Law reflect DAB's commendable attempt at modernizing Afghanistan's legal framework for governing securities. The laws are based on almost universally accepted concepts of security creation, perfection, priorities and enforcement. However, both laws contain a serious shortcoming. That is, their application is generally limited to securities granted to secure loans provided by persons that are licensed, by DAB, to provide banking services inside Afghanistan. As such, foreign lenders, who generally do not have a banking license in

Afghanistan - are not entitled to the benefits of the Moveable Property Law and the Immoveable Property.

Foreign lenders must therefore look to the Commercial Code and the Civil Code for the recognition and enforcement of their securities. In summary, under these codes, only securities granted over tangible assets that are, or their title deeds are, in the physical possession of the foreign lenders are recognized. The Commercial Code does in theory recognize non-possessory security interests over negotiable instruments and 'other commercial documents.' However, senior members of the Afghan judiciary have made it clear that such security interests will only be recognized and enforceable between the borrower and the lender, and will not have an impact on the rights of a third party.

Furthermore, in practice, only securities over land are capable of being perfected under the Commercial Code and the Civil Code, i.e. a security instrument can only be registered with the registry of the Commercial Court. The registry of the Commercial Court will only register securities over land – securities over other assets will not be registered. However, under the Constitution of the Islamic Republic of Afghanistan 2004, a foreigner's interest in land is arguably limited to a leasehold interest. Any other interest granted to a foreigner, including a security interest, may be considered unconstitutional and therefore unenforceable. Consequently, foreign lenders may not be able to enforce a security interest in land against any party, including the borrower.

Conclusion

The framework for the recognition and enforcement of security interests under the Commercial Code and the Civil Code is extremely narrow and does not sufficiently recognize the current security structures devised and implemented by foreign lenders in connection with their financings in Afghanistan. Consequently, the vast majority of securities held by foreign lenders may not create valid security interests under Afghan law and may not provide foreign lenders with priority against the borrower's other creditors and third parties that have acquired the secured assets. Accordingly, foreign lenders are at risk of suffering extensive losses if Afghan borrowers default on their repayment obligations.

Unfortunately, due to the likelihood of an economic slowdown and a weaker Afghan currency, an increase in borrower default leading up to and after 2014 may be imminent. Foreign lenders can, before the economic slowdown, restructure their securities and implement other measures to ensure their positions are adequately protected.

Foreign lenders should consider engaging Afghan counsel to undertake an immediate review of their existing securities and transaction structures, amend existing securities and implement quasi-security and other measures to better protect the foreign lenders' position and restructure transactions to take advantage of foreign assets and other protections.

Way forward

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Firm Profile

(1) Afghanistan Lawyers International ("ALI" or "the Firm") is an Afghan legal and government affairs advisory firm staffed by experienced lawyers with qualifications from Afghanistan, the United States

and Australia. The Firm provides legal and regulatory advice and strategic government advisory services on complex and significant matters for the Afghanistan market.

(2) Personnel:

- The Firm’s partners and senior staff have extensive experience in advising on legal, taxation and government affairs matters in Afghanistan.
- Mr. Zmarak Zhouand – Partner – Mr. Zhouand is Afghan-Australian and was admitted as a barrister and solicitor in New South Wales, Australia, in 2001 and as an attorney and counselor at law in New York, USA, in 2014. Between 2001 and 2008, Mr. Zhouand worked with Henry Davis York and Gadens Lawyers, both leading Australian corporate law firms, where he represented “blue-chip” national and international clients across the corporate, commercial, banking and finance and litigation practice areas. Mr. Zhouand returned to Afghanistan in 2008 to work as Senior Legal Counsel with Roshan¹, where, until early 2011, he co-led Roshan’s legal and government affairs team and was also in charge of the legal and regulatory function for Roshan’s wholly owned subsidiary, M-Paisa. In the beginning of 2011, Mr. Zhouand re-entered private practice and founded ALI together with Prof. Mahjoor on October 5, 2013. Mr. Zhouand² regularly represents and advises foreign investors, development finance institutions, United States Government implementing partners and contractors, Government of Afghanistan agencies, foreign governments and non-governmental organizations on some of the largest and most complex Afghanistan related matters and transactions. He focuses on banking and finance, mergers and acquisitions, projects (telecommunications, mining and infrastructure, energy), litigation, regulatory and general commercial. Mr. Zhouand has been and continues to be consistently recognized as one of Afghanistan’s leading corporate, finance and mining lawyers by a large number of publications and bodies including The Legal 500, Chambers and IFLR1000. He has a B.A (SCU) (1998) and a LL.B. (UNE) (2000) and is a member of the Chartered Institute of Arbitrators.
- Prof. Abdul Shukor Mahjoor – Partner – Prof. Mahjoor is an Afghan-American advocate registered with the Afghanistan Independent Bar Association. He has worked extensively in Afghanistan in the legal and government affairs environments over several years including having worked as a consultant with Mr. Zhouand. Prior to forming ALI with Mr. Zhouand, Prof. Mahjoor was, for a period of almost 3 years, Managing Partner of a specialist dispute resolution law firm in Kabul, Afghanistan. Prof. Mahjoor is Chancellor of, and Professor of Law at, Karwan University, Kabul, Afghanistan. In addition to lecturing at Karwan University, Professor Mahjoor is frequently called upon to train high-ranking Government of Afghanistan officials on legal and diplomatic matters. He is a regular speaker at conferences on issues relating to rule of law and economic development and often features on television programs where topical legal issues are discussed. Prof. Mahjoor is a dispute resolution specialist, and arguably one of Afghanistan’s most effective dispute resolution lawyers. He frequently represents United States Government implementing partners and contractors, their foreign employees, and foreign legal and natural persons generally in relation to multi-million dollar disputes with Afghan counterparties, and in relation to Office of the Attorney-General investigations and commercial and criminal court

¹ Roshan is Afghanistan’s largest private company and taxpayer. Roshan’s shareholders are the Aga Khan Fund for Economic Development, Monaco Telecom International (an affiliate of Cable & Wireless PLC) and Teliasonera B.V.

proceedings up to and including the Supreme Court of Afghanistan. Prof. Mahjoor has a B.A. (Law) (Aazhar University), LL. M (Arab League University) and LL.M (University of Missouri).

- The Firm's practice is supported by a number of commercially experienced international and locally admitted lawyers.

(3) Sectors: Telecommunications, mining and infrastructure, oil and gas, information technology, banking and financial services, media, intellectual property, security, logistics, commercial aviation, contracting and non-governmental sectors.

(4) Services:

- (i) Corporate and investment: specific and integrated full legal services to organizations doing business, and overseas investors looking to do business, in Afghanistan.
- (ii) Tax: the Firm specializes in the full range of tax issues such as tax exemptions, BRT, withholding taxes, corporate income tax, customs and tax dispute resolution.
- (iii) Projects: providing local counsel support for large and complex projects across a range of industries including mining and infrastructure, oil and gas and telecommunications.
- (iv) Donor funds/PPP: advisory and transactional support to participants engaged in donor funded projects including complex Public Private Partnerships (i.e. donors, public entities, private entities, prime grantees, and downstream grantees).
- (v) Commercial contracts: broad practice encompassing a range of commercial contracts and joint ventures, together with agency, distribution, franchising, sale of goods and services, procurement and other forms of transaction structures.
- (vi) Banking and finance: acting for financiers, borrowers and other intermediaries, strategic advice and practical structuring solutions, opinions, as well as documentation, for all types of transactions.
- (vii) Dispute resolution: negotiation, mediation, arbitration, specialist tribunals, primary and appellate courts.
- (viii) Government of Afghanistan advisory and lobbying services: including advising clients on devising engagement strategies with the Government of Afghanistan at the ministerial and deputy ministerial levels.
- (ix) Employment: including drafting standard employment agreements, human resources policies and procedures, advising on compliance and managing employee exits and disputes.