

Scope of Rights of Creditor Banks over Mortgaged Property in Ethiopia

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Abstract

This article examines the Ethiopian mortgage system focusing on the scope of rights of creditor banks over the mortgaged property including its validity requirements. It employed a doctrinal research method, including the analysis of FSC cassation cases, relevant laws, and literature review. The article highlights that laws and cassation court practices give better rights and protections to banks in the Ethiopian mortgage system. Concerning the validity requirement, banks are exempted from the authentication. Banks also have the right to determine which property shall be sold first when more than one property is mortgaged. Besides, they are entitled to payments first when several creditors claim the same property and sell practically mortgaged property that belongs to the debtor or third-party in the same manner even if the third-party mortgagor is assimilated to a guarantor. Moreover, practically, banks prohibited the sale of mortgaged property by taking over its title deed and securing its injunction. The article argues that the law should empower banks to sell the mortgaged property even when it is transferred to third-party or belongs to third-party mortgagor in the same manner as they would sell properties directly mortgaged by the debtor. Accordingly, it recommends equitable procedural safeguards to all involved parties while addressing liabilities that arise from foreclosure procedures.

Keywords: Bank, Ethiopia, Mortgage, Mortgagee's Rights, Rights of Creditor

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1. Introduction

Banks play a very important role in the economic development of every nation as they have control over a large part of the supply of money circulation. The contribution of banks to growth lies in the central role they play in mobilizing savings and allocating these resources to the most productive uses and investments.¹ Access to credit is crucial for economic growth and is the engine of private sector development.² Since creditors may not trust solely the borrower's promise for payment, they often demand collateral. Thus, borrowers guarantee the performance of the credit commitment by offering particular collateral.³ The various forms of collateral include mortgage, pledge, performance bond, lien, anthicresis, and surety. Each of them has its own particular feature that may vary from the other.⁴ The two most commonly used types of security under the Ethiopian legal system are personal and real security.⁵ However, this study focuses on the security of real property, i.e., mortgages under Ethiopian laws.

The 1995 Constitution of FDRE and subsidiary laws⁶ regulate issues of private property including mortgages of immovable property. Accordingly, every Ethiopian shall have the full right over private properties including the right to use, transfer, or claim compensation when damage is caused to it.⁷ These all guarantee the transfer of private immovable property including in the form of a mortgage. As a result, a

¹ Tihitina Ayalew, *Legal Problems in Realizing Non-Performing Loans of Banks in Ethiopia* (LL.M Thesis, AAU, 2009) p. 1

² World Bank, *Secured Transactions, Collateral Registries and Movable Asset-Based Financing* (Knowledge Guide, November, 2019) p.3

³ Habtamu Bishaw, *Mortgage Valuation in Ethiopia: The case of Commercial Banks* (PhD Dissertation, 2021) p.15

⁴ Mekuriaw Alemenew, *Mortgage on Immovable Property: The Law and the Practice in Ethiopia; with reference to East Gojam Zone Administration, Amhara Regional State, Ethiopia* (The International Journal of Humanities & Social Studies Vol.5, Issue 10, 2017) p. 316

⁵ *Id.*, p. 318

⁶ The specific laws governing mortgage are Arts. 3041 to 3116 of Civil Code, Property Mortgaged with Banks Proc. No. 97/1998 (with its Amendment Proc. No. 216/2000), Arts. 394-449 of Civil Procedure Code and FSC cassation decisions as per art. 26(3) of Federal Courts Proc. No. 1234/2021.

⁷ Art. 40 (7) of FDRE Constitution

mortgage is a common way for creditor banks to get their money back by way of foreclosure in case the debtor does not pay such money on the due date. The mortgage gives the bank a stronger right than what it gets under the general law which provides that the rights of creditors are protected by all assets of the debtor.⁸ However, if the creditor has mortgaged property, he will have a priority right to be paid first from the proceedings of the mortgaged property.⁹ In addition, other contracts entered by his debtor after the creation of the mortgage would not be set up against the claims of the mortgagee.¹⁰

Several studies have been conducted on the Ethiopian mortgage system, but they did not adequately and thoroughly address every issue. For instance, Adamu Shiferaw studied laws on the power of sale foreclosure in Ethiopia and argued that they are discriminatory and incomplete, enabling banks to cause injustice to both mortgagers and non-bank creditors. He also states that the FSC is reluctant to invalidate sales conducted in violation of these laws.¹¹ However, this study is limited to one perspective of the power of sale foreclosure, i.e., protection of borrowers, and thereby doesn't address the rights of creditor banks over mortgaged property. Besides, Tihitina Ayalew evaluated the problems faced by banks for non-performing loans. Her findings identify legal gaps and institutional issues that hinder the resolution process, mainly the collateral-based credit system's inadequacy to protect financial securities such as guarantee bonds and negotiable instruments.¹² However, the study is general and doesn't focus on the rights of creditor banks over mortgaged property.

⁸ Art. 1988 of Civil Code of the Empire of Ethiopia, Proclamation No. 165 of 1960, *Negarit Gazeta*, 19th Year, No. 25th May, 1960 (herein after, Civil Code).

⁹ Art. 3076 of Civil Code.

¹⁰ Art. 3089 of Civil Code.

¹¹ Adamu Shiferaw, *The Law and Practice of Power of Sale Foreclosure in Ethiopia* (LL.M Thesis, AAU, 2005)

¹² Tihitina, *supra* note 1.

Similarly, Sintayehu Demeke examined the validity requirements of mortgages focusing on the requirement of authentication and witnesses.¹³ Relevant to mortgage contracts, this study is only limited to the requirements of authentication and witness. Mekuriaw Alemenew also evaluated how, in Ethiopia, mortgage laws on immovable property are applicable by a court of law and other government machinery, and highlighted the practice which violates mortgagors' ability to transfer their mortgaged property.¹⁴ Nevertheless, the current study overlooks the rights of the mortgagee bank over mortgaged property. Furthermore, Habtamu Bishaw addressed mortgage valuation in Ethiopian commercial banks;¹⁵ Bereket Alemayehu examined the concept of security interests, methods, and procedures for the enforcement of pledged property by banks in Ethiopia;¹⁶ Alefe Beza also discussed the rights and obligations of the pledgee and mortgagee under Ethiopian law in general.¹⁷ However, these studies neither show other rights of creditor banks over mortgaged property nor focus on the mortgaged property or the scenario of the right of creditor banks over mortgaged property.

Therefore, this article builds upon these studies to address the existing gaps and issues concerning the legal and practical scope of the rights of Ethiopian banks over mortgaged property from different scenarios. Firstly, to realize mortgage rights, at the outset, mortgage rights shall be validly created, and thus a clear understanding of the validity requirements for mortgage contracts shall be made. Secondly, in the process of enforcement of mortgages, different issues may arise. The issue can be as to whether banks have the discretion of determining a property to be sold when more

¹³ Sintayehu Demeke, Mortgage and its Validity Requirements: A Case Based Analysis of the Requirements of Authentication and Witnesses (International Journal of Law and Policy Review (IJLPR), Vol. 5 No.2 July 2016).

¹⁴ Mekuriaw, *supra* note 4.

¹⁵ Habtamu, *supra* note 3.

¹⁶ Bereket Alemayehu, The Scope of Banks' Power in the enforcement of security interests Under Ethiopian Law: Lesson from the US and the OHADA Laws (LL.M Short Thesis, Central Europe University, 2018)

¹⁷ Alefe Beza, The Right and Obligation of Mortgagee and Pledgee under Ethiopian Law, The Law and Practice, (LL.B Thesis, St. Mary's University College, 2009).

than one property is mortgaged. Moreover, when several creditors claim the same property, their ranking and whether banks can prohibit the sale of mortgaged property by other creditors of the debtor need clarification. When mortgaged property belongs to third-party or is transferred to 3rd party, the nature of the right of a bank is worth explaining. From this perspective, the paper addresses the legal and practical scope of rights of Ethiopian banks over mortgaged property. Accordingly, a doctrinal research method was employed where more than 20 FSC cassation cases were reviewed and relevant laws and different literature were analyzed. These discussions are presented in a systemic and organized form, including the meaning, theoretical foundations and validity requirements of mortgages under Ethiopian legal frameworks. In addition, the article provides a detailed exploration of the legal framework and practice on the scope of the rights of banks over mortgaged property in Ethiopia from different views. Finally, it provides conclusive remarks and recommendations.

2. Conceptual Understanding of Mortgage

2.1. Mortgage: Concept and Theory

A mortgage is derived from the French terms - ‘mort’ and ‘gages’ which means ‘dead pledge’.¹⁸ The notion behind the word is supposed that if the mortgagor fails to repay the loan, the property mortgaged as security is lost, or becomes ‘dead’, to him or her. As a mortgage secures the repayment of the money, it facilitates money circulation for the ultimate effect of business transactions and contributes to the economic development of a country.¹⁹ The legal theories that underpin mortgages and their application vary from one legal system to another.²⁰ These differences among legal systems on the essence and nature of mortgage make providing a universally agreed definition a difficult task.

¹⁸ Mekuriaw, *supra* note 4, p.316

¹⁹ *Id.*, p. 318

²⁰ Andra Ghent, *The Historical Origins of America’s Mortgage Laws* (Research Institute for Housing America, Special Report, October, 2012) p. 21

Yet, the legal dictionary Black Law defines a mortgage as:

*...An estate created by a conveyance absolute in its form, but intended to secure the performance of some act, such as the payment of money, and the like, by the grantor or some other person, and to become void if the act is performed agreeably to the terms prescribed at the time of making such conveyance.*²¹

This definition displays that mortgage is principally the conveyance (delivery) of title to property given as a security, i.e., it shows that the title to the property has to be transferred to the creditor temporarily until the date of performance of the obligation and extinguishes upon the performance of the obligation.

On the other hand, Marcel Planiol defines a mortgage as:

*a real security which without presently dispossessing the owner of the property hypothecated, permits the creditor at the due date to take it over and have it sold, in whosoever hand it is found and to get paid from the proceeds by preference to the other creditors.*²²

This definition shows that a mortgage is a real security, i.e., the right that creates a relation between the creditor and the property given as security; and the right that can be enforced against everybody in the world. Secondly, it indicates that the creation of a mortgage doesn't result in dispossession of the debtor thereby allowing him to use, enjoy, administer, or do anything he wants to do with his property. Thirdly, a mortgage by its nature entitles the creditor to exercise his security right only if the debtor fails to perform his obligation at the due date. Lastly, the definition

²¹ Bryan A. Garner, Black's Law Dictionary (St. Paul Minn. West Publishing Co, 8th ed. 2004) p. 793

²² Gadissa Tesfaye & Mebrathom Fetewi, Law of Sales and Security Devices (Prepared under the Sponsorship of the Justice and Legal System Research Institute, 2009) p. 199

provides for the principal rights of the mortgagee creditor, i.e., the right of pursuit and the right of preference.

Unfortunately, regarding the definition of mortgage in our legal system, there is no provision dedicated to the definition of mortgage. However, it is possible to understand the essential features of a mortgage from different provisions of the Civil Code dealing with various aspects of mortgage which is similar to the definition of Marcel Planiol. For instance, art. 3047 of the Civil Code indicates that a mortgage is a juridical act where a mortgagor offers immovable properties as a security for borrowing money. Mortgages can charge immovable properties only. However, certain kinds of movable properties including aircraft, specific types of ships, and vehicles are also considered as a mortgage as per art. 3047(2) of the Civil Code. Moreover, the Commercial Code provides that a person who is capable under civil law and who owns a business may mortgage such a business.²³ Thus, a mortgage can be understood as a juridical act between a creditor and his debtor or a third-party on behalf of the debtor whereby immovable property or in some cases special movable property, without affecting possession and title, is given as a security to guarantee the creditor if the debtor default to take it over and have it sold, in whosever hand it is found and to get paid from the proceeds by preference to the other creditors.²⁴

The legal theory underlying mortgage differs from jurisdiction to jurisdiction based on the rights of the mortgagor and the mortgagee on the mortgaged property. The main division is among title theory, lien theory, and intermediate theory. Under the title theory, the title of the property has been transferred from the mortgagor to the

²³ Art. 148 of the FDRE Commercial Code, Federal Negarit Gazette Extra Ordinary Issue, Proc. No.1243/2021 (Here in after, Commercial Code). See also, Arts. 2/27 & 3/1 of Movable Property Security Right Proclamation No. 1147/2019.

²⁴ See Art. 3047 of Civil Code (as a subject property is immovable and special movable property); Arts. 3109(1) & 3110(a) of Civil Code (as it is accessory to the principal obligation); Arts. 3084 & 3088 of Civil Code (as it doesn't affect possession & title of mortgagor); Art. 3059 of Civil Code (as it creates rights of preference & pursuit for mortgagee). See also, Gadissa & Mebrathom, *supra* note 22, p. 197

mortgagee upon the formation of the mortgage under the condition that the mortgagor would get his ownership back when the principal obligation is discharged.²⁵ Thus, the mortgagee retains the title of the mortgaged property during the mortgage term while the mortgagor would get his possession back when the principal obligation is discharged. Although this type of mortgage was the original form of mortgage, in many common law system countries, it is either abolished or minimized today.²⁶

On the other hand, under the lien theory, a mortgage creates only a priority right upon the mortgaged property for the creditor, and the title remains vested in the owner of the property during the duration of the mortgage. The lien theory does not affect the ownership and possessory rights of the mortgagor. The mortgagor remains the owner of the property and in principle, he collects rents and fruits of the mortgaged property.²⁷ The mortgagor enjoys all rights of an owner including transferring of the ownership of the mortgaged property for consideration or no consideration.

The third theory is the mixture of the two theories which is called an intermediate theory.²⁸ It has some commonalities with the two theories where the title remains with the mortgagor, but the mortgagee may take back the title of the mortgaged property if the borrower defaults on the loan, i.e., the mortgagee has no right of possession until the mortgagor is in default which makes it similar to the lien theory. Moreover, the mortgagor cannot transfer or mortgage the property for a second time since he/she is no owner of the mortgaged property, making it identical to title theory.

²⁵ Andra, supra note 20, p.15

²⁶ Habtamu, supra note 3, p.16

²⁷ Andra, supra note 20, p.16

²⁸ Habtamu, supra note 3, p.17

Regarding the theory incorporated under Ethiopian mortgage laws, it is stipulated under the Civil Code that the mortgagor retains the right to possess full ownership including the right to transfer the ownership of the mortgaged property and even an agreement to limit this right is void under the law.²⁹ This unequivocally confirms that the mortgagor remains the owner of the mortgaged property after the creation of the mortgage and the mortgage would not affect the ownership rights of the mortgagor. Furthermore, the mortgagor is entitled to collect fruits from a mortgaged property and to become an owner thereof.³⁰ Therefore, it can be concluded that the Ethiopian mortgage laws are based on the lien theory of mortgage.

2.2. Validity Requirements of Mortgage

Validity requirements are essential conditions that provide legally sufficient circumstances for the valid constitution of a juridical act including mortgage, and its non-fulfilment renders the juridical act unenforceable, as it produces no legal effect.³¹ The general contract rules provide that any valid contract must meet basic elements to be enforceable. To this end, parties to the contract must be capable, and give consent sustainable at law. The object of the contract must also be sufficiently defined, possible, lawful, and moral, and must follow the form if the law requires so.³² Therefore, as with any other contract, a mortgage contract must fulfil such requirements in addition to the following special requirements belonging to it.

2.2.1. Existence of Mortgaged Property

The existence of the immovable is a mandatory requirement and a mortgage shall be of no effect where it relates to future immovable.³³ To render a mortgage valid, the act establishing it must state precisely the nature and situation of each of the

²⁹ Arts. 3084 and 3088 of Civil Code

³⁰ Art. 3093 of Civil Code

³¹ Sintayehu, *supra* note 13, p. 191

³² Art. 1678 of Civil Code

³³ Art. 3050(3) of Civil Code

immovable on which the mortgage is granted.³⁴ Such act shall specify in particular the commune in which the immovable is situated, the nature of the immovable, and where appropriate, the number of the immovable in the cadastral survey plan.³⁵ Registration of the mortgage requires these descriptions concerning the immovable mortgaged,³⁶ which in turn also requires existing immovable property.

2.2.2. Existence of Ownership or Special Authority

Generally, a security right can be created only when the mortgagor has the power to create a security right.³⁷ To have a validly established mortgage, ownership title, or a special authority³⁸ to dispose of the immovable by mortgage is necessary. The mortgage shall be valid where it is created by a person who is the owner of the immovable under a title deed issued to him by the competent authorities.³⁹ Besides, a person may not secure his debt by mortgage unless he is entitled to dispose of the immovable for consideration.⁴⁰ In case the mortgagor is a third-party, it is stipulated that a person may secure the debt of another by mortgage where he is entitled to dispose of the immovable gratuitously.⁴¹

In Ethiopia, individuals have no ownership over land and thereby cannot sell or dispose of land as they have only possession rights. This can lead us to ask whether it is possible to mortgage land under the current legal framework in Ethiopia; however, the question is partially answered by the urban land lease proclamation which expressly allows urban land acquired by lease to be mortgaged to the extent of the paid lease price.⁴² However, it is still arguable whether it is possible to

³⁴ Art. 3048(1) of Civil Code

³⁵ Art. 3048(2&3) of Civil Code

³⁶ Arts. 1605&1606 of Civil Code

³⁷ World Bank, *supra* note 2, p. 61

³⁸ Art. 2205 of Civil Code

³⁹ Art. 3051 of Civil Code

⁴⁰ Art. 3049 (2) of Civil Code

⁴¹ Art. 3049 (3) of Civil Code

⁴² Art. 24/1 of Urban Lands Lease Holding Proc. No.721 of 2011, *Negarit Gazeta* Year 18, No.4. It means a person who acquired a lease right over urban land can mortgage the land to the extent of the

mortgage a right over rural land⁴³, and urban land that is not acquired by the lease system such as urban lands occupied under the permit system.

Moreover, the mortgagor must have the right or authority to dispose of the property at the time of the creation of the mortgage and thus the title or the authority to subject property in the mortgage will not produce any effect if it is acquired subsequently.⁴⁴ Acquiring the right to dispose of the property after the formation of the mortgage contract would not make the mortgage contract valid because the law does not allow future rights to be given as securities.

However, sometimes a person may acquire a title deed mistakenly and his rights might be invalidated later on, then the fate of the mortgage created by the invalidated title deed is questionable. Yet, article 3051 of the Civil Code has enunciated that the mortgage contract will remain valid unless the mortgagee is in bad faith. Furthermore, the FSC Cassation Bench decided on this issue affirming that the cancellation of an ownership certificate by government bodies would not invalidate a mortgage contract duly formed unless the bad faith of the mortgagee is proved.⁴⁵

lease price he has paid not for the unpaid lease price he would pay in future. This is to control speculation in the land market as well as to promote a healthy financial market. Furthermore, this is also in harmony with the Art. 3050/3 of Civil Code disallowance of mortgaging a future ownership right.

⁴³ In Ethiopia private ownership of land under the FDRE constitution is prohibited. As stated under Art. 40 of the constitution, the land belongs to the state and the public property. As a result, one can only have the right to use it and not to alienate it. Since the security of land for loans has an ultimate effect of alienation when the debtor fails to repay the loan, it can be argued that he is not allowed to mortgage it. But, currently Amhara Regional State's Rural Land Use and Administration Proc. No. 252/2017 under its art. 19 provides that any rural landholder may mortgage his right to financial institution which has been given recognition by the country's National Bank for not more than 30 years. When the borrower is unable to return his debt within the period indicated in the loan contract, the lender will use (develop by itself or transfer by rent) the land for the period specified in the loan contract not exceeding 30 years. More recently, Oromia Rural Land Use and Administration Proc. No. 248/2023, under its arts. 9 (1) (h) and 17, rural landholders are allowed to mortgage their landholding to access credit from financial institutions.

⁴⁴ Art. 3050(2) of Civil Code

⁴⁵ FSC Cassation Decision Vol. 8, File No. 41388 (The case of Developmental Bank of Ethiopia Vs Mr. Kefyalew Multot).

2.2.3. Written Form

General contracts law provides that where a special form is expressly prescribed by law, such form shall be observed.⁴⁶ Mortgage is one of the juridical acts that require mandatory writing requirement. The contract creating a mortgage shall be of no effect unless it is made in writing.⁴⁷ From the cumulate reading of articles 1723 (1), 1725 (e), and 3045 of the Civil Code a contractual mortgage legally to be formed and to have legal effect has to have written form. The writing formality comprises three elements, i.e., it has to be supported by a special document that has to be signed by all the parties bound by the contract, and it has to be attested by two witnesses.⁴⁸ The effect of noncompliance with written formality is that the contract-creating mortgage shall be of no effect.⁴⁹ The FSC Cassation Bench also confirmed that, even though a contract concerning immovable properties is concluded before a notary public or court registrar (authenticated), it would not produce any effect as long as two witnesses do not attest it.⁵⁰ This decision, therefore, affirms that even authentication cannot exclude written formality, i.e., witness requirements as they are independent requirements for the constitution of contracts concerning immovable properties.

2.2.4. Specification of the Maximum Claim Secured by the Mortgage

The act creating a mortgage to be valid has to specify in Ethiopian currency the amount of the claim secured by a mortgage. Unless this requirement is fulfilled, the mortgage shall not have any legal effect.⁵¹ This is important for the mortgagor to get a second-degree mortgage contract from another mortgagee if the first mortgage does not absorb the total eligible value of the immovable properties.⁵² Furthermore, the

⁴⁶ Art. 1719 (2) of Civil Code.

⁴⁷ Art. 3045(1) of Civil Code

⁴⁸ Art. 1727 of Civil Code.

⁴⁹ Art. 3045 of Civil Code.

⁵⁰ FSC Cassation Decisions Vol. 12, File No. 57356 (The case of Meseret Bekele Vs Elsa Somonela).

⁵¹ Art. 3045(2) of Civil Code

⁵² Habtamu, *supra* note 3, p.80

third-party who acquires the immovable has to know the amount of encumbrance he is going to be duty-bound to pay. The emphasis in secured transactions including mortgage is the amount of the claim to which security is furnished as opposed to the total claim which might be a total of secured and unsecured claims.

2.2.5. Registration of Mortgage

The Civil Code stipulates that a mortgage, however, created, shall not produce any effects except from the day when it is entered in the register of immovable property at the place where the immovable mortgaged is situated.⁵³ The validity of the contract shall be completed only where the act of mortgage is registered in the registers of immovable property. Once the registration is kept public and accessible to the public, no one can argue on the grounds of lack of knowledge about any information contained in the register of any type.⁵⁴ Thus, the registration of mortgages is important to address claims of third-parties and the priority of mortgages among many mortgagees if more than one mortgagee has a claim on the mortgaged property.⁵⁵

The time of registration is very decisive because an entry relating to a mortgage shall be of no effect where it is made after a third-party, who is not liable for the payment of the debt, has acquired the immovable and registered his rights in the registers of immovable property.⁵⁶ An entry relating to an immovable shall also have no effect where it is made after an action for the attachment of the immovable has been brought and entered in the registers of immovable property or after the mortgagor has been declared bankrupt.⁵⁷ Thus, the mortgage contract can be registered anytime

⁵³ Art. 3052 of Civil Code

⁵⁴ Aniel W/Gebriel & Melkamu Belachew, *Ethiopian Legislation on Immovable Registration*, available at: <https://www.abysinialaw.com/study-on-line/395-land-law/7901-ethiopian-legislation-on-immovable-registration>, accessed on January 16, 2023.

⁵⁵ Habtamu, *supra* note 3, p.80

⁵⁶ Art. 3057(1) of Civil Code

⁵⁷ Art. 3057 (2) of Civil Code

with the proviso that at the time of registration, the immovable owned by the mortgagor and is solvent.

The registration is valid for ten years and to extend the validity of a mortgage contract for more than ten years, a new entry shall be made before the expiry of the prescribed ten years.⁵⁸ The new entry will have the effect of extending the mortgage contract for an additional ten years. To keep the original date of registration of the mortgage the renewal shall be made before the expiry of the ten years of the first registration. If the renewal is made after the expiry of the ten years, then the renewal is not possible and it would be considered as a new registration. The FSC Cassation Bench also confirmed that the mortgage is effective for ten years from its registration, and to realize the mortgage right, giving default notice by the mortgagee bank within 10 years is sufficient though the property is not sold within 10 years.⁵⁹

2.2.6. Issues of Authentication of Contract of Mortgage

General contract rules require authentication⁶⁰ for contracts of assignment of rights in ownership or bare ownership or a usufruct, servitude, and mortgage on immovable properties.⁶¹ Therefore, such contracts relating to the immovable property even though reduced into writing are not adequate as long as it is not made before a notary or court registry. The FSC Cassation Bench also held the same position stating that even though the agreement of parties suffices to establish a contract as per Ethiopian law, certain contracts especially those involving immovable properties must follow

⁵⁸ Art. 3058 of Civil Code

⁵⁹ FSC Cassation Decision Vol.10, File No. 44800 (The case of Mr. Abdurazaki Hamid Vs Commercial Bank of Ethiopia).

⁶⁰ Arts. 2/2 cum 2/5 of Authentication and Registration of Documents' Proc. No. 922/2015 defines authentication as signing and affixing a seal by notary witnessing the signing of a new document by the person who has prepared such document or the person it concerns and after ascertaining that this formality is fulfilled; or to sign and affix a seal on an already signed document by ascertaining its authenticity through an affidavit or specimen signature and/or seal.

⁶¹ Art. 1723 of Civil Code.

strict formalities like authentication.⁶² This special attention is particularly given because the lawmaker believes that immovable properties are the most valued assets for individuals as well as for the nation. But by subsequent cassation decision,⁶³ the FSC limited the scope of its precedent with regards to authentication stating that ruling on File No. 21448 regarding the interpretation of art. 1723(1) of the Civil Code does not apply to the situation where parties admit the existence of contracts but challenge their validity for not being authenticated as art. 1723 requires. The Cassation Bench further explained the requirement of authentication under art. 1723(1) of the Civil Code serves the purpose of proof when the litigating parties challenge the existence of the contract. Therefore, if parties admit the existence of the contract, they cannot challenge its validity merely because their undertaking is not authenticated.

At least for two years, File No. 21448 established a very firm precedent regarding the requirement of authentication for contracts concerning immovable properties including mortgages. Later on, File No. 21448 caused the promulgation of Civil Code Amendment Proc. No. 639/2009 which established that banks and micro-financial institutions may conclude a valid contract of mortgage without the need to authenticate it. Accordingly, the Proclamation added the following under Article 1723 of the Ethiopian Civil Code as Sub- article (3);

*Notwithstanding the provisions of sub-article (1) of this article, a contract of mortgage concluded to provide security to a loan extended by a bank or micro-financing institution may not be required to be registered by a court or a notary.*⁶⁴

⁶² FSC Cassation Decision Vol.4, File No. 21448 (The case of Gorfe Workineh Vs Aberash Yitbarek et al).

⁶³ FSC Cassation Decision Vol.13, File No. 36887 (The case of Alganesh Abebe Vs Gebru Eshetu & Workit Eshetu).

⁶⁴ Art. 1723(3) of Civil Code as Amended Proc. No. 639/2009, Federal Negarit Gazeta, No. 46, 30th June, 2009 (herein after, Civil Code as Amended Proc. No. 639/2009).

As a result, when the mortgagee is a bank or financial institution, authentication as a basic requirement of a mortgage has been excluded by an amendment proclamation.⁶⁵ The rationale for excluding authentication is that it is believed to exert a negative impact on the efficiency of loan provision service which is the day-to-day activity of banks and micro-financing institutions.⁶⁶ Moreover, had it not been corrected in such a way, there would have been a huge loss in public wealth of the banks and the micro-financing institutions due to the missing practice of authentication.

There is a problem with the English version of the amendment proclamation like that of Art. 1723 of the Civil Code as they did not use the term authentication or notarization except in its preamble. Yet, File No. 21448 makes it clear that the apparent contradiction, which seems to exist between the English version of Art. 1723 and 2878 of the Civil Code result from the fact that Art. 1723 employed the word registration while it should have stated authentication or notarization like the Amharic version. Thus, the essence of Art. 1723 (3) of the Civil Code refers to authentication, not registration. If we insist on sticking to the term “registration” than “authentication”, Art. 1723 does not only contradict art. 2878 of the Civil Code, but it also contradicts Art. 3052 (on registration of mortgage). If the amendment is to registration, the bank cannot exercise the right to priority or pursuit against the third-party who acquires the rights over the mortgaged property. Thus, the law relieves the banks from the obligation of making the mortgage contract in front of a court or a notary but not registration.

This amendment proclamation also secures the debt given by the bank and micro-financial institution by providing that the validity of the contract of mortgage concluded before the effective date of this proclamation to provide security to a loan

⁶⁵ The implication of this proclamation is that, mortgage contracts concluded by creditors other than banks and micro finance institutions need to be authenticated.

⁶⁶ Preamble of Civil Code as Amended Proc. No. 639/2009.

may not be challenged on grounds of authentication.⁶⁷ Besides its retroactive effect, the proclamation also rejects court decisions rendered before its date of effect.⁶⁸ Consequently, a contract of mortgage concluded to provide security to a loan by a bank or a micro-financing institution, shall not be affected for not being notarized by a court or notary (authenticated) as per Art. 1723 of the Civil Code.

3. Rights of Banks over Mortgaged Property

3.1. General Overview of the Rights of Creditor Banks over Mortgaged Property

In principle, creditors must enforce their security rights by applying to court.⁶⁹ However, a large number of states allow the power of sale foreclosures, which are non-judicial foreclosures that are essentially bank-conducted.⁷⁰ The power of sale refers to a clause in the mortgage contract in which the borrower agrees ahead of time to a private, non-judicial foreclosure.⁷¹ Ethiopia has also issued a Proc. No. 97/1998 which recognizes power of sale foreclosure for banks.⁷² The objectives of power of sale foreclosure law are avoiding the long time it takes to obtain a judgment, from the court of law, for the sale of property mortgaged with banks, avoiding problems in the execution of judgments, and avoiding its adverse effect on public

⁶⁷ Art. 3(1) of Civil Code as Amended Proc. No. 639/2009.

⁶⁸ Art. 3(2) of Civil Code as Amended Proc. No. 639/2009. As a result, it can be criticized for contraventions to basic legal principles. It is against the constitutional principle of separation of power when the proclamation renders ineffective any court decision regarding a contract of mortgage (either pending or finalized) by banks and microfinance institutions for not being authenticated (notarized). The lawmaker in doing so acts ultra-virus because it has passed the boundary of making laws and acted like a judiciary.

⁶⁹ Dominic Griffiths (ed.), Secured Lending Comparative Guide (Mesfin Tafesse & Associates MTA, 05 September 2022) p.19. Available at: <https://www.mondaq.com/finance-and-banking/1140250/secured-lending-comparative-guide>, accessed on January 12, 2023

⁷⁰ Dana David A., Why Mortgage Formalities Matter (*Faculty Working Papers, Loyola Consumer Law Review* Vol. 24:4, 2012) p.107

⁷¹ Ibid.

⁷² But still, banks use court auctions as an asset disposal method for credit extended on clean bases and credit extended on personal guarantees or when the security held is not enough.

money received by banks by way of saving deposits or acquired from other sources.⁷³ Furthermore, the law is expected to create a conducive environment for economic development by enabling banks to collect their debts from debtors efficiently and thereby promote a good business culture.⁷⁴ The Proclamation provides the power of sale foreclosure as follows;

*“an agreement authorizing a creditor bank with which a property has been mortgaged or pledged and whose claim is not paid within the time stipulated in the contract, to sell the said property by auction upon giving a prior notice of at least 30 days to the debtor and to transfer the ownership of the property to the buyer or if no buyer appears at the second auction, to acquire the property at the floor price set for the first auction and have the ownership of the property transferred to it, shall be valid”.*⁷⁵

This is an exception to the general rule which prohibits an agreement authorizing the creditor, in the event of non-payment on the due date, to sell or take pledged or mortgaged property without complying with the formalities required by law.⁷⁶ Thus, the power of banks to sell the mortgaged property emanates from the mortgage contract. Banks can sell the mortgaged property by auction if the debtor fails to discharge his obligation within 30 days after notice.⁷⁷ The sale made by the bank is considered a sale made on behalf of the debtor creating agent-principal rights. In this

⁷³ Preamble of Property Mortgaged or Pledged with Banks Proc. No. 97/1998, Federal Negarit Gazeta, No.16, 19th February, 1998 (herein after, Property Mortgaged or Pledged with Banks, Proc. No. 97/1998).

⁷⁴ Preamble of Property Mortgaged or Pledged with Banks, Proc. No. 97/1998.

⁷⁵ Art. 3, Property Mortgaged or Pledged with Banks Proc. No. 97/1998 and Art. 2(1) of Property Mortgaged or Pledged with Banks (Amendment) Proc. No. 216/2000.

⁷⁶ Arts. 2851 & 3060 Civil Code.

⁷⁷ Art.3 of Property Mortgaged or Pledged with Banks, Proc. No. 97/1998. But currently, Art. 654 of the Commercial code by providing general stay of individual enforcement action including for secured creditors, stay power of banks to foreclose properties during observation period. Yet, this doesn't deprive the bank's right to foreclose rather it is to give opportunity to reorganize or rehabilitate business of debtor to enforce payment. Furthermore, as per Arts. 761(3) & Art. 781(1) of Commercial code, the secured bank is paid in priority though the trustee has the power to sell all asset including incumbered property except pledge during bankruptcy.

regard, the FSC Cassation Bench also decided that selling mortgaged property by bank auction doesn't need a court decision or permission.⁷⁸ If creditor banks while exercising the power of sale foreclosure caused damage to the debtor, by not following procedures, they are liable. Furthermore, the court decided that when banks bring the suit to the court against the debtor despite the existence of the mortgaged property, it cannot be concluded that the bank waived the power of sale foreclosure. Banks can even seek stoppage of the auction by courts and exercise power of sale foreclosure.

Moreover, the FSC Cassation Bench also passed a binding decision stating that the creditor bank while foreclosing the mortgaged property can also bring the suits to court against the debtor for payment of a loan.⁷⁹ The process of foreclosure cannot bar banks from bringing court action for the payment of a loan. In the process of foreclosure, if the property is sold or acquired by the bank, the price of the property will be deducted from the claimed payment during judgment execution. Thus, the court decision clearly shows that banks have the discretion to bring suit to the court and exercise the power of sale foreclosure simultaneously.

One important point about the rights of the mortgagee is that even if at the due date of the secured obligation, the security right (mortgage) becomes ineffective, the creditor is still entitled to proceed against other properties of the debtor as an ordinary creditor, i.e., on equal footing with creditors whose claim is not secured.⁸⁰ In other words, the loss of security right in no way entails the loss of the principal right.

In this regard, the FSC Cassation Bench decided on the period of limitation to claim the remaining debt stating that when a bank takes over the mortgaged property upon default of the debtor by following the foreclosure procedure, and if there is still

⁷⁸ FSC Cassation Decision Vol.12, File No. 65632 (The case of Hibret Bank Vs Mr. Ali Abdu)

⁷⁹ FSC Cassation Decision Vol.10, File No. 44164 (The case of Commercial Bank of Ethiopia Vs Mr. Hassen Ibrahim).

⁸⁰ Art. 3059(3) of the Civil Code.

unsettled debt, the remaining debt shall be claimed within 10 years.⁸¹ The court also clarified that a period of 10 years shall be counted from the time the bank can bring the suit which is from the time of taking over of the property or selling of the property and then knowing the remaining debts. Furthermore, FSC Cassation decided concerning the period of limitation to claim for judgment execution for the remaining debts stating that it shall be within ten years from the time of court decision but it can be interrupted by action taken by the bank exercising the right of power of sale foreclosure or judicial enforcement.⁸²

3.2. The Rights of Creditor Bank When More than One Property Is Mortgaged

In Ethiopia, it is provided that the mortgage shall charge all mortgaged immovable property together with its intrinsic elements and accessories.⁸³ However, the law is not clear, whether the creditor bank can proceed against any properties where more than one property is mortgaged.

In this regard, the FSC Cassation Bench decided that where banks mortgaged two or more properties for the same loan, concerning the order of sale of mortgaged properties, the debtor cannot bring an application and the court cannot decide on the order of properties to be sold.⁸⁴ Thus, when two or more properties are mortgaged, upon default of the debtor, as to which property shall be sold first is determined by the creditor bank, not by the court or the debtor. Besides, the court decided that the court has no mandate to determine the initial price of the property to be sold by power of sale foreclosure. In addition, in the process of foreclosing, if banks fail to follow the required procedures, especially articles 394-449 of the Civil Procedure Code, and

⁸¹ FSC Cassation Decision Vol.12, File No. 56010 (The case of Commercial Bank of Ethiopia Vs Mr. Qadiro Nure).

⁸² FSC Cassation Decision Vol.13, File No. 74898 (The case of Commercial Bank of Ethiopia Vs Mr. Fikadu Tesfaye (et al)).

⁸³ Art. 3064(1) of Civil Code.

⁸⁴ FSC Cassation Decision Vol.13, File No. 70824 (The case of Wegagen Bank Vs Biruk Cheka et al).

thereby the debtor sustains damage due to that irregularity, the bank is liable. The debtor is also not entitled to bring a claim to stop the sale due to irregularities rather the debtor can claim the compensation after completion of foreclosing procedure.⁸⁵ The FSC Cassation Bench also passed binding decision regarding the period of limitation for a claim of compensation by the debtor against the bank for irregularities during an auction or sale made under the power of foreclosure where the irregularities entail loss on the mortgagor and the fact that the bank is liable for the compensation.⁸⁶ The court clarified that the compensation for sustained damage shall be claimed within two years reasoning that the claim arises from the law and thereby considered as extra-contractual claim.⁸⁷

To identify the irregularities that make banks liable, it is important to scrutinize the procedure to be followed by banks during exercising the power of sale foreclosure. The debt recovery law of Ethiopia requires banks to be subject to procedural laws provided under Arts. 394- 449 of the Civil Procedure Code to execute their right of debt recovery.⁸⁸ The bank is liable for any damage it causes to a debtor in the process of selling by auction without following procedural laws.⁸⁹ In realizing the mortgaged property, the main things to be handled by the bank are giving 30 days default notice, advertisement of auction, fixing the value of the asset to be sold by auction, and sale of mortgaged property to the highest bidder.

In this regard, the FSC Cassation Bench elucidated the essence of the power of sale foreclosure stating that if the debtor is not willing, the bank has the right to take over the property with the assistance of the registrar and police, and sale by giving 30

⁸⁵ Ibid.

⁸⁶ FSC Cassation Decision Vol.13, File No. 68708 (The case of Mr. Nasir Abajabir (et al) Vs Commercial Bank of Ethiopia).

⁸⁷ The decision of the court is based on cumulative reading of Art. 7 of Property Mortgaged or Pledged with Banks Proc. No. 97/1998, Arts. 2035 and 2143(1) of Civil Code.

⁸⁸ Art. 6 of Property Mortgaged or Pledged with Banks Proc. No. 97/1998.

⁸⁹ Art. 7 of Property Mortgaged or Pledged with Banks, Proc. No. 97/1998.

days default notice.⁹⁰ The court also decided that whether the debtor is in default is determined by the foreclosure rules of the bank and if it is determined that the debtor is in default, the bank can pass a foreclosure decision and then give 30 days' default notice for the debtor after which the advertisement for auction is made.

As per the power of sale foreclosure laws and the practice, the mortgaged property will be sold to the highest bid, but if there is no bidder in 1st and 2nd auction, the bank will acquire the property at the estimated value. The FSC Cassation Bench clarified that in the process of auction, the price of sale at the second auction is not only to the highest bidders above the estimated value of the property but also to the highest price offered by bidders even if it is below the initial price.⁹¹ FSC Cassation Bench also affirmed that the bank shall take over the mortgaged property at the initial price of 1st auction if there is no buyer at 1st and 2nd auction.⁹² Furthermore, the court decided that the bank could not compete as a bidder reasoning that as per art. 430(1) of Civil Procedure Code judgment creditor cannot bid without permission of the court, and also while selling the property by auction, the bank acts as an agent of the debtor as per art. 5 of Proc. No. 97/98.

However, in Ethiopia, the substantive and procedural law is silent about the criteria to be followed by banks in fixing the price of the asset to be auctioned. Moreover, there is no valuation framework or regulatory institution for valuation and professional valuation firms.⁹³ Furthermore, the law does not give any direction on what should be done if banks are not interested in receiving the property by estimated value. Also, there is no specific time that is provided under the foreclosure law

⁹⁰ FSC Cassation Decision Vol. 7, File No. 16218 (The case of Development Bank of Ethiopia Vs Ms. Askale Hunde (et al)).

⁹¹ FSC Cassation Decision Vol.15, File No. 89088 (The case of Commercial Bank of Ethiopia Vs Mr. Molla Irke).

⁹² FSC Cassation Decision Vol. 7, File No. 19283 (The case of Ms. Medahanit Hailu (et al) Vs Construction and Business Bank).

⁹³ Habtamu Bishaw (et al), Understanding the Bases and Approaches of Mortgage Valuation in Ethiopia (Journal of African Real Estate Research Vol., 5 Issue 1, 2020) P.64

regarding how much time banks can spend without issuing the auction. In this regard, the FSC Cassation has clarified that there is no legal base neither for the debtor nor the heirs to require the sale of the property held as security by the bank to be relieved from their obligation.⁹⁴ The court further decided that the proclamations on foreclosure only give the banks the right to issue two auctions, but do not limit them to only two auctions and that they are not obliged to take the property even after the second auction. So, the choice is left to the banks under the law.

3.3. The Rights of a Creditor Bank When There Are Several Creditors

Secured creditor bank has the priority right or the right of preference which is the right to be paid from the proceeds of the sale of the mortgaged property in priority to other creditors. The priority may be either in reference to unsecured creditors or secured creditors.⁹⁵ Unsecured creditors have rights to be paid after all secured creditors, i.e., all having mortgage contracts with the mortgagor are paid, if, surplus money exists from the sale of the immovable. Recent law of Ethiopia has also clarified the priority rights of secured creditors over preferred creditors. It provides that secured creditors shall have an exclusive/absolute right over the encumbered assets, after deduction of costs and expenses for the realization of such encumbered assets under Ethiopian bankruptcy law.⁹⁶ Specifically over mortgaged property, creditor banks have also priority over preferred creditors including the claims of employees and tax authorities.⁹⁷ But tax authority has priority over creditor bank for claims of withholding tax, value added tax, turnover tax, excise tax, and payment under a garnishee order excluding interest and penalties on these claims.⁹⁸ These

⁹⁴ FSC Cassation Decision File No. 15711 (The case of Ethiopian Commercial Bank Vs Ms. Tesfalem Agegne et al) 1999

⁹⁵ Alefe, *supra* note 17, p.28

⁹⁶ Cumulative reading of Arts. 785(1) & 781(1) of Commercial Code.

⁹⁷ Art.786 of Commercial Code. And also, Federal Tax Administration Proc.No.983/2016 under its art.39(2&7) provides that if the notice of security is registered over the property mortgaged by the banks, the priority of banks in relation to secured claims applies so long as the banks, before lending any amount, confirm that the taxpayer has a tax clearance certificate from the Authority.

⁹⁸ Cumulative reading of Arts. 33(1) & 39 of Federal Tax Administration Proc. No.983/2016; Art. 786(7) of Commercial Code.

priority tax claims represent claims for payment of taxes from a debtor who collected and has been holding the taxes in trust on behalf of the government and does not even form part of the debtor's estate.

The issue of priority may also arise in reference to secured creditors. The mortgagor can have the right to create two or more mortgages in a similar period on a given immovable property of him, hence several creditors may secure their loan on a single property. When one property is mortgaged to several creditors a priority between secured creditors is determined according to the principle of first-in-time doctrine.⁹⁹ Thus, if several creditors secured their claims on the same immovable, their rank is determined according to the date on which the contract of mortgage was registered but the date on which the claim is certain or eligible is not considered in the ranking.¹⁰⁰ That means the person whose claims are registered first gets paid first, and the second one gets paid second, and so on. Nevertheless, where the claims against the mortgaged properties are the legal mortgage of the seller and the contractual mortgage, the legal mortgage ranks before the contractual mortgage.¹⁰¹ Where creditors whose claims have been registered on the same date, it shall rank equally and be paid in proportion to the amount of their claim.¹⁰²

Upholding these rules, the FSC Cassation Bench decided that the same property can be mortgaged by several creditors and the priority among several creditors is made based on the date of registration of the mortgage.¹⁰³

The FSC Cassation Bench also elaborated the scope of the rights of a bank over mortgaged property stating that the bank shall have the right to preference over the

⁹⁹ Habtamu, *supra* note 3, p. 24

¹⁰⁰ Art. 3081 of Civil Code

¹⁰¹ Art. 154(3) of the Commercial Code.

¹⁰² Art. 3081 of the Civil Code

¹⁰³ FSC Cassation Decision Vol. 7, File No. 25863 (The case of Development bank of Ethiopia Vs Commercial Bank of Ethiopia).

mortgaged property.¹⁰⁴ The court further decided that any creditors (secured or unsecured) can claim for payment by attaching and selling any of the properties of the debtor including the mortgaged one. If other creditors of the debtor claim for the attachment and sale of the mortgaged property, the bank shall claim for its payment in priority to other creditors. The court further decided that if the bank failed to claim for priority payment and the property was sold for judgment execution of other creditors, the bank has no right to follow from the buyer who bought the property by auction.¹⁰⁵ In the same manner, in another file, the FSC Cassation Bench decided that it is possible to sell mortgaged property for the execution of the judgment of other creditors and the bank cannot reject the sale rather it has the right to claim for payment in priority to other creditors from proceeds of the sale.¹⁰⁶

In the question of priority, any mortgagee may pay a creditor having priority with the consent of him or where the immovable mortgaged is attached at the request of the creditor without his/her consent and the creditor who has paid shall get the status of subrogation over the creditor to whom the payment has been made.¹⁰⁷ That is to mean if another person who may be a creditor fully pays the debt subject to a mortgagee, the latter shall transfer the rights arising from the mortgage along with its benefits effective from the registration date of the mortgage to that person.

3.3.1. The Priority Rights of a Bank in Terms of Claims

An important issue here is the extent (limit) of priority right. The first claim that the creditor can demand to be paid in priority to other creditors is the principal claim itself.¹⁰⁸ Secondly, the creditor can demand to be paid in priority the contractual interest to be calculated on the principal claim that is stipulated in the contract as far

¹⁰⁴ FSC Cassation Decision Vol.9, File No. 36013 (The case of Ms. Zemzem Nuru Vs Development bank of Ethiopia).

¹⁰⁵ Ibid

¹⁰⁶ FSC Cassation Decision Vol. 7, File No. 26553 (The case of Bahirdar Special Zone Finance Office Vs Construction and Business Bank (et al)).

¹⁰⁷ Art. 3083 of the Civil Code.

¹⁰⁸ Art. 3076 of the Civil Code.

as it is not above the maximum amount stipulated in the contract of mortgage. However, the mortgagee can claim only two years of interest to be paid in priority from the proceedings of the mortgaged immovable. The law has put a mandatory restriction that only two years of interest should be covered by the mortgage contract and parties cannot agree to include more than two years of interest payments within the protected debt amount.¹⁰⁹ As a result, if there is an interest that has been calculated for more than two years, then as regards the payment of such interests the creditor will assume the position of an ordinary creditor i.e. he can't claim to be paid such interest in priority to other creditors.

The third claim of the creditor which is covered by preferential payment is the expenses it incurred for the maintenance of the mortgaged immovable, insurance premiums, and cost of attachments.¹¹⁰ Also, legal interests (which will be calculated over the sum of the principal claim + the agreed interest on the principal claim + necessary expenses for preservation + insurance premium+ cost of attachment) from the date of attachment until sale by auction, are the last claims which the creditor can demand to be paid preferentially.¹¹¹

3.3.2. The Priority Rights of a Bank in Terms of Property

Another aspect of priority rights is the property to which the priority right applies/extends. In the first place, the priority right of the creditor applies to the immovable itself including the intrinsic elements from which the immovable is made and some objects that may be fixed to the immovable as accessories.¹¹² However, the mortgagor may transfer some of the intrinsic elements or accessories to third-parties separately from the immovable itself. Now, the question is, whether the mortgagee creditor can challenge such acts of transfer, by the mortgagor, of intrinsic

¹⁰⁹ Art. 3077 of the Civil Code.

¹¹⁰ Arts. 3078 & 3079 of the Civil Code

¹¹¹ Art. 3080 of the Civil Code

¹¹² Art. 3064 of the Civil Code

elements or accessories to a third-party. The law clearly provides that the creditor cannot follow the intrinsic elements or the accessories in the hands of a third-party.¹¹³ This is because the intrinsic elements and the accessories, when independently considered, are principally movable and anybody who acquires movables in good faith is entitled to legal protection as such.¹¹⁴ Hence, the mortgagee creditor cannot proceed against such third-parties if the mortgagor transfers some of the intrinsic elements or accessories to the third-parties.

On the other hand, the transfer of intrinsic elements or accessories separately from the immovable reduces the value of the immovable and this in turn affects the security right of the mortgagee. Hence, the law provides an alternative remedy for the mortgagee whose security right has been reduced by the transfer of the intrinsic elements and accessories of the mortgaged immovable. These remedies are: the creditor can demand the debtor to provide another property that can replace the intrinsic elements or accessories transferred to third-parties; and if the debtor cannot provide such property, the creditor has a right to demand immediate performance of the part of the principal claim which turns out to be unsecured because of the reduction in the value of the mortgaged immovable which resulted from the transfer of the intrinsic elements or accessories.¹¹⁵

Besides, the law considers the priority right as extending to improvements that may be made to the mortgaged immovable.¹¹⁶ Another property to which the security right extends is the rent which may be collected from the mortgaged immovable. Once the due date of the secured obligation arrives, the debtor failed to pay it, and the immovable is attached to satisfy the claim of the creditor, any rent collected after

¹¹³ Art. 3065 (1) of the Civil Code

¹¹⁴ Art. 1161 of the Civil Code. See also, Gadissa & Mebrathom, *supra* note 22, p.216

¹¹⁵ Arts.3065 (2), 3073, 3074 & 3107 of the Civil Code.

¹¹⁶ Art. 3066 of the Civil Code.

the attachment of the immovable forms a part of the property to which the priority extends and, hence the creditor will have priority right on such rents too.¹¹⁷

The priority of the creditor also extends to any compensation that is paid for the loss or expropriation of mortgaged property.¹¹⁸ In this regard, the FSC Cassation Bench decided that although the insurer shall pay compensation for mortgaged property for the mortgagee creditor bank, the insurer cannot claim payment of unpaid premium from the mortgagee rather it can claim from the insured/mortgagor.¹¹⁹

3.4. The Rights of Creditor Banks in Cases of Third-Party Involvements

3.4.1. When Mortgaged Property is Transferred to Third-Party

As the Ethiopian law of mortgage is based on a lien theory, the mortgage contract will not preclude the mortgagor from transferring the ownership of the immovable to a third-party or from creating a right in rem on the mortgaged property. The law even goes to the extent of prohibiting any agreement that restricts the right of the mortgagor to transfer the ownership of the mortgaged property.¹²⁰ It is also not possible to enter into agreements that restrict the right of the mortgagor to create a usufruct, servitude, or any other right in rem on the mortgaged property.¹²¹ In the same way, third-parties can deliberately acquire a property subject to a mortgage by checking whether the mortgage contract is registered or not in a public registry.

Fortunately, the transfer of the ownership of the mortgage would not relieve the original debtor from his obligation unless the person who acquired the mortgaged immovable undertakes to pay the debt and the creditor does not object to the release of the original debtor within one year since he has been informed about the agreement between the original debtor and the third person to release the original

¹¹⁷ Art. 3068 of the Civil Code.

¹¹⁸ Art. 3069 of the Civil Code.

¹¹⁹ FSC Cassation Decision Vol.20, File No. 115763 (The case of National Insurance Company Vs Commercial Bank of Ethiopia).

¹²⁰ Art. 3084 (2) of Civil Code.

¹²¹ Art. 3088 of Civil Code.

debtor from his obligation.¹²² Thus, no arrangement between both parties (transferor and transferee) can discharge the liability of the mortgagor to the mortgagee without the consent of the latter.

Moreover, the law has given the mortgagee a right to attach the mortgaged property in the hands of a third-party acquirer whose rights have been registered after the registration of the mortgage.¹²³ Registered rights of rem on an immovable mortgaged property shall not affect the mortgage where such have been registered after the mortgagee registered his mortgage and the mortgagee may cause the immovable to be sold as though such rights had not been created. Thus, the creditor has the right to follow the property and satisfy his claim in whosever hand the property may be found. This is because the mortgage is a real right in the sense that the security right of the creditor is against the mortgaged immovable and shall be enforced by disregarding all the rights of third-parties which have been created and registered after the registration of the mortgage.¹²⁴ Moreover, the mortgagor or transferee cannot demand that the mortgage claim should be proportionally reduced to the property she/he owned because the mortgage entails indivisible obligation.¹²⁵

Besides, where the thing mortgaged is transferred for whatever reason to a third-party, and the third-party acquirer destroys or reduces the value of the mortgage, the mortgagee may demand new security or discharge of the debt mortgaged to the extent of distraction or reduction.¹²⁶ This right is commonly labelled as the right of acceleration. Where the mortgagor or third-party acquirer intentionally or by negligence reduces or endangers the value of the immovable mortgaged, the mortgagee may demand new securities.¹²⁷ When the mortgagor fails to vanish such

¹²² Art. 3086 of Civil Code.

¹²³ Art. 3085 of Civil Code.

¹²⁴ This shows that it is the duty of third-party, before entering into contract of sale, to check what rights have been already created and registered on the immovable subject to the pain of being ousted from the immovable.

¹²⁵ Art. 3087 of Civil Code.

¹²⁶ Art. 3107 (2) of Civil Code.

¹²⁷ Arts. 3073 & 3074 of Civil Code.

securities within the period reasonably fixed to him by the mortgagee, the mortgagee may demand that an adequate part of the debt be discharged.¹²⁸ However, the mortgagee may not demand new securities nor that part of the debt be discharged where the actual or possible reduction in the value of the immovable mortgaged is due to unforeseen causes (not by negligence or intentional act).¹²⁹

On the other hand, the law considers the acquirer of mortgaged immovable as a guarantor who can raise all possible defenses including the defense of benefit of discussion, and defend himself against the action brought by the creditor who claims to have security right on the immovable.¹³⁰ Thus, if the mortgagee is to face all defenses available for the guarantor from the acquirer of the mortgaged property, one may question the purpose of having real securities like a mortgage which creates rights in rem. These protections of the third-party acquirer cause a very serious challenge as it changes the real right of the mortgagee to the personal right as the mortgagee is going to face all the defenses that may be raised against a creditor who proceeds against his guarantor.

Practically, to overcome these challenges, banks take over the title deed of mortgaged property during the mortgage so that the mortgagor cannot transfer the mortgaged property before settlement of the loans.¹³¹ In this regard, there is no legal provision that requires to hand over the title deed to the mortgagee during the mortgage and neither any prohibition to hand over the title deed.

Previous research focusing on Ethiopian Banks also reached the conclusion that practically where a creditor enters into a mortgage contract, and an application is made to be registered, a municipality would give assurance through a written letter

¹²⁸ Art. 3073 (2) of Civil Code.

¹²⁹ Arts. 3075 & 3092 (1) of the Civil Code of Ethiopia

¹³⁰ Arts. 3090 cum 1920-1952 of Civil Code.

¹³¹ My personal observation and Interview with Mr. Worku Dirissa, Litigation and Foreclosure Team Manager at CBO, in March 2023) revealed that the practice of CBO shows that the bank takes over the title deed of mortgaged property during the mortgage until settlement of the loan.

that the mortgaged property shall not be sold or transferred from the date of registration except being confirmed by the creditor upon the completion of the payment of the debt.¹³²

My observation also confirmed that banks, upon entering into a mortgage contract to secure loans, send a letter to the urban land development and management office requesting the office to assure that the property to be mortgaged is free from any encumbrance, and then register the mortgage and injunct the property from any transfer until letter showing payment of the debt is written by the bank. Then, the office writes a confirmation letter stating that the mortgaged property is prohibited from any transfer or encumbrance until the bank confirms the debt is fully paid. In this regard, the law clearly, under arts. 3084 and 3088 of the Civil Code, even go to the extent of prohibiting any agreement that restricts the right of the mortgagor to transfer the ownership or create rights in rem over the mortgaged property.

In general, practically, banks have systematically overcome the challenges they will face from third-party acquirers of mortgaged property by precluding the mortgagor from any transfer or encumbrances and thereby preventing possible disputes.

3.4.2. When Third-Party is Mortgagor

The issue here is the rights of the creditor bank when the third-party is a mortgagor, i.e., where the immovable is given as security by a third-party on behalf of the debtor. The law refers to such third-party as a guarantor under arts. 3106 cum 3090, and arts. 3105 – 3108 of Civil Code. This third-party is not liable for the payment of primary debt. It is because of his good faith or because of his good relation with the debtor or the creditor that he is securing the debt of another person.

Hence, the law provides that the maximum liability of the third-party mortgagor is limited to the immovable that he has given as security, and thus other properties of

¹³² Mekuria, supra note 4, p.326

the third-party mortgagor are not liable.¹³³ In other words, if the value of the immovable that the guarantor has given as security cannot settle the whole claim, the creditor cannot proceed against the third-party mortgagor rather s/he can proceed against the debtor for the unsettled part of the claim.

Moreover, the third-party mortgager can avail himself of all the defenses that are available for any third-party who acquires the immovable mortgaged from the debtor including defenses of the benefit of discussion.¹³⁴ But she/he cannot resist producing new security when by his (or third-party that acquired immovable from him) intention or negligence reduce or endanger the value of the mortgaged property.¹³⁵ Hence, the mortgagee had to argue with the third-party mortgagor and could not directly enforce the mortgage right because of the remedies the law provides for the third party mortgagor.

However, practically in this regard, the FSC Cassation Bench decided that when out of two mortgaged properties; one property belongs to the debtor and the remaining one property belongs to a third-party, the order of property to be sold first by foreclosure shall be determined by the bank, not by the mortgagor or the court.¹³⁶ Moreover, the cassation court decided that the third-party mortgagor has no right to claim for the sale of property of the debtor before the sale of his/her property as in the mortgage contract the mortgagor agreed that once the debtor is at default the mortgagee can sale the property by auction upon giving 30 days default notice. Furthermore, the court stated that the defense of benefit of discussion is against ordinary mortgagees (not applicable for banks and microfinance) as it is against the

¹³³ Art. 3105 of Civil Code.

¹³⁴ Art. 3106 of Civil Code.

¹³⁵ Arts. 3107 & 3108 of Civil Code.

¹³⁶ FSC Cassation Decision Vol.13, File No.70824, supra note 84.

aim of power of sale foreclosure laws which are intended to help banks for easy and speedy re-collection of public money disbursed for development purpose.

Thus, it can be concluded that third-party mortgagors can raise all possible defenses available for guarantors against all mortgagees except banks and microfinance. In other words, banks and micro finances can sell mortgaged property be it belonging to the debtor or third-party in the same manner by following the rules of foreclosures.

4. Conclusion and Recommendation

Although Ethiopian law doesn't define the term mortgage, it can be understood as a juridical act between a creditor and debtor or a third-party on behalf of the debtor whereby immovable property or in some cases special movable property, without affecting possession and title, is given as a security to guarantee the creditor, if the debtor default, to take it over and have it sold, in whosever hand it is found and to get paid from the proceeds by preference to the other creditors.

Furthermore, mortgage as a juridical act has its peculiar validity requirements such as the requirement of written form, the existence of the mortgaged property, the need for ownership or special agency by the mortgagor, specification of the maximum secured claim, registration, and issues related authentication (which is exempted for banks and micro-financial institutions). Once the mortgage is validly established, parties assume their respective rights and obligations. This paper mainly addressed one of the principal effects of mortgage which is the right it creates for the mortgagee bank from the following perspectives: -

Firstly, though the law is not clear with the mandate of banks, the FSC Cassation practice shows that when two or more properties are mortgaged, upon default of the debtor, determining as to which property shall be sold first is the right of the creditor bank, not of the court or the debtor. However, in the process of foreclosing, if the bank fails to follow the required procedures, especially Arts. 394-449 of the Civil Procedure Code and thereby the mortgagor sustains damage, the bank is liable. Yet,

the mortgagor is not entitled to bring a claim to stop the sale due to irregularities rather s/he can claim compensation after completion of the foreclosing procedure.

Secondly, where there are several creditors, the secured bank that registered the mortgage first has the right of preference in payment including over preferred creditors. The claims that the creditor can demand to be paid in priority to other creditors are the principal claim, agreed interest on the principal claim, necessary expenses for preservation, insurance premium, cost of attachment, and legal interests. These bank's priority claims are extended to the mortgaged property with its intrinsic and accessories, the improvements to the mortgaged property, the rent, and compensation paid for the loss of mortgaged property. However, it is possible to sell mortgaged property for the execution of the judgment of any other creditors, and thus, the mortgagee bank cannot reject the sale rather it has the right to claim for payment in priority to other creditors from proceeds of the sale. Moreover, if the bank fails to claim for priority payment and the property is sold for judgment execution of other creditors, the bank has no right to follow from the buyer.

Thirdly, when mortgaged property is transferred to 3rd party, the creditor has the right to follow the property in the hands of third-parties whose right is registered after the registration of the mortgage. On the other hand, the transferee is assimilated to the guarantor and thereby can invoke any defenses available for a guarantor including the defense of benefit of discussion against the secured creditor. Practically, to overcome these challenges, banks take over the title deed of the mortgaged property and secure its injunction from any transfer during the term of the mortgage. In this regard, legal provisions neither require nor prohibit handing over the title deed to the mortgagee though the law prohibits the restriction on full ownership of the mortgagor.

Fourthly, when the mortgaged property belongs to 3rd party, the mortgagor can raise all possible defenses available for the guarantor including the defenses of benefits of

discussion against mortgagees. But practically, banks and microfinance are impliedly exempted from such defenses under the guise of power of sale foreclosure. As a result, banks and micro finances are selling mortgaged property whether it belongs to the debtor or third-party in the same manner by following the rules of foreclosures.

Based on these findings, this article suggested addressing the identified gaps and harmonizing the mortgage system specifically the rights of banks over the mortgaged property. Particularly, it recommends that the foreclosure law should empower banks to sell the mortgaged property when it is transferred to third-party or the mortgagor though the property is at the hand of the debtor and belongs to the debtor. As amended, Art. 1723 (3) of the Civil Code, which intends to exempt banks and micro-financial institutions from requirements of authentication for the formation of mortgages, should also employ words like authentication or notarization rather than registration. As it seems, it relieves the banks from the obligation of registering the mortgage contract in the appropriate office.