

# An Overview of the UAE Insolvency Regime and its Effectiveness

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June – July 2016

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In these challenging economic times, some businesses are struggling to cope with financial pressures and financiers are concerned with their customers' ability to service their financing arrangements. An effective insolvency regime is, therefore, an important element of financial system stability. The statutory insolvency regime in the United Arab Emirates ("UAE") has often been regarded as under-developed and remains largely untested. This article seeks to examine the application and the effectiveness of the insolvency regime in the UAE and consider the consequences of, and primary issues surrounding, insolvency from the perspective of commercial debtors and creditors.

The key provisions of insolvency laws in the UAE are comprised within Federal Law No. 18 of 1993 ("Commercial Code"), which governs bankruptcy proceedings, and Federal Law No. 2 of 2015 ("Companies Law"), which governs liquidation proceedings. Liquidation is the process by which a company's existence is ended, which can be (but is not always) insolvency related. We will focus in this article on bankruptcy in the UAE.

## **Bankruptcy**

Under the Commercial Code, a trader may be declared bankrupt if it ceases or suspends payment of its commercial debts at their maturity dates due to financial instability or lack of available credit. Subject to certain exceptions, an individual or a company which undertakes a commercial activity is deemed as a 'trader' under the Commercial Code. These insolvency provisions are, however, applicable to companies incorporated in the free zone, unless such free zones are exempted from compliance thereto. The Dubai International Financial Centre, for example, has its own distinct legal and regulatory framework in this respect.

A petition for bankruptcy can be initiated by a trader, a public prosecutor, a court, or a creditor. From the lender's perspective, a trader will have committed a criminal offence of bankruptcy by default if it has suspended payment for more than 30 days and failed to file a petition for bankruptcy within the 30 days period. In practice, however, we have not seen this offence pursued by the relevant authorities. If the level of prosecution for such offences change, it is possible that the bankruptcy regime would more frequently be triggered by trader's seeking to protect themselves.

Where a petition for a declaration of bankruptcy against a trader has been filed, the court will issue a judgment for a declaration of bankruptcy and is empowered to fix a provisional date for suspension of payment, order that the debtor's place of business be sealed, and appoint a trustee in bankruptcy. The Commercial Code stipulates that the date of suspension of payment may not be brought back to a period of more than two years from the date for adjudication of bankruptcy. This has implications in respect of the antecedent transactions regime, as mentioned below.

Bankruptcy proceedings may be terminated only if: (i) all creditors are repaid; (ii) by way of judicial composition; or (iii) by the company waiving all its assets in favour of its creditors.

Upon the declaration of bankruptcy, a moratorium comes into effect such that no proceedings may be

brought by a creditor against the debtor. However, this will not affect the rights of secured creditors to enforce their security. This is one of the factors to which we believe the lack of bankruptcy in the UAE may be attributed.

### **Voidable transactions**

A creditor is entitled to challenge any of the following pre-bankruptcy transactions entered into by the debtor for a period decided by the court, subject to a maximum of two years prior to the adjudication of bankruptcy:

- All donations excluding customary small gifts.
- Payment of a term debt before its maturity, regardless of the manner of such settlement.
- Payment of immediate debts other than in the manner agreed upon for payment.
- Provision of security for pre-existing debts.
- Transactions that are detrimental to creditors, where the payee is deemed aware that the trader has ceased to pay its debts.

The remedy for a successful challenge would be to restore the parties to their original positions.

### **Liability of Directors**

Under the UAE regime, in addition to the general duties owed by a director to the company, a director may be subject to both civil and criminal liability in the event that the company is declared bankrupt.

If the assets of the company are insufficient to satisfy at least 20% of its debts, the court may order the members of the board of directors, or all of the directors, jointly or severally, to pay the debts of the company, in whole or in part, but only where the court finds that (a) the directors are found liable for a breach under the Companies Law and (b) such breach caused the shortfall in payment.

Members of the company's board of directors, its managers, or the liquidators are criminally liable if it is established that they have committed any of the prescribed offences under Article 879 and 882 of the Commercial Code, which relates to acts of directors concealing the company's property and financial position. Further, the Penal Code also contains provisions that penalise managers involved in fraudulent activities relating to a bankruptcy.

Therefore, debtors should be mindful of the consequences of antecedent transactions and potential directors' liability arising from preferential treatment of lenders in a bankruptcy situation.

Where the losses of a limited liability company exceeds 50% of its share capital, the directors are required to notify the shareholders; where losses exceed 75% of the company's share capital, shareholders holding greater than 25% of the company can require its dissolution.

Notwithstanding the personal liability noted above, it is true that bankruptcy is seldom initiated in the UAE (unlike other jurisdictions where debtors or directors initiate insolvency proceedings to protect themselves and limit their liability).

### **Composition**

An adjudication of bankruptcy can be avoided by a debtor by entering into a composition with its creditors. Such compositions are available in the form of (i) a protective composition and (ii) a judicial composition.

#### **Protective composition**

A protective composition allows a debtor (except for joint stock companies and companies already in a

state of liquidation) to apply for a protective arrangement, to avoid bankruptcy, within 20 days following a suspension in payment of its debts. The debtor must be able to demonstrate that it has practiced its business continuously during the year that precedes the submission of the application and during this period has complied with all applicable provisions of law.

As part of the composition proceedings, the debtor must submit a proposal to repay its debts such that it shall repay not less than 50% of the debt within 3 years from the date on which the arrangement has been ratified.

If the court agrees to hear the application, it will appoint a judge and trustee for the arrangement. Creditors will be invited to meet with the trustee and all execution procedures against the debtor will be suspended.

The arrangement, once finalised, will be binding on all unsecured creditors if the creditors comprising the majority of those who vote at the meeting (and two thirds of the debt represented by the creditors voting at the meeting) approve the proposal. If no agreement is reached at the meeting, the deliberations may be extended. Following the vote, any interested person may comment on the arrangement and the judge will either cancel or ratify the arrangement within 3 days from the lapse of such period whereby any interested person is entitled to comment on the arrangement. The arrangement, if ratified, will bind all ordinary creditors whether or not they voted for it. If the debtor fails to carry out the terms of the arrangement, the debtor may proceed with an application for liquidation.

Due to the strict requirements for protective compositions, protective compositions are not used at all.

### **Judicial composition**

Following a declaration of bankruptcy, a judge may initiate a judicial composition whereby creditors, the debtor, and the trustee in bankruptcy are invited to a composition meeting. Similarly, a composition scheme can be proposed and approved by a majority of the creditors (those holding two thirds or more of the total debts). A judicial composition may grant the debtor extended periods for settlement of debts and may include a waiver of certain debts through the composition which the debtor is to pay as a natural debt.

Upon the court's approval of a composition arrangement, the debtor retains the full right and authority to manage its own business. Accordingly, the duty of the trustee in bankruptcy shall expire and the debtor shall take over from him all his properties, books, and papers related to the bankruptcy.

In the event of a nullity (e.g. where the debtor has committed fraudulent bankruptcy after the approval of the composition) or termination of the composition (e.g. if the debtor fails to execute the conditions of the composition), an appeal for termination may be made to the court by creditors. The court will appoint a judge and trustee in bankruptcy and will order the sealing of the debtor's property. The trustee in bankruptcy will call upon the new creditors to submit documents of their debts in order to be realised in accordance with the procedures for realisation of debts.

Similarly to protective composition, judicial compositions have not been tested in the UAE.

### **Liquidation following bankruptcy**

Where an agreement is not concluded between the debtor and its creditors, or the debtor is further unable to settle its debts notwithstanding the bankruptcy proceedings, bankruptcy can lead to liquidation of the trader/company.

Upon the commencement of liquidation proceedings, liquidators are appointed, the powers of the board of directors cease, and the liquidator acquires the powers to preserve the company's assets and raise and defend legal claims. Following realisation of assets, satisfaction of debts, and distribution of any remaining

funds to the shareholders of the company, a company is dissolved upon the registration of the completed liquidation with the commercial register.

## **Practical analysis**

Historically, creditors' rights in recovery of debts have been the focus of the insolvency regime in the UAE whilst debtor friendly restructuring options under the legislative framework are not a viable option due, in our view, to the stringent statutory requirements. Instead, informal consensual restructurings prevail.

It can be noted from our discussion above that the current bankruptcy and composition proceedings are processes driven by courts which may be perceived as uncertain, lengthy, and cumbersome. In the absence of less formal out of court procedures, debtors are discouraged from restructuring their liabilities and seeking protection before their financial situation worsens. In our experience, consensual solutions more often come about due to creditor pressure than proactive debtors. From the perspective of creditors, there are no favourable incentives to enter into a composition arrangement given that such a court led process does not accord them with sufficient influence over the terms and timetable of the composition. Thus, parties have conventionally resorted to private commercial negotiations out of court or, for secured creditors, enforcement of their security through the tried and tested processes in place.

While the existing legislation provides the mechanics for protective composition, in reality this is of little use to debtors given the strict requirements for a statutory composition.

## **Law reform**

In view of the deficiencies of the existing insolvency regime, a proposed Federal Law on Financial Restructuring and Bankruptcy ("Proposed Bankruptcy Law") has been in circulation for some time, which aims to modernise the insolvency regime to better suit the needs of the current business environment.

It is anticipated that the Proposed Bankruptcy Law would, amongst others: (i) introduce a more definite basis for the commencement of a bankruptcy proceeding in the form of both a cashflow (i.e. the debtor has stopped meeting or servicing debts) and balance sheet (i.e. the debtor's assets do not cover liabilities) test of insolvency; (ii) streamline rescue procedures designed to reform the current preventative composition procedures, including financial reorganisation procedures available for debtors who are in financial difficulties but who are not yet insolvent, to enter into a 'consent agreement' with its creditors; and (iii) provide further guidance on the application and effects of the claw-back provisions and the positions of secured creditors versus unsecured creditors upon liquidation.

The Proposed Bankruptcy Law has been making its way through the formal legislative process since 2009. It remains to be seen when it will come into force and in what shape. Therefore, for now, the current regime remains relevant.