New UAE Bankruptcy Law: Analysis and highlights

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The New UAE Bankruptcy Law was published on 29 September 2016 and will enter into force on 29 December 2016 (the "New Law"). The objective of the New Law is to modernise and streamline the bankruptcy procedures available onshore for UAE companies in line with international best practice, and to destigmatise business failure whilst maintaining a backdrop of accountability for directors of failed enterprises.

This briefing highlights some of the key features of the New Law, including an overview of the revamped insolvency processes from a procedural standpoint, and discusses certain features that did not make the final version for further consideration amongst market participants.

Sources and influences

Consistent with other forms of UAE legislation, the bankruptcy laws have historically been influenced by French, civil law traditions. The New Law has not sought to abandon those principles but incorporates modern French law mechanics, together with best practice concepts found in German, English and US insolvency legislation.

Analysis: New Law

- The expansion and modernisation of the Protective Composition Procedure ("**PCP**") and rescue within bankruptcy is an extremely welcome development. However, as secured creditors are not bound by the processes (and security may continue to be enforced with the permission of the Court while the PCP processes are ongoing), it seems unlikely that these are rescue procedures which could be utilised by a large corporate with secured creditors. The ability to bind secured creditors and an automatic moratorium on enforcement of security, are two attractive features of other insolvency regimes including other regional insolvency legislation such as Decree 57 for 2009 (*Establishing a Tribunal to decide the Disputes Related to the Settlement of the Financial Position of Dubai World and its Subsidiaries*) and the Abu Dhabi Global Market's Insolvency Regulations wh ich do not apear in the New Law.
- The inclusion of a supervisory committee of creditors to oversee and monitor the implementation of a PCP plan will be welcomed by lending institutions. However, given that duties are owed to the general body of creditors (and the Court) it remains to be seen, in practice, if larger institutional creditors (who may have the most experience to bring to such a role) are willing to commit to a process which may carry risk and could last up to three years without any compensation.
- The New Law does not have any private, out-of-court pre-insolvency procedure (similar to the French *conciliation* process) applicable to entities that have not yet formally entered the zone of insolvency, and which has the aim of achieving a consensual, private settlement between the parties. Experience from the French law equivalent *conciliation* dictates that the involvement of an official mediator can help break deadlock situations and avoid more formal court proceedings. Perhaps an element for further consideration is whether the opportunity could be taken in the future to include a similar process within the legislation.
- The expansion of the insolvency test to include a balance sheet element is a positive step. It is hoped that further procedural guidance may be issued which assists companies with objectively quantifying if they are indeed in a state of cessation of payments or are balance sheet insolvent pursuant to the stipulations of the New Law.
- It is not clear how contractual subordination provisions (such as those contained within intercreditor agreements) would be treated by an officeholder within the processes prescribed by the New Law. Given that the overall aim of the New Law is modernisation, it is hoped that they would be recognised, particularly where experts are engaged (and who may also take the benefit of legal advice on the point).
- Although there is a provision for statutory insolvency set-off, the New Law lacks close-out netting provisions, which could result in further complications for counterparties undergoing an insolvency process under the New Law.
- The New Law does not include provisions regarding jurisdictional and judicial recognition and cooperation, to apply in circumstances where a company incorporated in the UAE (or a trader based in the UAE) operates across borders (both international and within the UAE) and may therefore be subject to insolvency proceedings in more than one jurisdiction, or may have assets located outside of the UAE that creditors wish to seek to recover. Enforcement of judgments under the New Law in other non-UAE jurisdictions are likely to face the same procedural hurdles encountered currently with all UAE court decisions. Again, it is hoped that further procedural guidance or regulation will be made available in due course to clarify this point. Adoption by the UAE of the UNCITRAL Model Law on Cross-Border Insolvency may be a natural next step that the legislators could consider.
- Some practical considerations applicable in the UAE may mean that certain timeframes included within the New Law could be challenging for creditors to comply with, such as:
  - proving of debts in a UAE court process has typically required production of original documentation and translations, given that many loan agreements are entered into in English. Lenders may now wish to have loan agreements translated into Arabic at the start of a transaction as standard procedure; and
  - security enforcement in the UAE can be a lengthy process. Secured creditors who may not be fully collateralised will need to ensure that any unsecured element of their claim is claimed for within any process within the requisite timeframes and early engagement with the officeholder will therefore be key.

Industry oversight

Clearly, with the aim of ensuring a commercial, modern and industry-focused approach to restructuring, the New Law establishes a Financial Restructuring Committee ("**FRC**"), with the role of monitoring the implementation of the New Law and reporting back to the Minister of Finance. The FRC will also be responsible for the selection of a roll of industry experts (insolvency professionals potentially from private practice) to assist the Courts with the new insolvency and restructuring procedures, and the setting up of public registers relevant to the New Law, capturing details of insolvent companies and disqualified directors.

Application and scope

The New Law will apply to companies incorporated pursuant to the Commercial Companies Law, corporate entities and individuals trading for profit (such as lawyers and accountants), with certain key exceptions such as governmental bodies, and companies incorporated within free zones which have their own comprehensive insolvency laws that provide for composition, restructuring or bankruptcy procedures, such as the DIFC and the ADGM. Entities wholly or partially owned by the local or Federal government and which are not incorporated pursuant to the Commercial Companies Law may wish to opt in to the New Law pursuant to their constitutional documents to get the benefit of the New Law.

A number of commercial enterprises in the UAE are established as decree companies, whose levels of government holdings will vary from direct to indirect/ultimate beneficial ownership stakes. UAE legislation does not generally provide an unambiguous definition of "government entity" and it is therefore unclear whether decree-formed commercial companies which are indirectly held through government-owned investment companies may also be exempted from the New Law without a specific opt-in.

Further legislation is expected in the near to medium term in respect of insolvent financial institutions and potentially in relation to other regulated enterprises such as insurance companies. In the meantime, the New Law prescribed that the FRC has the authority to oversee financial restructuring procedures concerning regulated financial institutions and some bespoke insolvency provisions capturing insurance companies and commercial banks contained in existing federal legislation remain in place, although interaction with the New Law is unclear at this stage

Amended insolvency procedures

Determination of "insolvency"

Crucially, the criteria for determining when a company is insolvent have been clarified – the cash flow test for insolvency has been refined and, in addition, a balance sheet insolvency test has been introduced, which is based on the German "overindebtedness" test, whereby the assets of a debtor do not cover its current liabilities. This is to encourage debtors in distress to seek to restructure at an early stage.

Insolvency processes

The New Law offers two court procedures: (i) a court-based debtor-led composition process (again, which is to be used by a company which is in financial difficulties but is not yet technically insolvent); and (ii) formal bankruptcy, which itself comprises a rescue procedure within bankruptcy or liquidation.

Protective Composition Procedure ("PCP")

This procedure follows the French *sauvegarde* model, whereby a debtor which is (i) experiencing financial difficulties but is not yet insolvent or (ii) has been in a state of overindebtedness or cessation of payments for less than 30 consecutive business days, proposes a compromise with its creditors.

PCP cannot be applied for if the debtor has already been subject to a PCP procedure within the past year, or the debtor has already entered bankruptcy proceedings. An application for PCP can only be made by the debtor or ordered by the Court – an application may not be made by creditors. A shareholders' resolution approving the application for PCP must also be submitted to the Court.

Once the debtor has applied for PCP and submitted the necessary documentation, the next step is for a Court-appointed expert to prepare a report on the financial condition of the debtor, determining whether the conditions are met for PCP to commence, and whether the debtor has sufficient funds to cover the costs of the PCP process. If the Court accepts the application, a moratorium on creditor action will immediately apply. The Court will place the debtor under the control of one or more officeholders appointed from the FRC's roll of experts, for an initial observation period of up to three months (which may be extended with permission of the FRC). The moratorium will not prevent the enforcement of secured claims which may still occur with permission of the Court. The entry into the PCP process is then made public, and creditors are invited to submit proofs of claim for the purposes of voting on the compromise by a claims bar date.

During the PCP, the debtor continues to manage its business, albeit under the supervision of the officeholder. The officeholder has wide powers in relation to the preservation of assets and the continuation (or otherwise) of the debtor's business, which can be invoked if required.

The debtor is given time to devise a restructuring plan under the supervision of the officeholder. The New Law prescribes certain features of the restructuring plan, including that the duration of the plan cannot exceed three years (unless the requisite majority of creditors agree to an extension). Once the plan has been reviewed by the Court and permission has been granted to convene creditors' meetings, the plan is then voted on by creditors. In order for the plan to be approved, a majority representing at least two-thirds in value of each class must vote in favour. If the requisite majorities and the Court approve the plan, the dissenting minority of creditors (whether they voted or not) will be bound by the PCP plan. It is not possible for one voting class to "cram down" another.

Other key tools of PCP seek to build upon useful features of US bankruptcy law:

- the ability to raise debtor-in-possession (DIP)-style priority funding in order to allow the business to continue during the PCP process, which may be secured on unsecured assets or be granted in respect of secured assets either on a priority or a subordinated basis (albeit with safeguards included for existing secured creditors);
- *ipso facto* provisions which prevent counterparties from using insolvency-linked contractual termination provisions, provided the debtor performs its executory obligations; and
- appointment of a supervisory creditor committee nominated by the creditors and, where there are several nominations, the final choice of who takes the role is subject to the choice of the Court, which must take into account the level of debt each potential committee member holds or represents (and where there are both unsecured and secured creditors, at least one member must be appointed from either group). A regulator may also take up a position on the committee. The role of the committee appears to be to

monitor the implementation of the PCP and to report progress to the Court, for the benefit of the general body of creditors. No fees may be charged by the committee for its role.

Bankruptcy

The bankruptcy process is split into two elements: (i) a rescue process within formal bankruptcy proceedings ("**rescue within bankruptcy**"), which is procedurally similar to the PCP (including an automatic moratorium and ability to raise DIP funding); and (ii) a formal liquidation procedure.

When must a bankruptcy filing be made and who can file?

- A company is obliged to make a bankruptcy filing if it has been (i) in a state of "cessation of payments" of due and payable debts or (ii) a state of "over-indebtedness", in either case for 30 consecutive business days. A shareholders' resolution approving the filing must also be submitted to the Court with the application.
- A creditor may petition for a company's bankruptcy if a statutory demand in the minimum amount of AED 100,000 has been served, and has remained unpaid for 30 consecutive business days.
- The Court or a regulator may also initiate bankruptcy proceedings in certain prescribed circumstances.
- The Court has discretion to postpone the bankruptcy proceedings for up to a year, if it is in the interests of the national economy to do so and there is evidence that the debtor can continue to trade in the meantime.

Once bankruptcy has been applied for and the necessary documentation submitted, the next step is for a Court-appointed expert to prepare a report on the financial condition of the debtor, determining whether the conditions are met for bankruptcy proceedings to commence, and whether the debtor has sufficient funds to cover the costs of the process.

If the Court accepts the application, a moratorium on creditor action (excluding enforcement of secured claims which may occur with permission of the Court) will immediately apply and the Court will place the debtor under the control of one or more officeholders appointed from the FRC's roll of experts and, if considered necessary, one or more supervisory judges. The entry into the bankruptcy process is then made public, and creditors are invited to submit proofs of claim by a claims bar date for the purposes of voting on the restructuring.

Following the commencement of bankruptcy, the officeholder takes over the management of the debtor's business and is bestowed with wide powers in relation to the preservation of assets and the continuation (or otherwise) of the business. Creditors' committees may also be formed from different creditor classes (e.g. unsecured or secured) for the purposes of the review of any restructuring plan and for the facilitation of communication with the wider creditor group.

The officeholder prepares a report on the debtor's business for the Court, in consultation with the debtor. The report must state whether:

- in the opinion of the officeholder there is a reasonable prospect of restructuring the debtor's business (and, if so, confirmation from the debtor that it is willing to continue its business);
- a restructuring plan should be prepared for submission to the creditors; and
- there is likelihood of sale of the whole or part of the debtor's business as a going concern in the event that the debtor goes into liquidation.

Once the Court is satisfied with the report, it is then provided to creditors for comment, ahead of a hearing attended by the officeholder, any expert, the debtor, any creditors' commitee and the creditors. At this hearing the Court will either order the production of a restructuring plan for creditors to vote on, or the liquidation of the debtor.

If the Court orders a restructuring plan to be put together, the procedural aspects described above in respect of the PCP process (in relation to voting/approval of the restructuring plan, the length of the "observation process", DIP financing and *ipso facto* provisions) are also applicable to this rescue within bankruptcy process.

The New Law also provides a clear framework for liquidation, should it not be possible to rescue or rehabilitate the debtor, pursuant to PCP or the rescue within bankruptcy processes.

Other key features of the new insolvency procedures

Statutory priorities

A waterfall of priority of claims is established within PCP and bankruptcy, and the treatment of preferential creditors within bankruptcy (we assume to be paid from the pool of funds available to unsecured creditors) is covered.

Insolvency set-off

Similar to most civil law systems, the UAE Civil Code has historically allowed the set-off of debts. Under the old UAE bankruptcy provisions in the Commercial Transactions Law, Article 688 had envisaged post-bankruptcy set-off, but only on those debts which were "associated" with one another, the presumption of "association" being made where the debts arise from the "same cause" or from the same "current account". There had not been any guidance on whether the UAE Civil Code or the UAE bankruptcy provisions on set-off would take precedence following a counterparty's insolvency.

The sole set-off provision in the enacted version of the New Law is at Article 183, which:

- allows set-off between a creditor and debtor if it had been contractually agreed prior to insolvency, but not in respect of debts which arise after the commencement of an insolvency procedure (whether PCP or rescue within bankruptcy); and
- provides for a creditor to submit a claim for the "post set-off" amount to the insolvent party's estate or, if the creditor owes the insolvent party the "post set-off" sum, then the creditor would pay this sum to the insolvency estate.

In the absence of further clarity on the nature of the sums which can be used as part of Article 183 set-off, the provisions of the UAE Civil Code governing "mandatory set-off" – namely, that "*each of the parties must be both the obligor and the obligee of the other and the obligations must be of the same type and description, must be equally due and must be of equal strength or weakness*" would remain of relevance to a legal analysis of set-off rights.

Post-insolvency netting for derivatives contracts

In the context of derivatives contracts, the post-insolvency enforceability of close-out netting is of particular significance as an effective counterparty credit risk mitigating tool.

The key difference between close-out netting and set-off is that close-out netting could take place across a number of transactions, regardless of when payments would otherwise have become due (in other words, values are calculated on unperformed obligations such as future swap payments or deliveries under outstanding swap transactions, which become part of the sums being applied as part of close-out netting).

In the absence of any UAE legislation providing specific recognition of close-out netting, statutory insolvency set-off can – in some respects – go part of the way to enable a similar effect to close-out netting upon counterparty insolvency. However, insolvency set-off provisions, unless combined with further provisions, do not alone provide sufficient support for a completely positive netting analysis because there remain other factors under which a lump sum close-out amount can be undermined.

For example:

- termination of contract – the first step to effecting close-out netting is to terminate all outstanding transactions, which are often contrary to the statutory requirement for contracts to continue during a period of moratorium. Whereas the PCP provisions in the New Law include a carveout to allow terminations required to effect Article 183 set-off, an equivalent is not expressly provided for rescue within bankruptcy procedures;
- cherry-picking – in all of the three procedures available under the New Law, the insolvent party's officer has powers to review the sums which are submitted as claims on the insolvent estate. This power would make it possible for lump sum close-out amounts to be picked apart across multiple transactions, with the effect that the creditor has to pay the gross amount of all or some of the "in the money" transactions to the insolvency estate, whilst filing a claim separately for the claims under the "out of the money" transactions; and
- valuation of close-out transactions – as mentioned above, the valuation of close-out amounts includes ascribing values to amounts which may not yet have become due (for example, on unperformed obligations) such as those in market standard documents such as the ISDA Master Agreements or the ISDA/IIFM Tahawwut Master Agreements which may not be recognised in every jurisdiction.

We are working with a range of relevant UAE market participants to foster greater awareness of the benefits of having a positive netting analysis for the UAE, particularly in light of the demand driven by the wider G20 global financial market reforms. We would welcome further development of laws and regulations to provide certainty on netting enforceability so that the UAE can continue on its trajectory to become one of the world's leading financial hubs.

UAE Directors – what do they need to know?

Personal liability

In relation to directors, general managers and shadow directors, the New Law has retained much of the current regime of potential civil and criminal liabilities where they have contributed to the bankruptcy of a company. Fraudulent conduct leading to the bankruptcy of a company (or fraudulent conduct following the entry into proceedings) can result in up to five years' imprisonment and fines of up to AED 1 million. A sliding scale of punitive measures (again including potential prison sentences and substantial fines) is included for other mismanagement or wrongful conduct which the Court finds has precipitated the failure of the company and caused losses to creditors (including acts which occurred within the insolvency proceedings themselves), including, potentially, an obligation to contribute to the losses of the company in whole or in part if creditors make less than 20% recovery. Failure to file for bankruptcy within the 30-day time period referred to above, however, no longer of itself confers criminal liability, but may be a ground for disqualification (see below).

In addition, the New Law has introduced a disqualification regime (similar to that found in English insolvency law) whereby directors who are found guilty of the bankruptcy/linked offences may be disqualified from playing any role connected with the administration of a company for up to five years and may also be subject to fines. The New Law also refers to a register of disqualified directors being compiled and held within Government.

It should be noted that it appears the New Law also confers wide powers on the Court in certain circumstances to declare the bankruptcy of shareholders of a bankrupt company which is undergoing liquidation, or to force the shareholders to contribute their equity or share capital towards repayment of the debts owed by the bankrupt company.

Bounced cheques

Where the Court has accepted an application for the PCP or rescue within bankruptcy proceedings, the New Law prescribes that any criminal proceedings relating to bounced cheques of the debtor will be suspended with the agreement of the Court, and the relevant creditor will be included within the body of unsecured creditors that must vote on the restructuring plan. If the creditor vote is passed and the Court also approves the arrangements, the stay will continue until the restructuring plan is completed according to its terms, at which time the debtor can apply to have the criminal proceedings permanently stayed or terminated.

Antecedent transactions

Certain transactions (such as security granted for a pre-existing debt or disposals without sufficient consideration) which take place during the two years prior to the commencement of insolvency proceedings may be declared invalid and unwound by the Court, if it is found that the relevant transaction occurred at a time when the creditor knew, or ought to have known, that the debtor was insolvent and where it can be shown that the transaction has caused detriment to the other creditors. The Court may refuse to reverse the transaction to the extent that the Court finds that the transaction was made in good faith and for the purpose of continuation of the debtor's business, and that there were grounds for the debtor to believe that the transaction would be of benefit to the business. Personal liability may also accrue to directors and general managers in connection with preferential treatment of creditors and transactions at an undervalue (see *Personal liability* section above).

Lenders who may have colluded with a bankrupt debtor in order to obtain special treatment or inflation of amounts owed, in each case to the detriment of other creditors, may also face imprisonment, and any such transactions will be reversed by the Court.

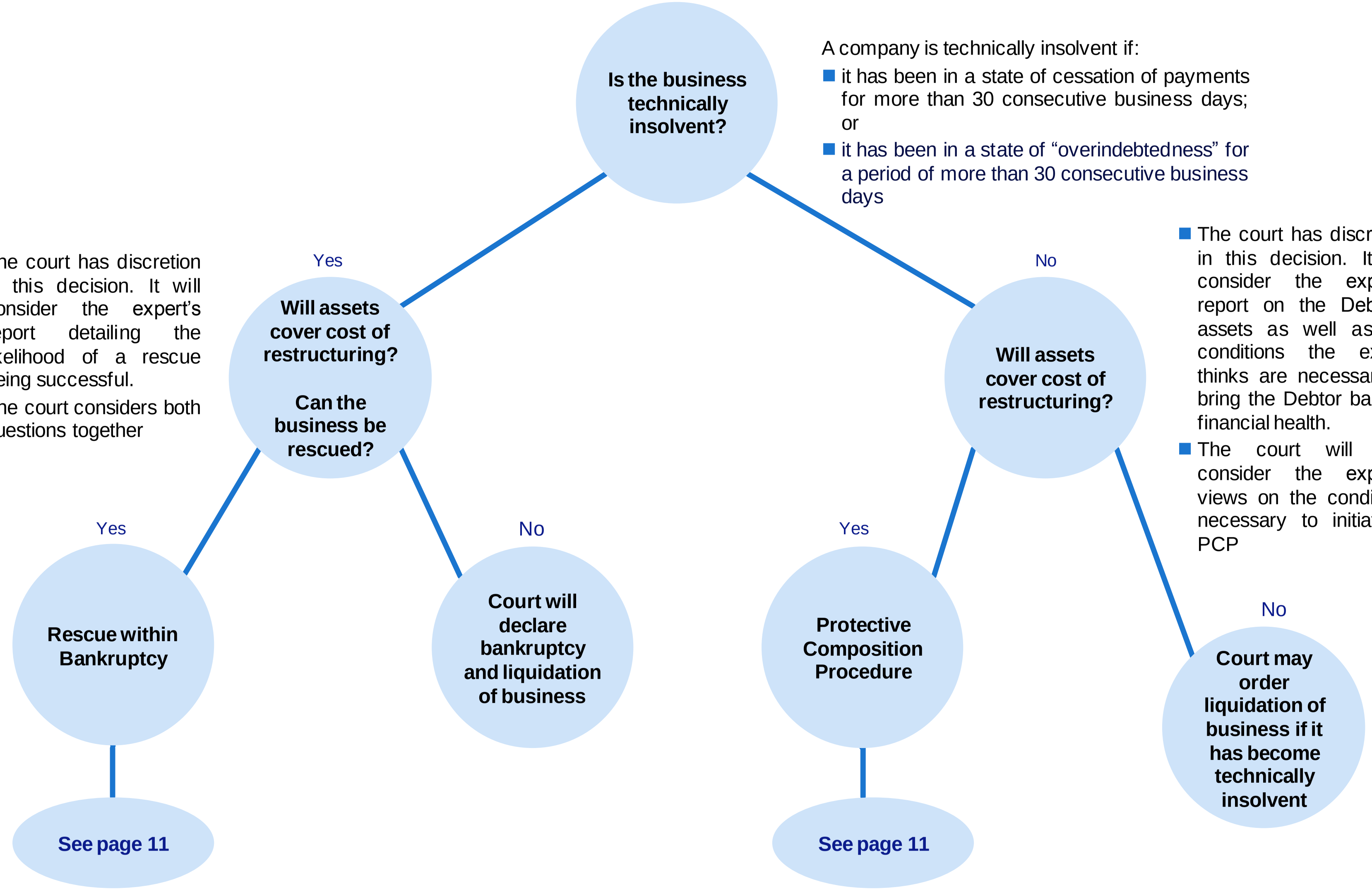
Concluding thoughts

The New Law will provide an excellent springboard for the development of a modern and robust insolvency framework in the UAE, but ultimately its success will depend on how it is applied in practice. This, in turn, will rely upon an effective and efficient Court and good support structures introduced to aid its practical application, including training for the judiciary, implementing regulations, a strong roll of accredited insolvency experts (properly licensed and regulated) and a publicly accessible central register of insolvency proceedings and list of disqualified directors for the UAE.

Availability of Procedures under the New Law

A company is technically insolvent if:

- it has been in a state of cessation of payments for more than 30 consecutive business days; or
- it has been in a state of "overindebtedness" for a period of more than 30 consecutive business days



- The court has discretion in this decision. It will consider the expert's report detailing the likelihood of a rescue being successful.
- The court considers both questions together

- The court has discretion in this decision. It will consider the expert's report on the Debtor's assets as well as the conditions the expert thinks are necessary to bring the Debtor back to financial health.
- The court will also consider the expert's views on the conditions necessary to initiate a PCP

Summary of Key Steps:
Protective Composition Procedure and Rescue within Bankruptcy

Step 1 – Submission of Application

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Application can be made by:

- Debtor
- Creditor of at least AED 100,000 due and unpaid for 30 consecutive business days
- Regulator
- Public Prosecutor

Application must include documentary requirements set out in the New Law plus a copy of a shareholders' resolution approving the filing

Court appoints an expert to prepare a report on Debtor's assets and liabilities

Court may impose interim measures until a decision on the application is taken

Step 2 – Expert submits initial report

T+20 business days
T+10 business days

- The report will state whether the assets of the debtor are enough to cover the costs of the restructuring. In a rescue within bankruptcy, the expert will also detail whether it is possible to restructure the business

Step 3 – Court decides on the application

T+25 business days
T+15 business days

- Upon court approval, one to three experts are chosen from the Roll of experts to assist the debtor to draft and implement a restructuring plan (the "**Trustee**")
- The Trustee publicises the court decision, their appointment and invites submission of claims, within 5 days of being notified of their appointment, in one English and one Arabic newspaper
- Creditor representatives and/or an expert may be appointed to support and/or oversee the process

Step 4 – Creditors file claims

T+50 business days
T+40 business days

- Trustee may admit, reject or amend claims
- The list of creditors is submitted to court within 10 business days, and is publicised in two newspapers within 3 business days in one English and one Arabic newspaper
- Rejected creditors may appeal

Step 5

- In a Rescue within Bankruptcy, the Trustee will also submit a report on the viability of a restructuring vs liquidating the business
- The deadline for submission is set by the court
- Admitted creditors, creditors' committee, the debtor and the Trustee will consider the report, and the court makes the decision on whether to restructure or declare liquidation
- The Trustee then prepares a restructuring plan

Step 6 – Trustee submits a proposed restructuring plan to the court

T+75 business days
T+53 business days + 3 months

Step 7 – Court approves the restructuring plan

T+85 business days
T+63 business days + 3 months

Step 8 – Creditors meeting

T+105 business days
T+83 business days + 3 months

- Creditors shall be furnished with a draft of the restructuring plan
- Restructuring plan must be approved by majority of unsecured creditors, holding at least two thirds of the total value of the admitted debt

Step 9 – Court sanctions the restructuring plan

T+115 business days
T+103 business days + 3 months

- The court's decision may be challenged by a creditor within 5 days of the court's decision

Step 10 – Implement restructuring plan

Maximum +3 years
Maximum +5 years

- The restructuring may be annulled within 6 months of a criminal claim against one of the parties involved in the plan
- No annulment more than two years after the court sanctions the plan

Key	
PCP and Rescue within Bankruptcy	Moratorium start/end
Rescue within Bankruptcy only	Court may declare bankruptcy and liquidation

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