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Insolvency 2023

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UAE: Trends and Developments
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UAE

Trends and Developments

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Cleary Gottlieb Steen & Hamilton is an international firm, with more than 1,200 lawyers across 16 offices in major global financial centres. Its Abu Dhabi office opened in 2012 and offers clients in MENA and those doing business in the region access to a full range of legal services, including leading restructuring and insolvency, M&A, capital markets, financing, energy and infrastructure practices. The Abu Dhabi office is fully integrated with Cleary Gottlieb's MENA practice, which comprises more than 30 partners based in Abu Dhabi, London, Paris and New York. It represents corporates, asset managers, financial institutions and sovereign clients operating or looking to invest in MENA in a variety of matters, from complex and transformational assignments to innovative middle-market transactions, across a wide range of sectors. Harnessing its integrated global partnership and network of locally qualified lawyers, the firm advises on cross-border restructurings and insolvency proceedings across MENA and the globe.

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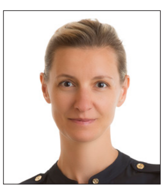

Polina Lyadnova is a finance and restructuring partner in the London office of Cleary Gottlieb Steen & Hamilton. She focuses on a broad range of cross-border debt transactions at various levels of capital structure. Polina's experience ranges from complex and transformational assignments to innovative middle-market transactions, and covers debt restructuring, bank financing, capital markets, sanctions laws and regulations, with a particular focus on the MENA region. Polina is a co-editor and contributor to Cleary Gottlieb's "Emerging Markets Restructuring Journal", which analyses new laws and their practical applications from emerging markets across the globe.

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Introduction

A distinguishing factor of the UAE legal regime is the operation of financial free zone areas, each with its own laws and regulations. The mainland or "onshore" regime is based on civil law and is comprised of federal law, which applies throughout the country, and the laws promulgated in each of the seven emirates. Each free zone has its own "offshore" regime, with the most prominent being the Abu Dhabi Global Market (ADGM) and the Dubai International Financial Centre (DIFC), which are both common law-based. The mainland bankruptcy regime is governed by Federal Decree Law No 9 of 2016 and its amendments (the "Federal Bankruptcy Law"). Insolvency Law DIFC Law No 1 of 2019 (the "DIFC Insolvency Law") applies in the DIFC, while the Insolvency Regulations 2022 (the "ADGM Insolvency Regulations") apply in the ADGM. The jurisdiction for insolvency proceedings is typically determined by the place of incorporation of the debtor, though certain regimes allow debtor's migration.

UAE Mainland/Onshore Regime

The majority of insolvency petitions are initiated in onshore courts, as most companies operating in the UAE are incorporated under federal law. The Federal Bankruptcy Law applies to:

- companies incorporated under UAE Federal Decree Law No 32 of 2021 on Commercial Companies (or its predecessors);
- companies incorporated in free zone areas (other than the ADGM and the DIFC);
- licensed civil companies of professional character; and
- merchants or traders (ie, individuals undertaking commercial activities).

The scope of the Federal Bankruptcy Law does not, however, extend to natural persons, whose insolvency is governed by Federal Decree Law No 19 of 2019 on Insolvency.

Historically, companies in the UAE avoided filing for bankruptcy, as there was a clear regulatory preference for companies to find a resolution through extensive negotiations with creditors or otherwise face liquidation. To attract foreign investment, and following rumblings in many sectors after the 2008–09 financial crisis, the UAE modernised its insolvency regime to focus more on restructuring and salvaging businesses, rather than on outright liquidation. This shift has led to the implementation of procedures designed to facilitate the rehabilitation process both for creditors and for debtors.

In particular, the law introduced the so-called preventive composition regime, to allow a debtor to reach a settlement with their creditors under court supervision with a court-appointed trustee through a restructuring plan. Only the debtor may apply for preventive composition, provided that they have not ceased to pay due debts for a period exceeding 30 consecutive business days. The debtor continues to run the business. All proceedings against the debtor are stayed from the date of the court's acceptance of the application until the earlier of:

- the ratification of the restructuring plan; or
- ten months from the court's acceptance.

While the aim is to allow debtors to recover and resume their business, the regime has its limitations – as mentioned, it is not available to debtors with long payment default, and importantly, secured creditors do not vote on the restructuring plan and are not bound by it.

If preventive composition is not available, the debtor may end up in a formal bankruptcy procedure, either in the form of restructuring or liquidation. The debtor, the public prosecutor's office or creditors with a debt of at least AED100,000 that remained unpaid for a period of 30 consecutive business days after the debtor was notified may apply for either procedure.

Following the filing of a bankruptcy procedure, a court-appointed expert will ascertain the financial position of the debtor, and draft a report on:

- whether, in their opinion, the debtor's restructuring is possible; and
- whether the debtor's assets are sufficient to cover the costs of the procedure.

If the court approves the application, a restructuring procedure ensues. All proceedings against the debtor are stayed, but the court-appointed expert will be in charge of the management of the business. If the court rejects the application, the debtor's assets are liquidated and distributed to their creditors. One or more court-appointed liquidators undertakes the liquidation. If a debtor's liquidated assets are insufficient to cover at least 20% of its debts, the court may compel the directors, jointly or severally, to pay all or some of the company's debts where their liability for mismanagement is established.

Offshore Regimes

The ease of doing business afforded by UAE free trade zones has not only facilitated the establishment of free zone entities, but has also promoted an inflow of companies (including distressed companies) looking to re-domicile in these zones. Although the UAE has over 40 such free zone areas, the most prominent still appear to be the DIFC and the ADGM, which this section covers.

Both the ADGM and DIFC regimes are modelled on English common law, with the ADGM expressly incorporating English common law into its regulatory landscape by virtue of the Application of English Law Regulations 2015. The ADGM restructuring regime also borrows from Australian and US laws. In addition to the insolvency regulations, both the ADGM and DIFC companies laws provide the framework for the scheme of arrangement (ie, an arrangement or compromise between the debtor company and its creditors or members). Both regimes incorporate the UNCITRAL Model Law on Cross-Border Insolvency.

ADGM

Restructuring options in the ADGM include:

- administration;
- deeds of company arrangement (DOCA); and
- schemes of arrangement (SOA).

In an administration, an administrator is appointed by the debtor company, its directors, secured creditors, or the court. The administrator serves the interests of all creditors and follows a specific priority order for distributing proceeds. Administration comes with a moratorium on enforcement actions. The DOCA establishes a structured approach for handling a debtor's financial matters (within administration), contingent on creditors' approval (see further below, under Comparing both regimes).

Finally, an SOA enables arrangements between a company and its creditors or members through a court-led process. The existing management retains control, and the process does not trigger an automatic moratorium unless combined with administration. Approval of a scheme requires a 75% value endorsement by creditors, and, following court sanction, will be binding on the company and all relevant creditors, irrespective of their participation or voting outcome.

DIFC

Restructuring options in the DIFC include:

- administration;
- company voluntary arrangements (CVA);
- debtor-in-possession (referred to as rehabilitation); and
- SOA.

Initiating a DIFC administration procedure requires two conditions:

- filing an application for a rehabilitation plan; and
- providing evidence of misconduct by management.

The process is fairly similar to the ADGM administration, save for a few nuances. For instance, in the DIFC, the court may only appoint an administrator to approve a rehabilitation plan, CVA or SOA, or to investigate fraud. A moratorium applies as long as the administrator remains in office.

A CVA process is initiated by the debtor itself, to rehabilitate the distressed company, without necessarily being insolvent. At least 75% (in value) of creditors present and voting must approve the CVA. A moratorium does not automatically apply to a CVA process. Directors would need to apply to the court through an insolvency practitioner and show how a moratorium would benefit creditors.

The rehabilitation procedure allows the debtor to continue to manage its business and assets following court approval. An automatic moratorium will apply where the rehabilitation option is adopted.

The DIFC also offers SOA as a restructuring tool.

Comparing both regimes

While similar restructuring procedures are offered in both offshore jurisdictions, there are nonetheless a few differences. For instance, the DOCA procedure is only available under ADGM law, while the company voluntary arrangement and the rehabilitation plan are only available in the DIFC.

Both regimes allow SOA to be pursued to restructure debts. There is, however, a slight difference in majorities required – for example:

- under DIFC law, approval of stakeholders representing 75% in value and a majority in number of each class of stakeholders present and voting is required; and
- under ADGM law, the scheme only needs to be approved by 75% in value of each class of creditor.

As mentioned above, the ADGM has introduced the concept of DOCA, which provides a structured framework for managing a debtor's financial affairs. Under the DOCA, the appointed administrator prepares the DOCA instrument, setting out governing terms related to the conduct of the business of the company, particularly arrangements between the distressed company and its creditors. The instrument includes essential statutory information, such as:

- property available for creditor satisfaction;
- the nature and duration of any moratorium;
- termination conditions;
- priority of distribution; and
- other relevant terms and conditions.

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One notable restriction of the DOCA is that secured creditors do not participate in voting on the restructuring plan, and they are not legally bound by its provisions. Importantly, any person bound by the DOCA, including creditors, the administrator, officers and members of the company, is prohibited from petitioning for the winding-up of the company or initiating enforcement or other legal proceedings against the company concerning its property. The DOCA aims to prioritise the equitable treatment of preferential creditors, including expenses such as employment-related costs and contributions, with an equal ranking or proportionate abatement in cases where available assets are insufficient to satisfy these debts. This structured framework ensures that the company's financial affairs are managed effectively, while providing protection against winding-up petitions and legal actions during the restructuring process.

Trends and Developments

Rise in debtor bankruptcy filings

Due to several factors – such as the Russia-Ukraine conflict, supply chain issues, labour shortages, rising inflation and interest rates, and the risk of recession – there has been a clear increase in debtors filing for bankruptcy in the region following the COVID-19 pandemic. This trend is expected to continue, not least due to the fact that certain insolvencies were delayed by the pandemic, rather than prevented.

That said, filings undergo scrutiny, and in a few cases where the debtor has filed for bankruptcy, courts have doubted whether the companies involved were indeed experiencing financial distress and the reasons leading to such a situation. In some cases, the court dismissed the application for insufficient evidence, and in others referred the matter to the public prosecutor's office to determine whether or not fraud had been committed. One fraud case was eventually dismissed, but only after a nearly two-year-long investigation into the debtor's finances.

Directors' liability

Despite the clear intention in the bankruptcy regime reforms to lift the stigma attached to insolvencies in the region and, in particular, to address the criminal liability issue, there has been a number of cases where the directors have been held personally liable for the debts of the insolvent entity.

One notable case is the Dubai Court of First Instance decision of 24 October 2022, which declared Arabtec Holding Company (a construction giant that built many of the UAE's most famous landmarks) bankrupt and approved the liquidation of its assets. The company collapsed under the weight of its huge debt load and the cancellation of construction projects. The Arabtec case emphasised the risk that directors and officers of a distressed company may be held liable under the provisions of the companies or bankruptcy law.

In the Marka PJSC case, the Dubai Court of First Instance held, in a judgment of 5 October 2022, that six board members of Marka (which had filed for bankruptcy in 2017) were personally liable to pay company debts to the tune of AED531.2 million. The Court noted that decision-makers of a company may be held personally liable for a company's debts when its assets are insufficient to cover 20% of its liabilities and the decision-makers either:

- disposed of the company's assets at lower than market value or for no or insufficient consideration; or

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- discharged the debts of one creditor to harm other creditors.

These decisions highlight the need for officers to:

- exhibit good judgment and duty of care;
- ensure that they are acting in the best interest of the company and its stakeholders; and
- keep adequate records to justify their actions should such a need arise, to avoid being held personally liable.

Non-performing loans

With the rise of bankruptcies in the UAE, banks are exploring alternatives to legal enforcement for repayment, such as the sale of their non-performing loans (NPLs) to third parties at a reduced cost. NPLs can adversely affect a financial institution's balance sheet, credit rating, capital requirements, profitability and, ultimately, its stability. NPLs are expected to become more common as financial institutions clean up their balance sheets. One such deal is Abu Dhabi Commercial Bank's sale of NPLs, valued at around USD1.1 billion, and consisting of corporate loans to small and medium-sized enterprises (in January 2023). However, this is a sensitive topic for banks, as several of them have issued press releases denying such transactions.

Emerging tools

Following the COVID-19 pandemic, some new tools introduced by Federal Law No 21 of 2020 have enhanced flexibility in the UAE restructuring and bankruptcy framework.

First, a new procedure to deal with an "emergency financial crisis", which is defined as a "public situation that affects trade or investment in the state, such as the outbreak of an epidemic, a natural or environmental disaster, war or other case whose duration shall be determined by a cabinet resolution […]". In such a scenario, a bankruptcy filing may be deferred even if:

- a debtor has ceased to pay their debts for a period exceeding 30 consecutive working days; or
- a debtor's liabilities have exceeded their assets.

A debtor may still decide to go through bankruptcy if they deem it in the best interests of all stakeholders.

Second, new financing, approved by the court, may be secured by encumbered assets if the lender is a financial institution and the new security does not exceed 30% of the value of the encumbered assets. New financing will be given priority over unsecured debts, and may even be secured and given priority over other secured debts on the encumbered assetsif the new financing is deemed necessary by the court for purchasing materials or services for the continuity of the business or helping the debtor achieve returns to settle outstanding debts. In January 2022, Emirates Hospitals Group (EHG), an entity of KBBO Group, obtained the Abu Dhabi Court's approval for new financing totalling AED150 million from investment firm Fidera, secured by a super-priority ranking security over EHG assets. On 15 September 2023, the Abu Dhabi Court approved KBBO Group's restructuring plan, which included said new financing.

The last few years have also showcased some forum shopping in the region. In 2020, NMC Healthcare and 34 of its operating companies applied for and were granted re-domiciliation to the ADGM from onshore UAE jurisdictions. This process afforded NMC the favourable regime under the ADGM Insolvency Regulations, which offered more certainty and sophisticated mechanisms for the eventual restructuring or liquidation of the companies involved.

Cross-border insolvencies

Unlike the ADGM and the DIFC, the UAE has not integrated the UNCITRAL Model Law on Cross-Border Insolvency into its federal bankruptcy regime. The UNCITRAL Model Law aims to facilitate cross-border insolvency proceedings through co-operation and recognition between jurisdictions applying similar rules. There are also no co-operation agreements or treaties in place between the UAE and foreign jurisdictions. Until recently, there was a huge disparity between the onshore UAE regime and other jurisdictions, which made any reciprocity untenable.

However, by adopting measures that align with widely accepted principles of best-in-class restructuring regimes – such as the ability to provide new financing secured by fully encumbered assets – the UAE has begun to implement procedures that would be capable of recognition by foreign courts globally, particularly by jurisdictions that have adopted the UNCITRAL Model Law. Such reforms are a welcome addition considering that, as the restructuring market matures and more filings take place in the UAE, insolvencies will involve other jurisdictions. Given the UAE's influence as a trading and financial hub, this will necessitate a uniform cross-border regime.

Federal Decree-Law No. (51) of 2023 promulgating the Financial Reorganisation and Bankruptcy Law was adopted in the UAE mainland at the time of publishing, it will enter into force on 1 May 2024, and is yet to be analysed.

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