Bahrain's New Bankruptcy Law

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On May 30, 2018 the Reorganisation and Bankruptcy Law (Bahrain Law No. 22/2018) (the "**Bankruptcy Law**") was adopted in the Kingdom of Bahrain. The Bankruptcy Law aims to maximise the value of bankrupt estates in the country and encourage corporate reorganisation over liquidation. Whilst local in its implementation, the Bankruptcy Law is international in scope and design. The Bankruptcy Law utilises restructuring concepts drawn from the U.S. Bankruptcy Code's Chapter 11 procedure, including a moratorium on enforcement proceedings, the ability to sell assets out of the bankrupt estate free from security, obtain financing on superpriority terms and implementing a reorganisation plan. These 'debtor-friendly' restructuring tools are familiar to, and popular with, international companies and investors. The message here is clear – the introduction of the Bankruptcy Law is intended to show that Bahrain is an increasingly frictionless place in which to do business.

This article will explore the origins of the Bankruptcy Law and outline some of its key features. It will further contextualise the Bankruptcy Law within the sphere of global restructurings.

Historical Context

Previously, the Bankruptcy and Composition Law No. 11 of 1987 and aspects of the Commercial Companies Law No. 21 of 2001 together comprised the legislation that applied to bankruptcies, reorganisations and insolvency matters in the Kingdom of Bahrain. There is also the Central Bank of Bahrain and Financial Institutions Law 2006 that holds separate and further detailed insolvency rules for financial institutions licensed by the Central Bank of Bahrain and continues to operate as the new Bankruptcy Law does not apply to these institutions as noted below.

The purpose for the development of a new Bankruptcy Law is twofold. The first is to provide further increased certainty and protection to those currently operating in the market including those that wish to start a new business and secondly, to allow for a restructuring component, which is critical for companies with heavy debt. The new Bankruptcy Law allows for cross border insolvency and the ability to restructure business which had been missing from the previous law.

Additionally, one of the key focus areas for the government has also been to galvanize the Kingdom's plans for a thriving ecosystem of start-ups. Bahrain is looking at fostering innovation and entrepreneurship and in a key effort to do so, has put in place a bankruptcy framework that decriminalises failure, enhances impartiality and transparency in the hopes of transforming the ecosystem.

Key Features of the Bankruptcy Law

Scope

Debtors that are companies or trading individuals are within the Bankruptcy Law's scope, but persons licensed by the Central Bank of Bahrain are excluded. In addition, a debtor's personal, family and consumer debts are excluded from the scope of the Bankruptcy Law.

Commencing a Claim

Under the Bankruptcy Law either the debtor or its creditors can commence proceedings. To fall within the Bankruptcy Law's jurisdiction, the debtor must also have failed to pay its debts for a period of thirty days, or be incapable of paying its financial liabilities as they fall due. In addition, the petitioner can present evidence that the debtor's financial obligations exceed the value of its assets.

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Management stay in place

The Bankruptcy Law adopts a 'debtor-in-possession' framework. Whilst the administrative and management arm of the company remains in place, an independent "Bankruptcy Trustee" is appointed. The Bankruptcy Trustee owes a fiduciary duty to act in the best interests of the estate and performs a myriad of functions, including helping prepare the Reorganisation Plan (as discussed below) and producing an inventory of the debtor's assets. Importantly, the approval by the court of the opening of bankruptcy proceedings allows the debtor to utilise the restructuring tools identified below.

Moratorium

A critical feature of the Bankruptcy Law is the moratorium on claims against the bankrupt estate. Activated when the court approves the opening of bankruptcy proceedings and lasting for an initial period of 120 days in the case of secured creditors, the stay on enforcement proceedings should provide critical breathing room to manage the reorganisation of the estate and encourage continued trade. The moratorium can be extended at the Bankruptcy Trustee's request, provided consent is obtained from the secured creditors or the court deems the extension as essential to maximising the estate's value.

There are certain exceptions to the moratorium's scope. Financial derivative contracts are not subject to the stay. The court also maintains discretion to terminate the moratorium. Along with certain other conditions, the stay can be lifted upon the motion of a secured creditor if the value of their secured funds decreases and they do not receive adequate protection against impairment or any other losses during the moratorium. Unsecured creditors may apply to terminate the stay if their claim has been previously litigated or is subject to a right of set-off, but only where the adjudication of the claim or exercise of the set-off would facilitate administration.

Sale of assets

The Bankruptcy Law allows assets to be sold out of the bankrupt estate. For the sale to be sanctioned, the court must deem the disposal in the best interests of the bankrupt estate. A method of sale that maximises value should in principle also be utilised.

Providing flexibility to the sales process and enhancing the saleability of the assets, secured assets can be sold free from security if:

— the secured creditor consents;

— the cash proceeds from the sale is not less than the secured debt;

— the cash proceeds from sale is not less than fair market value; or

— the sale is made under a Reorganisation Plan (as explained at more length below).

If the property is sold free of security, the security rights automatically attach to the proceeds of the sale with the same priority. Secured creditors can also request to bid for the purchase of the property and apply any right of set off among the purchase price and the secured claim.

DIP Financing

Similar to Chapter 11 in the USA, the Bankruptcy Law introduces provisions that allow the debtor to raise credit whilst in bankruptcy, with court approval. Providing a potential lifeline to the company and encouraging continued trade, the court can approve the funding if the terms are fair and reasonable and the financing is necessary for the proper administration of the bankruptcy estate.

The clear advantage of DIP financing is the ability to provide priority credit. Unless otherwise agreed between the parties, unsecured DIP loans will be given first priority status and can be repaid without court approval. Secured DIP loans will rank behind existing security unless the existing secured creditors agree to relinquish priority. However, the court can authorise the creation of security rights with priority even if the existing creditor objects if:

— the secured creditor has the opportunity to be heard;

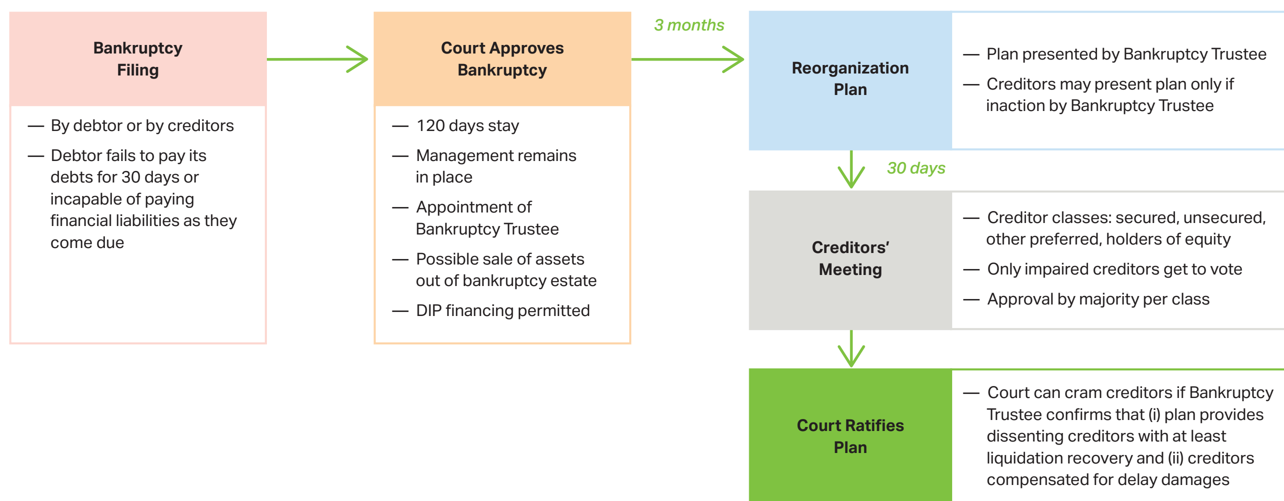
— the debtor cannot obtain alternative financing; and

— security is provided to the existing creditor.

Guarantees can also be given on the funds of the bankrupt estate, but these are subject to any existing liens on the property.

These provisions should encourage lenders to extend credit to companies in financial distress and help keep the company afloat during the reorganisation process.

Bahrain Bankruptcy Process Overview



Reorganisation Plan

Introduction

The Bankruptcy Law provides a framework to help debtors engage with creditors and attempt to agree a restructuring plan for the company (the "**Reorganisation Plan**").

Within three months of the opening of bankruptcy proceedings, the Reorganisation Trustee must submit a Reorganisation Plan. A committee of creditors (the committee representing unsecured creditors) or creditors holding at least one third of total claims can file a Reorganisation Plan, but only when proceedings have been pending for at least six months and the Reorganisation Trustee has failed to make progress.

The Reorganisation Plan can be a broad range of different things, allowing for a comprehensive alteration of the debtor's capital structure:

— a sale of property;

— an investment by third parties into debt or equity securities issued by the debtor;

— a recapitalization of the debtor;

— a merger or other transaction; and

— the continuation, rescission or assignment of contracts.

The Reorganisation Plan can propose a myriad of treatments in relation to the existing debt, including modifying its terms and conditions, such as the maturity date or interest rate. Alternative techniques such as issuing new securities to creditors in exchange for their existing claims and cancelling equity interests without consideration can also be deployed.

Procedure

A disclosure statement must be prepared for consideration by the creditors. Amongst other details, the statement should include information on the debtor's financial position, the grounds on which the debtor will continue to operate and information on the voting mechanics. Similar to documentation requirements for U.K. schemes of arrangement, a comparator analysis must be presented showing the returns that creditors are expected to receive under the Reorganisation Plan as compared to liquidation. When deciding whether to sanction the Reorganisation Plan, the court will consider whether the disclosure statement contains sufficient detail to enable the creditors to make an informed decision on whether to accept or reject its terms.

Within thirty days of its submission, the court will convene a meeting of the creditors to vote on the Reorganisation Plan. Creditors are classified into different classes for voting purposes. The Bankruptcy Law outlines the following classes, although a special category could be established if it would facilitate proceedings: secured creditors, unsecured creditors, other preferred creditors and holders of equity interests. Critically, only those creditors whose rights will be affected by the Reorganisation Plan are entitled to vote.

The Reorganisation Plan will be approved if it is accepted by the majority of creditors in each category, provided those creditors account for at least two thirds of the total amount of the debts of such category. Creditors whose debts will be fully discharged by the Reorganisation Plan or whose rights will not be affected are deemed to have approved the plan.

Following the vote and the hearing of any objections by creditors who did not approve the Reorganisation Plan, the court will decide whether to ratify the Reorganisation Plan and issue a decision to proceed with its implementation. The court can cram through the Reorganisation Plan even if it is not approved by a class of creditors, provided that the Reorganisation Trustee confirms that the Reorganisation Plan will give any creditor that has not voted in favour at least the same return as they would get in liquidation, and that creditors will be compensated for damages that occur from the delay.

Effect

If the Reorganisation Plan is approved by the court it is binding on all persons, wherever they are located and whether or not they voted for or against the plan.

International Context

Global Reforms

The introduction of the Bankruptcy Law has occurred during a period of global reform in bankruptcy regimes. The aftermath of the 2008 financial crisis emphasized the importance of having robust legislation that can facilitate corporate rescue on a cross-border basis. Jurisdictions such as India, Egypt and the United Arab Emirates have recently introduced new bankruptcy laws which reflect this shift in focus.[1] In the U.K., the government has presented proposals for a new form of reorganisation plan which allows for the cross-class cram down of creditors.

The most well-known bankruptcy reorganization tool is Chapter 11 of the U.S. Bankruptcy Code, and there is much in the Bankruptcy Law that will be familiar to American practitioners. In our view, the key reasons Chapter 11 has worked so well as a tool for rehabilitation of distressed companies are as a follows:

IT IS A PURPOSE-BUILT TOOL

In the first wave of distress after the financial crisis many European jurisdictions realized that their insolvency laws did not explicitly legislate for restructuring of companies. The focus of many legal regimes was on protecting creditors and providing them with mechanisms to enforce their claims. Where tools were available, often they were not specifically designed for debt restructuring, and had to be adapted (English schemes of arrangement being the best example).

Having a purpose-built legal mechanism for corporate restructuring gives all stakeholders a degree of certainty as to the timing and process for resolution of the situation. Have increased predictability on these aspects reduces the overall execution risk of any restructuring, and should lead to better outcomes.

IT FACILITATES RESTRUCTURINGS WITHOUT ALL CREDITORS PROVIDING CONSENT

Allowing a restructuring to be imposed on all stakeholders with the consent of a super-majority of creditors is helpful in two respects:

— **First**, if the debtor has a complex capital structure, it will be practically impossible to obtain active engagement and support from all creditors.

— **Secondly**, it mitigates the hold-out creditor risk. If unanimity is required for a plan of reorganization to be approved, the debtor will have to negotiate to the lowest common denominator – pacifying the most aggressive creditors in return for their support. That creates the risk that an individual creditor (or small group of creditors) can de-rail the process for the majority.

IT ALLOWS THE DEBTOR'S BUSINESS TO CONTINUE AS A GOING CONCERN

A big risk with any bankruptcy process is that the process itself leads to a destruction of value. In most cases that is because the debtor's business struggles to continue as a going concern when it comes under stress. If the business cannot continue to trade, often there will not be enough time to negotiate and agree a restructuring deal before the debtor is at risk of liquidation.

Three elements of the Bankruptcy Law help to mitigate this risk:

— **First**, management stay in place – absent fraud, they will be best-placed to run the business, deal with customers, suppliers, employees and creditors and generally to steady the ship whilst a deal is put together.

— **Secondly**, a moratorium on enforcement action by creditors allows management to focus on stabilizing the situation, and on putting together a restructuring plan that benefits all or a majority of the creditors. If individual creditors are able to take their own action in an un-coordinated manner, very quickly the management will be in a fire-fighting situation and confidence in the business will evaporate, further exacerbating the distress.

— **Thirdly**, having a DIP financing regime should give providers of capital the confidence to supply liquidity to a debtor at a time when it would otherwise be difficult or impossible to obtain. Furthermore, in addition to the cash supplied, the availability of a DIP loan should inspire confidence among other creditors (particularly trade creditors), who will be encouraged to continue to deal with the debtor without fear it is going to run out of money in the short term.

International Recognition

Cross-border recognition of bankruptcy rulings is a very complicated area. To give an example: imagine a Dutch company has debt governed by Italian law, and significant assets in Bahrain. How would you go about restructuring that in such a way as to be legally robust in each of those jurisdictions? Broadly, there are two options:

— *Option A*: Conduct some sort of court-process in each of those countries, and possibly also in countries where key creditors are located. Unfortunately that is very costly, and can lead to odd results where the consent thresholds and procedural requirements are different in each jurisdiction.

— *Option B*: Conduct one process in the company's centre of main interests, and then seek to have that court ruling recognized in all relevant jurisdictions.

Option B is clearly preferable, and there are various international frameworks that seek to facilitate recognition (the European Insolvency Regulation being the prime example). The Bankruptcy Law takes inspiration from the UNCITRAL Model Law on Cross-Border Insolvency (1997) in its adoption of provisions designed to facilitate cross-border insolvencies. Under the Bankruptcy Law, a foreign representative may apply to the Bahraini court to have foreign insolvency proceedings recognised. If a foreign proceeding is recognised, the court is empowered to grant relief most importantly in the form of staying actions against the debtors assets and suspending the right to transfer, encumber or otherwise dispose of the assets. Parallel proceedings to the foreign proceedings can also be commenced in Bahrain in regards to the debtor's assets in the country. The intention is to facilitate cross-border proceedings and provide legal certainty for trade and investment.

In this vein, the Bankruptcy Law also provides for enhanced cooperation with other bankruptcy jurisdictions, with foreign courts and representatives permitted to communicate and coordinate directly with the Bahraini courts and share certain information.

However, there are limits to how far domestic courts in certain countries are prepared to take Option B. Restructuring laws by their nature allow for some fairly significant consequences to be imposed on creditors, in some cases against their will. Some countries have 'red lines' which restrict the extent to which they can recognize the orders of foreign bankruptcy courts. For example, in England we have an ancient rule that says English law contractual obligations can only be discharged by an English law governed process. In practice this means that

English-law governed debt could not be discharged or modified in a Bahraini proceeding unless the creditor agreed to submit to the jurisdiction of the Bahraini court. If the creditor did not submit, they could seek to enforce their claims in the English courts. The scope of the Bankruptcy Law is therefore not without limits. A parallel U.K. Scheme of Arrangement, or alternative process, will be required in regards to English law governed debt obligations or for jurisdictions where a similar approach is taken to creditors rights.

CASE STUDY

There has also recently a case filed at the Bahraini courts by Garmco, the Bahrain-based international aluminum rolling mill, for a voluntary petition for relief under Section 3 of Law No 22 of 2018 which should serve as a useful case study for the implementation of the new processes and mechanisms.

Therefore, whilst some questions may remain regarding how the Bankruptcy Law will work in practice, its implementation represents a huge leap forward for businesses and their creditors alike. The Bankruptcy Law represents a clear shift in the Bahraini legislative environment towards more business-friendly laws designed to encourage investment in the country.

For more information about the Bankruptcy Law, visit www.bahrainedb.com. ■

1. For more details on the UAE and Egyptian bankruptcy regimes see, Mohamed Taha, *Egypt's New Bankruptcy Law: A Step Forward in the Business Legislative Reform Process*, Emerging Markets Restructuring Journal, Issue No.7 (Summer 2018); Lawale Ladapo and Mohamed Taha, *The New Bankruptcy Law of the UAE: Towards A More Business-Oriented Bankruptcy Regime, Emerging Markets Restructuring Journal, Issue No. 4* (Fall 2017).

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