The New Bankruptcy Law of the UAE: Towards A More Business-Oriented Bankruptcy Regime

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On September 20, 2016, the new UAE Bankruptcy Law No. 9 of 2016 (the "**New Bankruptcy Law**") was issued to replace the provisions regulating bankruptcy in the UAE contained in the Commercial Transactions Law and the Penal Code. The New Bankruptcy Law was published in the official gazette on September 29, 2016 and came into force on December 29, 2016. Together with the new Commercial Companies Law issued in 2015[1] and the implementing regulations of the Competition Law issued in 2016, the New Bankruptcy Law is part of the government's plans to introduce legislative reform to modernize the business laws in the UAE. The New Bankruptcy Law seeks to support this modernization initiative by introducing new measures to rescue businesses in distress, such as preventive compositions and debt restructurings, and by reforming the bankruptcy regime. Notably, the New Bankruptcy Law establishes the Financial Restructuring Committee to, among other things, supervise restructuring proceedings for licensed financial institutions.

Scope of Application

The New Bankruptcy Law applies primarily to corporate entities established under the laws of the UAE. Contrary to earlier press releases suggesting that the New Bankruptcy Law will be limited to corporate bankruptcies, the New Bankruptcy Law applies to individuals trading for profit (but excludes non-merchant individuals). The New Bankruptcy Law also applies to companies wholly or partially owned by the government where their charters expressly subject them to the provisions of the New Bankruptcy Law and companies can "opt-in" to the new regime by amending their charters. The New Bankruptcy Law will also apply to companies established in free zones with no specific regulations governing preventive composition, debt restructuring or bankruptcy. Companies established in the Dubai International Financial Centre (DIFC) and the Abu Dhabi Global Market (ADGM), which are self-legislating financial centres, each with their own comprehensive insolvency legislations, are excluded from the scope of the New Bankruptcy Law.

The New Bankruptcy Law is broadly composed of two main schemes that debtors undergoing financial difficulties can resort to, namely: preventive composition and bankruptcy.

Who Can Use The New Law

- UAE corporations
- Individual merchants
- Government-owned companies (if they opt-in)
- Companies established in free zones (if no specific regulations)

Preventive Composition

Preventive composition is similar to the voluntary arrangement schemes under English law and the safeguard proceedings (*procedure de sauvegarde*) under French law, as it provides a scheme for a solvent debtor to avoid liquidation by agreeing with its creditors to repay all or part of its debts pursuant to a court-approved settlement plan.

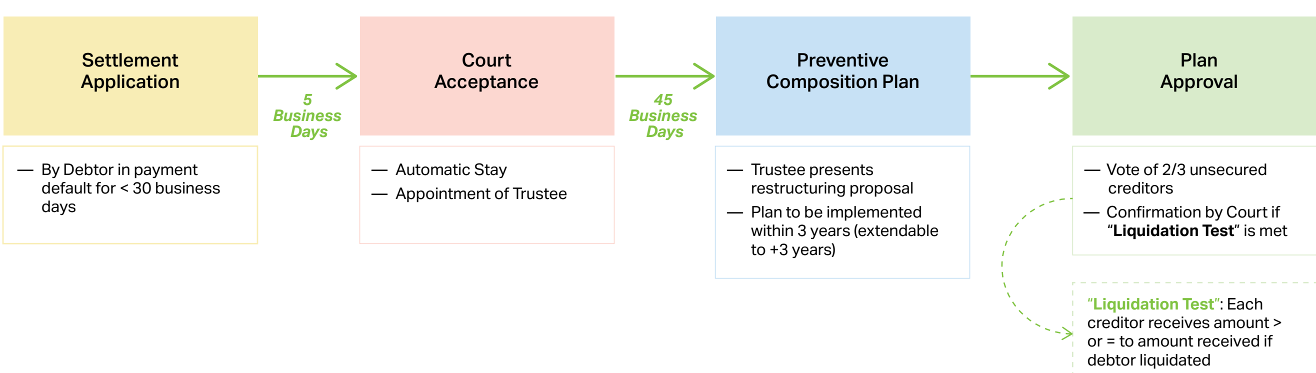
Initiating the Preventive Composition Application

An application for preventive composition can only be made by a debtor who has defaulted on repaying its debts due to financial difficulties, but is not insolvent; provided that the debtor has not been in default for more than 30 business days. The application is made to the court, and must outline, among other things, the debtor's cash flow projections, the proposed preventive composition plan and "guarantees", or assurances, for the implementation of the plan. The court will decide within five business days whether to accept or reject the application on an *ex-parte* basis and may appoint experts who will prepare a financial report on the debtor to assist the court in assessing the application.

The court may reject the application if, among other things, the applicant is already subject to existing debt restructuring or preventive composition proceedings, is found to be acting in bad faith, is convicted of a bankruptcy-related crime, or if the court decides that a preventive composition is inappropriate given the circumstances.

Interestingly, similar to the prohibition on *ipso facto* clauses seen in U.S. bankruptcy law, the initiation of preventive composition or restructuring proceedings under the New Bankruptcy Law will not constitute an event of default under any existing financing agreements. Any agreement to the

Preventive Composition



contrary will be void. This new approach introduced by the New Bankruptcy Law is inconsistent with the prevailing market practice, which generally considers a restructuring of the borrower's debts as an event of default under financing agreements.[2] Due to the novelty of this requirement in the UAE, it is not yet clear whether courts will tolerate an avoidance of this provision when a credit agreement of a UAE debtor is subject to a foreign law, or whether this requirement will be deemed an overriding mandatory provision that cannot be circumvented by simply changing the governing law clause in a credit agreement.[3] It is also worth noting that a court decision to accept the preventive composition application does not terminate any existing contracts between the debtor and third parties, unless the court so decides based on a request from the trustee.

In furtherance of the objective of the New Bankruptcy Law to address one of the major concerns under the old regime, which imposed strict criminal liability on issuers of bounced cheques, the New Bankruptcy Law provides that criminal proceedings against a debtor who has issued bounced cheques will be automatically stayed once a preventive composition proceeding is initiated.

Acceptance of the Application

If the court accepts the debtor's application for preventive composition, it will appoint one or more trustees to supervise the settlement process. The debtor may continue to manage its business through the preventive composition process, but the trustee enjoys broad powers to act on behalf of the debtor, including by applying to the court to secure new financing, and requesting the court to terminate any contract that the debtor is party to if such termination serves the interests of the creditors at large without materially prejudicing the interests of the counterparty to such contract.

Once the preventive composition application is accepted, the debtor is restricted from disposing of its assets or obtaining new loans unless it receives prior consent from the trustee or the court. In addition, a moratorium is automatically imposed on all claims and enforcement proceedings against the debtor (including enforcement proceedings by any secured creditors) until the preventive composition plan is approved, and no new guarantees will be enforceable on the debtor's assets unless pre-approved by the court. Secured creditors may, however, subsequently apply to the court requesting that it enforces their debts during this period.

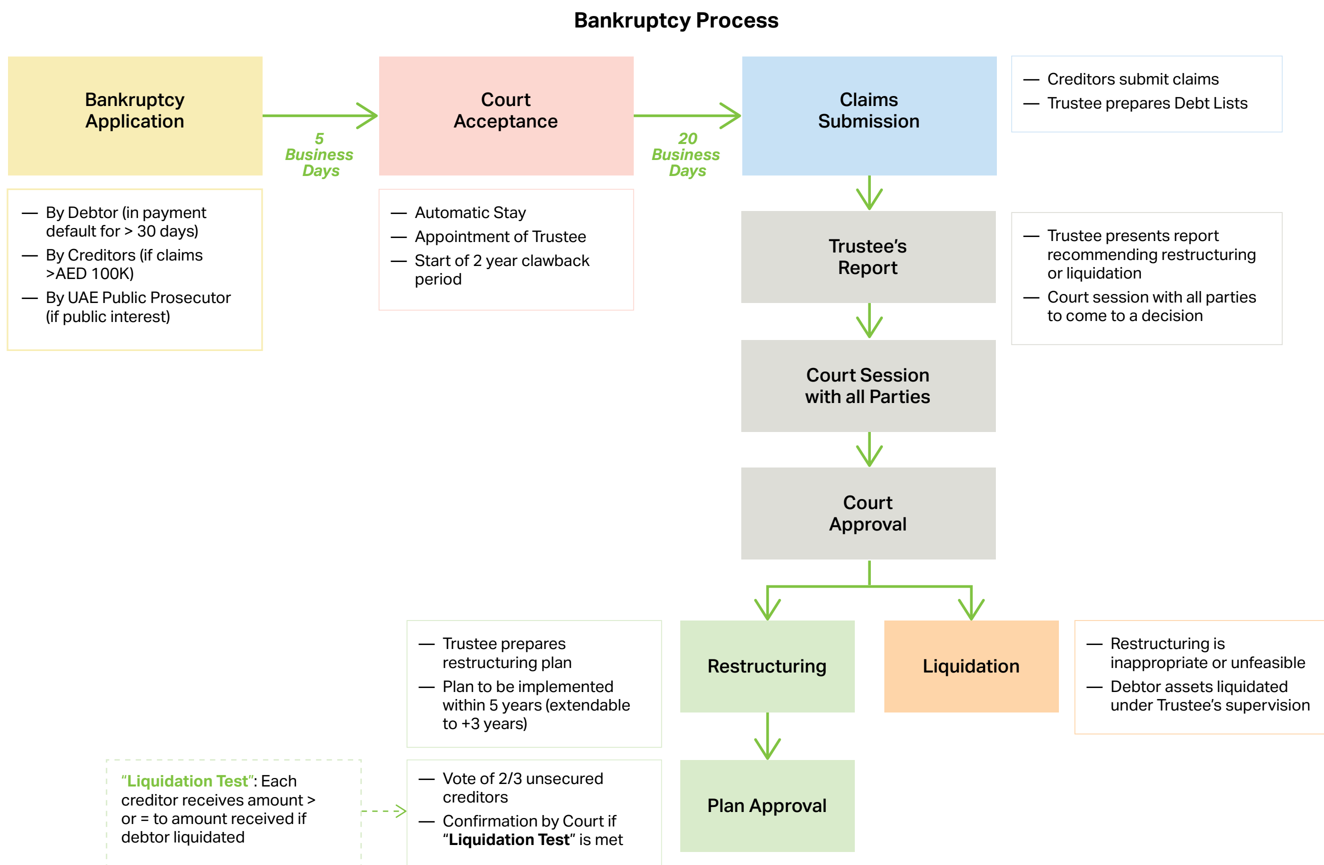
Preparing and Adopting the Preventive Composition Plan

The trustee shall, with the debtor's cooperation and input, prepare a draft preventive composition plan and submit it to the court within 45 business days of the court's decision to accept the application for preventive composition, which period can be extended by up to a further 20 business days with the consent of the court. The preventive composition plan should outline, among other things, the profitability prospects of the debtor, the possibility of converting the debt into equity of the debtor and a timeline for the implementation of the plan, which should not exceed three years subject to an extension for a further three years with the approval of unsecured creditors holding at least two-thirds of the then unpaid debts.

With the permission of the court, the preventive composition plan will be voted on by the unsecured creditors and can only be approved by a two-thirds majority vote of such creditors. Upon such approval, the preventive composition plan will be sent for final approval by the court, which will also decide on any objection to the preventive composition plan raised by a creditor. In approving the preventive composition plan, the court must be satisfied that each affected creditor will receive an amount not less than what it would have otherwise received had the debtor been liquidated at the time of the vote (the "**Liquidation Test**"). Once finally approved by the court, the preventive composition plan binds all unsecured creditors. Note that secured creditors are not permitted to vote on the preventive composition plan and are not bound by an approved preventive composition plan, unless they waive their security in advance of the vote, which waiver will only take effect if and when the preventive composition plan is approved.

Bankruptcy

The New Bankruptcy Law introduced substantial reforms to the bankruptcy regime in the UAE. Bankruptcy proceedings will no longer necessarily lead to a liquidation of the debtor under the New Bankruptcy Law, as was the case under the old regime. Rather, the bankruptcy proceedings will primarily aim to restructure the debts of the insolvent debtor with a view to rescuing it as a going concern. The debtor will only be declared bankrupt or liquidated, in the case of corporate debtors, where a restructuring proves or is deemed inappropriate.



Initiating the Bankruptcy Proceedings

The bankruptcy proceedings can be initiated by the debtor, the creditors or the Office of the Public Prosecutor in the UAE. A debtor must apply to the court to initiate bankruptcy proceedings if it is in default of paying its debts for more than 30 business days due to financial difficulties. A debtor's failure to initiate bankruptcy proceedings in this circumstance is no longer a criminal offence as was the case under the old regime.

For unsecured creditors to be eligible to apply to the court to initiate bankruptcy proceedings against the debtor, the New Bankruptcy Law requires that the value of the debt of such creditors be greater than AED 100,000 (USD 27,174).[4] However, the New Bankruptcy Law retained the requirement in the old regime that the creditors must first serve the debtor with a 30-day written request to pay the debts before initiating bankruptcy proceedings. The Public Prosecutor can initiate bankruptcy proceedings against an insolvent debtor if it determines that it is in the public interest.

In determining whether a debtor is insolvent, the New Bankruptcy Law applies a balance sheet test, as opposed to the cash flow test traditionally used in the UAE. According to the current test, a debtor is deemed insolvent if it appears that its assets do not, and will not at any time, cover its due liabilities.

The court will decide on the application to initiate the bankruptcy proceedings on an *ex-parte* basis within five business days from the submission thereof. In deciding on the bankruptcy application, the New Bankruptcy Law empowers the court to order any person with information relevant to the request to provide the court with any reasonable information it may request. A similar provision applies for an application for preventive composition. It is unclear to what extent this obligation overrides legal privileges such as the attorney-client privilege as attorneys may well be expected to be in possession of such relevant information under privileged circumstances.

Acceptance of the Application
If the court accepts the application, it will appoint one or more trustees to supervise the proceedings. The rules for appointing trustees in bankruptcy proceedings are similar to the rules for appointing trustees in the preventive composition proceedings, described above. Similarly, once the application is accepted, a moratorium will be imposed on all claims and enforcements proceedings against the debtor unless the court decides otherwise.

The New Bankruptcy Law designates the two-year period preceding the decision to accept the bankruptcy application as a "suspicion period" for clawback purposes and reviews all transactions conducted by the debtor during this period. Transactions occurring during this period, which are determined by the court to have been carried out with no consideration or to have been undervalued, will not be enforceable against other creditors unless with court authorization.[5] The statutory determination of a fixed two year "suspicion period" represents a more conservative approach compared to the previous regime, which allows the courts to designate a "suspicion period" of less than two years.

A court's approval of the bankruptcy application will automatically invalidate any set-off of new debts arising after such approval with creditors' claims, unless such set-off is approved by the court or included in the restructuring plan.

The trustee will publish the decision to initiate the bankruptcy proceedings in two daily newspapers that are widely circulated in the UAE and will invite the creditors (including secured creditors) to submit their claims together with the supporting documents within 20 business days of the date of the publication of the decision.[6] The trustee will then prepare a list of creditors and their claims (the "**Debts List**") and submit it to the court within 10 business days, which will again be published in two daily widely circulated newspapers. The court will hear any objection from the debtor or other creditors on the Debts List and decide on it within seven business days.

Based on its review of the Debts List and the debtor's resources, the trustee will prepare a report outlining whether the restructuring of the debtor's debts is feasible, or if the debtor should be declared bankrupt and, in case of corporate debtors, liquidated. The court will then hold a session with the trustee, the debtor and the creditors included in the Debts List to decide whether to restructure the debts of the debtor (provided the debtor so agrees), or to declare the debtor bankrupt. The two potential outcomes of the proceedings are considered below.

Debt Restructuring Proceedings
If the court decides to restructure the debts of the debtor, the trustee will prepare a draft restructuring plan within three months of the date of the court decision, which will outline the same elements as the preventive composition plan (e.g. profitability prospects of the debtor and the possibility of converting the debt into equity). The restructuring plan must include a timeline for its implementation, not exceeding five years, which can be extended for up to a further three years with the approval of two-thirds of the unsecured creditors. The draft restructuring plan will be voted on by the unsecured creditors who were included in the Debts List and, if approved by a two-thirds majority vote, will be referred to the court for a final approval. As with the preventive composition plan, secured creditors are not allowed to vote on the restructuring plan unless they waive their security, effective from the approval of the restructuring plan. The court will approve the restructuring plan if it meets the Liquidation Test.

As with the preventive composition proceedings, the debt restructuring proceedings will impose an automatic stay on all criminal proceedings against the debtor predicated on issuing bounced cheques.

Liquidation Proceedings
The New Bankruptcy Law provides for an exhaustive list of events that can lead to declaring the debtor bankrupt (and, in case of corporate debtors, liquidated), all of which imply that debt restructuring is either inappropriate or unfeasible. These events are:

a. if the court terminates the preventive composition proceedings because the preventive composition plan proved impossible to achieve or because the debtor has been in default for more than 30 business days due to its insolvency;

b. if the bankruptcy application was made by the debtor in bad faith or with the intention to avoid its financial obligations;

c. if the restructuring of the debts is deemed inappropriate for the debtor based on the trustee's report;

d. if the restructuring plan is not approved by the required creditor majority vote;

e. if the court disapproves the restructuring plan (including if it does not meet the Liquidation Test); or

f. if the court terminates the restructuring plan (including due to the debtor's commission of a bankruptcy-related crime or its inability to meet the conditions of the restructuring plan).

If the debtor is declared bankrupt, its assets will be liquidated under the trustee's supervision and all future obligations will become due.[7]

Other Notable Issues

Liability of Directors of a Bankrupt Company

Despite the New Bankruptcy Law's attempt to restrict the criminal liability of the debtor in certain bankruptcy-related offences, directors of insolvent companies are still subject to certain civil and criminal liabilities if the company is declared bankrupt and if the directors are deemed to have contributed to the company's bankruptcy.

For instance, if the assets of the bankrupt company are insufficient to satisfy at least 20% of its debts, the court may require the directors, jointly or severally, to pay the company's debts. Furthermore, the court may order the directors to pay a portion of the company's debts if it finds that, within two years from the date of accepting the bankruptcy application, the directors carried out the company's business without due risk assessment, entered into transactions with third parties that are undervalued, or paid any of the company's debts with a view to prejudicing other creditors.

Directors may be criminally liable for imprisonment and a fine for criminal conduct leading to the bankruptcy of the company or fraudulent conduct during the bankruptcy proceedings[8]. For the purposes of such criminal liability, any of the company's employees who effectively participates in the decision making process is deemed to be a "director". This also extends to any "shadow directors" whose instructions the directors are accustomed to following.

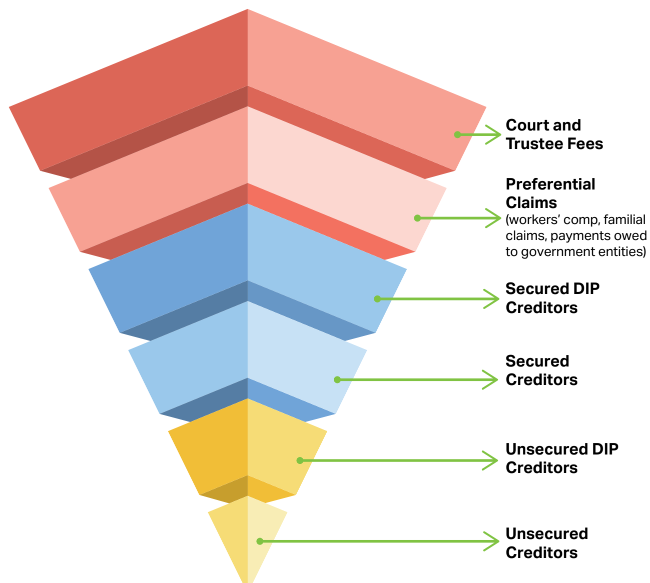
Applying for New Financing

In line with the objective of protecting a debtor from liquidation and rescuing it as a going concern, the New Bankruptcy Law introduced new provisions regulating the extension of new financing to a debtor who is subject to preventive composition or debt restructuring proceedings, similar to a debtor-in-possession (DIP) financing. The new financing must be approved by the court and the debt arising therefrom (the "**New Debt**") will take precedence over other unsecured debts of the debtor. The New Debt can also be guaranteed by any of the assets of the debtor; provided that such asset is not otherwise subject to any liens, or is subject to a lien guaranteeing a debt of a lesser value than the value of the asset, in which case the New Debt will rank below such existing lien. The court may exceptionally allow the New Debt to be guaranteed by a security ranking *pari passu* with or higher than an existing security if the court is satisfied that the New Debt will not prejudice the holder of the existing security.

Payments Waterfall

In the case of a preventive composition plan or the restructuring plan, The New Bankruptcy Law gives first priority to court and trustee fees. Payments approved by the court or the trustee after the approval of the preventive composition or debt restructuring plan come second, followed by unsecured DIP financing, and lastly, payments to the unsecured creditors in accordance with the preventive composition plan or the restructuring plan. As noted above, the preventive composition plan or restructuring plan does not bind secured creditors, unless they waive their security, in which case such creditors will rank *pari passu* with unsecured creditors.

Payments Waterfall



If the debtor is declared bankrupt and is to be liquidated, the trustee will deduct reasonable fees and expenses incurred in connection with the sale of the secured asset from the sale proceeds before distribution to the secured creditors, as appropriate. Secured creditors will have priority over new secured DIP creditors, unless the original secured creditors agree at the time the new DIP financing is obtained that the right of the DIP creditors should rank higher than or *pari passu* with their rights over the relevant security. Any surplus after the secured creditors are repaid in full will be distributed among the unsecured creditors. Note that secured creditors who are unable to realise the full debt from the proceeds of the sale of the security will become unsecured creditors in respect of the outstanding amount.

Scorecard of UAE's Current Insolvency Regime

Experience Level: Recently approved law or no established precedents

KEY PROCEDURAL ISSUES	
Can bondholders/lenders participate directly? (i.e., do they have standing to individually participate in a proceeding or must they act through a trustee/agent as recognized creditor?)	Yes
Involuntary reorganization proceeding that can be initiated by creditors?	No
Can creditors propose a plan?	No, but creditors can propose changes to the plan proposed by the debtor and the trustee
Can a creditor-proposed plan be approved without consent of shareholders?	N/A
Absolute Priority Rule?	Yes
Are ex parte proceedings (where only one party participates and the other party is not given prior notice or an opportunity to be heard) permitted?	No
Are corruption/improper influence issues a common occurrence?	N/A (as this is a new regime, there are no established precedents)
Viable prepackaged proceeding available that can be completed in 3-6 months	No, there is no separate prepackaged bankruptcy regime other than the debt restructuring procedure
Secured creditors subject to automatic stay?	Yes, but secured creditors can apply to court for permission to enforce their securities
Creditors have ability to challenge fraudulent or suspect transactions (and there is precedent for doing so)	Yes, but there are no precedents as this is a new regime
Bond required to be posted in case of involuntary filing or challenge to fraudulent/suspect transactions?	No
Labor claims can be addressed through a restructuring proceeding	Yes
Grants super-priority status to DIP Financing?	No
Restructuring plan may be implemented while appeals are pending?	Yes
Does the restructuring plan, once approved, bind non-consenting (or abstaining) creditors?	Yes
Does the debtor have the ability to choose which court in which to file the insolvency proceeding (or is it bound to file where its corporate domicile is)?	Not specified, and will be based on the relevant local civil procedure laws
Management remains in place during proceeding?	Yes
Other significant exclusions from automatic stay?	No
Prevents voting by intercompany debt?	Not specified
Strict time limits on completing procedure?	Yes

The New Bankruptcy law includes a class of "privileged debt", which is to be paid in the following order: court and trustee fees, certain categories of workers' compensations, familial claims, payments due to government entities and payments made after the approval of the bankruptcy application, as approved by the court or the trustee. Privileged debt will rank ahead of all other unsecured creditors but the law is silent on whether all privileged debt will rank ahead of secured debt, save for trustee fees, which are expressly given first priority in a bankruptcy.

Conclusion

The government of the UAE set out to introduce a more sophisticated, streamlined and widely used bankruptcy regime that eases the restructuring of companies, supports troubled businesses, mitigates bankruptcy risk and ensures a safe and attractive business environment in the UAE. The law was highly anticipated by businesses and advisors alike. While it is still early to assess the success of the regime, there are a number of issues that have not been addressed by the law. For example, the inability to bind secured creditors may undermine large corporate restructurings. There is also still no consolidated regime that addresses personal bankruptcies. On the whole, it is expected that the introduction of the preventive composition and debt restructuring options, which allow for a rescue of the debtor facing bankruptcy, will go a long way to aid struggling businesses. ■

1. Federal Decree Law No. 2/2015.
2. For example, Clause 22.5(e) of the LMA Standard Form Single Currency Term Facility Agreement for Developing Market Jurisdictions states that the borrower will be deemed in default if any member of its group "by reason of actual or anticipated financial difficulties, commences negotiations with one or more of its creditors…with a view to rescheduling any of its indebtedness."
3. This question may still be relevant even if a non-UAE court is deciding upon the validity of a clause designating restructuring of the borrower's debts as an event of default in a credit agreement closely connected to the UAE (e.g. concluded between two UAE parties). For example, a court in a European Union jurisdiction applying the Rome 1 Regulations might invoke Article 3(1) of the Rome 1 Regulations to uphold the UAE rule invalidating such a designation of event of default, notwithstanding the provision of the law chosen by the parties in the agreement. Article 3(1) of the Rome 1 Regulations states that "*where all other elements relevant to the situation at the time of the choice are located in a country other than the country whose law has been chosen, the choice of the parties shall not prejudice the application of provisions of the law of that other country which cannot be derogated from by agreement.*"
4. This threshold amount can be amended by a decision from the Council of Ministers. The USD equivalent is based on an exchange rate of 3.68 AED to 1 USD.
5. This also includes granting a guarantee to a creditor for a pre-existing loan.
6. A creditor who fails to submit its claim within this timeline may still submit it to the trustee who may accept it and include it in the Debts List if there was an acceptable reason for the delay in submitting the claim.
7. The court may discount a portion of the future obligations if such portion was not subject to interest.
8. Such conduct includes concealment of any of the company's records, misappropriation of its assets, fraudulently admitting non-existing loans, fraudulently entering into preventive composition or debt restructuring for the company, misrepresenting the company's capital, declaring illegal dividends or bonuses, overspending on speculative transactions, failing to keep records as prescribed by law, or granting one of the company's creditors a guarantee or other advantage to induce it to accept a preventive composition or debt restructuring proceedings.
9. But creditors can propose changes to the plan proposed by the debtor and the trustee.
10. New regime.
11. No separate prepackaged bankruptcy regime other than the debt restructuring procedure described.
12. But secured creditors can apply to court for permission to enforce their securities.

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