A WAY OUT

The UAE's new federal bankruptcy law will usher in a modernised rescue process for distressed companies, say Adrian Cohen and Melissa Coakley

Over the past two years, the federal government of the United Arab Emirates (UAE) has been working on a widely publicised overhaul of its insolvency legislation. The reforms aim to de-stigmatise the scarcely used bankruptcy process, moving towards a more debtor-friendly rescue and rehabilitation regime.

A significant move towards achieving a change in wider public perception to financial difficulties arose last year, when the UAE government announced that criminal sanctions for dishonoured cheques would be abolished, and local media are regularly reporting calls from the business community for a new, modernised rescue process for companies in distress. Currently, the draft bankruptcy law is undergoing a consultation process. It is hoped that legislation will take effect within the next 18 months.

The existing bankruptcy regime

The principal criticism levied at the existing UAE bankruptcy law is that it lacks a viable rescue procedure that could be used by a large corporate with secured creditors. Key areas of difficulty identified within the existing UAE bankruptcy law (which was last updated in 1993) are:

- High entry barriers for embarking on an insolvency process (ie the information to be provided to the court upon filing is document-intensive and mandatory filing deadlines are relatively short);
- The insolvency test is based upon whether a debtor has entered a 'cessation of payments', which is difficult to objectively quantify;
- Secured creditors cannot be bound into the insolvency procedures contained within the UAE bankruptcy law without their consent;
- Lack of moratorium against security enforcement during the bankruptcy process;
- The protective composition procedure prescribes that any restructuring plan must provide for repayment of 50% of debt within three years;
- Treatment of preferential creditors versus unsecured creditors is unclear;
- Differing interpretations of the operation of 'set-off' following bankruptcy; and
- The crossover between the formal bankruptcy provisions contained in the UAE bankruptcy law and the liquidation regime contained within UAE companies law is unclear.

The new bankruptcy law

In attempting to address the issues highlighted above, the draft bankruptcy law does not attempt to abandon the strong influence of French law that underpins UAE legislation. Instead, it seeks to build in modern French legal concepts, along with elements of best practice derived from German, English and US insolvency legislation.

Application of the new law

The new proposed law will apply to corporate entities and individuals trading for profit (such as lawyers and accountants) across the UAE, with certain key exceptions, such as governmental bodies, commercial banks, insurance companies and companies incorporated within free zones, which have their own insolvency law, such as the Dubai International Financial Centre. The law also prescribes a new insolvency regime that applies to individuals or 'civil debtors' not previously captured under federal bankruptcy law.

Entry into a corporate insolvency process

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

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The existing UAE bankruptcy law was last updated in 1993, and now requires further modernisation in order to provide a viable mechanism for UAE companies with secured creditors to rehabilitate and restructure. Despite the recent global financial crisis, no UAE companies have used the existing UAE bankruptcy law as a platform for restructuring – this lack of legislative framework can lead to inertia in restructuring discussions and limited options for distressed companies and their creditors.

In recognition of this, the UAE government is currently engaged in an ambitious legal reform programme to: (i) seek to align the UAE insolvency laws with international best practice; and (ii) promote a rescue culture, which will benefit the wider UAE economy.

balance sheet insolvency test has been introduced, which is based on the German 'over-indebtedness' test, whereby the assets of a debtor do not cover their current liabilities.

- A company is obliged to make an insolvency filing if it has been (i) in a state of 'cessation of payments' of due and payable debts; or (ii) in a state of 'over-indebtedness' for 45 consecutive days. But the 'over-indebtedness' test prescribes that even if an entity's liabilities are greater than its assets, the requirement to file for bankruptcy may, in certain circumstances, be suspended if the continuation of the company is predominantly likely, for example, if it can be demonstrated that the entity will be able to meet all payment obligations due in the next financial year.
- Before a creditor is able to petition for a company's bankruptcy, a statutory demand in the minimum amount of AED 10,000 must have been served, and must remain unpaid for 45 days.

The number of documents required to accompany an insolvency filing has been reduced, and mandatory time limits for filing have been increased to 45 days following the company becoming insolvent on a cash flow or balance sheet basis (the time limits under the existing law are 20 days in respect of protective composition and 30 days in respect of bankruptcy, in each case following a 'cessation of payments').

New procedures available to a company in distress

The existing protective composition and bankruptcy procedures prescribed within the current legislation have been expanded into the following processes: (i) a private, out-of-court pre-insolvency procedure; (ii) a court-based, debtor-led composition process; and (iii) formal bankruptcy, comprised of a rescue procedure within bankruptcy or liquidation.

A crucial element of the proposed new regime is a move towards heightened involvement of industry experts, or insolvency professionals potentially from private practice, within the bankruptcy processes themselves. The new law envisages the establishment of a Financial Reconstruction and Bankruptcy Commission, which will oversee the legislation and appoint accredited insolvency experts to assist the bankruptcy court with the various procedures.

In terms of the new insolvency procedures themselves:

Financial Reorganisation Procedure – an out-of-court, private *conciliation* process applicable to entities that have not yet formally entered the zone of insolvency, which has the aim of achieving a consensual, private settlement between the parties. An independent mediator with bankruptcy expertise is appointed by the Commission for a period of up to four months (which may be extended with permission of the Commission) to oversee discussions between the debtor and its creditors. Experience from the French law equivalent *conciliation* dictates that the involvement of an official mediator can help to break deadlock situations and avoid more formal court proceedings.

Protective Composition Procedure (PCP) – this follows the French *sauvegarde*, whereby a debtor that is (a) experiencing financial difficulties, but is not yet insolvent; or (b) has been in a state of over-indebtedness or cessation of payments for less than 45 days, proposes a compromise with its creditors outside of formal bankruptcy proceedings. Critically, the PCP includes a moratorium on creditor action (including enforcement of secured claims) and places the debtor under the control of an office holder appointed from the Commission's roll of experts, for an initial observation period of up to three months (which may be extended with the permission of the Commission). Other key tools of the PCP process include the ability to raise debtor-in possession (DIP)-style priority funding, which may be secured on unsecured assets or take priority over existing security and *ipso facto* provisions that prevent the invocation of insolvency-linked contractual termination provisions provided the debtor performs its executory obligations. The debtor is given time to file a plan, which is then voted on by creditors. Classes can be dispensed with when the size of the estate is below a certain threshold.

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

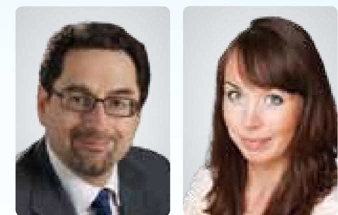
Other features of the new procedures

The new bankruptcy law also contains some additional clarification with respect to set-off arrangements, providing a linkage to mutual credits, mutual debts and other mutual dealings. A prohibition against the exercise of set-off after the issuance of PCP and bankruptcy proceedings is laid out, as well as a framework for mandatory insolvency set-off as part of liquidation proceedings.

The draft bankruptcy law also includes a section on financial collateral arrangements, which clarifies that (with certain exceptions), the provisions of the new law are not intended to impede the continued operation of such arrangements in accordance with their contractual terms.

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 the support structures introduced to aid its practical application, including implementing regulations, a strong roll of accredited insolvency experts and a publicly accessible central register of insolvency proceedings for the UAE.



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