ONPOINT / A legal update from Dechert
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The UAE Bankruptcy Law: Stepping up to the challenges raised by the COVID-19 crisis

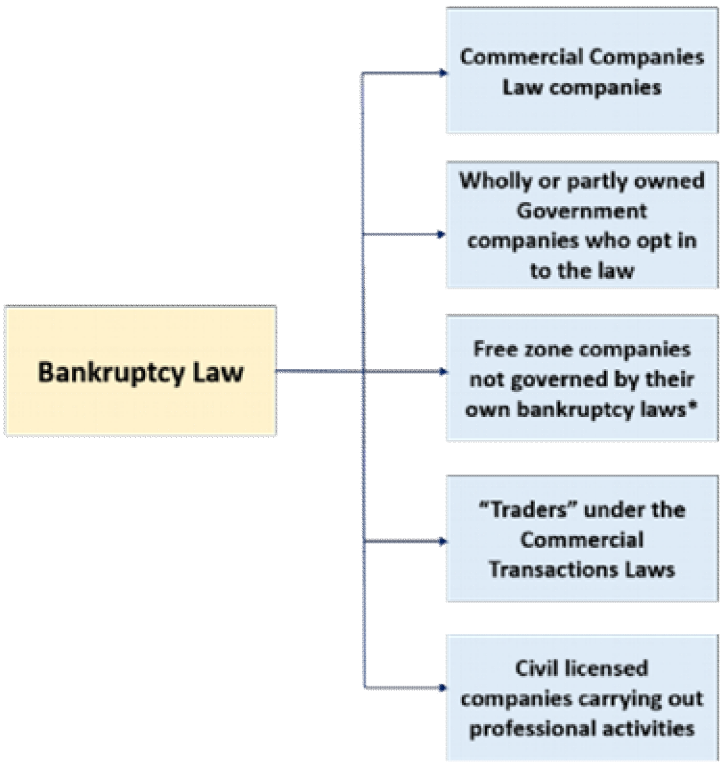
With the significant strain placed on market participants as a result of the combined impacts of the global COVID-19 pandemic, the oil price war and the ensuing liquidity and credit crunches, we expect that a number of enterprises in the United Arab Emirates ("**UAE**") will either be forced to carry out restructurings or otherwise undergo formal court-supervised insolvency processes. As a response to the 2008 Global Financial Crisis (which highlighted that the previous UAE insolvency regime was not adequate in that it did not provide a robust framework for the rescue of distressed businesses), and in line with the UAE Government's push to modernize its business legal framework, the UAE overhauled its bankruptcy regime on December 29, 2016 with the introduction of the New UAE Bankruptcy Law (the "**Bankruptcy Law**").

For the business community and legal practitioners, the Bankruptcy Law was a welcome change as it has streamlined the insolvency procedures available for UAE enterprises in line with international best practice (with certain key elements of the Bankruptcy Law being inspired by modern French insolvency law mechanics and the US bankruptcy regime). Generally, the Bankruptcy Law has destigmatized business failure with a greater focus than previously on turnaround and rescue whenever possible whilst maintaining a high degree of accountability for directors of troubled businesses.

Thus far, the Bankruptcy Law has only been anecdotally applied to a fairly small number of low profile insolvencies but is now likely to be tested on a larger scale both in terms of numbers and size of debtors affected by insolvency proceedings under the Bankruptcy Law. Against this backdrop, this alert is a refresher of some of the key features of the Bankruptcy Law and potential areas of concerns for debtors, their directors and their shareholders (including private equity sponsors who have injected cash in local UAE enterprises).

Application of the Bankruptcy Law

The Bankruptcy Law mainly applies to commercial companies governed by the Commercial Companies Law (Federal Law No.2 of 2015) (that is, generally speaking for-profit commercial enterprises), however, the scope of its application is much wider, as reflected in the below chart:



*The Bankruptcy Law does not apply to enterprises set-up in free zones that have their own standalone bankruptcy regimes such as the financial free zones of the Dubai International Financial Centre and the Abu Dhabi Global Market.

For completeness, we should mention that the UAE also overhauled its personal insolvency rules with the introduction on August 29, 2019 of the Insolvency Law No.19 of 2019 that now provides an enhanced regime for individuals (other than "traders" who fall within the remit of the Bankruptcy Law) facing financial difficulties.

Two court-supervised procedures: PCP vs. Bankruptcy Process

Initial drafts of the Bankruptcy Law provided for an out-of-court procedure (similar to the so-called "conciliation process" or "*procédure de conciliation*" under French insolvency law) for enterprises experiencing financial difficulties but not yet technically insolvent, in line with global trends in insolvency law reform. Except with respect to licensed financial institutions falling under the remit of the 'Financial Restructuring Committee' (See section headed '*Industry Oversight of Insolvencies of Financial Institutions*' below), such a procedure, however, has not been reflected for all categories of debtors across the board under the Bankruptcy Law, as enacted.
The Bankruptcy Law also does not provide a formal framework for "pre-packaged" restructurings (as would be the case under US bankruptcy legislation, for example), although it is possible that an expedited restructuring takes place informally outside the legislative framework (so long as the debtor is not yet technically insolvent and therefore required to initiate formal bankruptcy proceedings).

The Bankruptcy Law repeals certain previous criminal offences and expands the protective composition and bankruptcy procedures into two key court-supervised procedures, as follows:

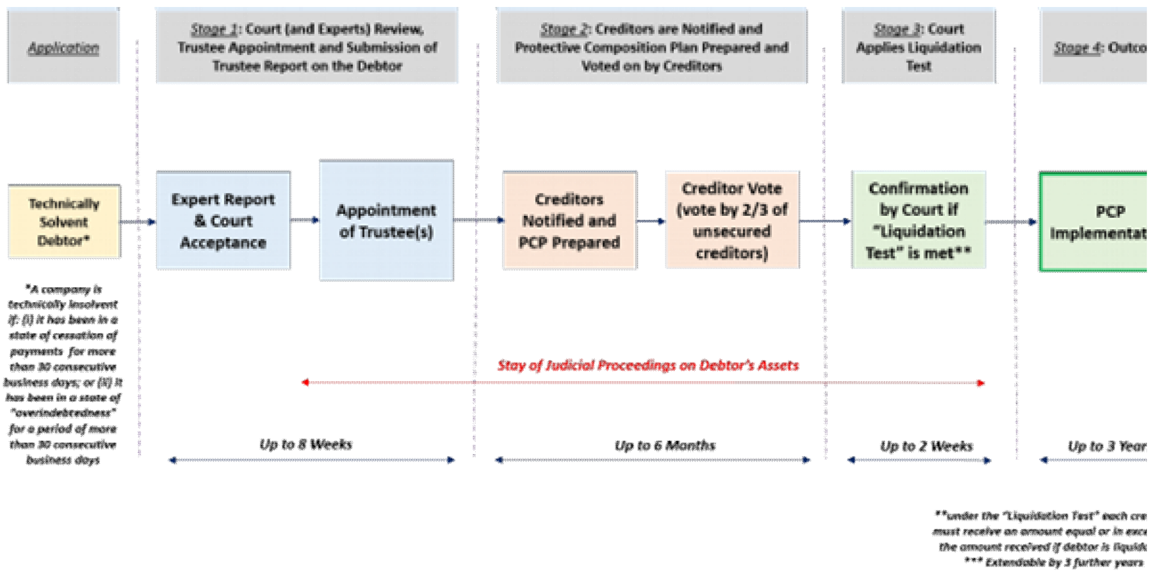
(A) Preventive Composition Procedure (or PCP); and
(B) Bankruptcy, the outcome of which may either be (i) a formal in-bankruptcy rescue procedure or (ii) an insolvent liquidation of the debtor.
Insolvency Tests. The availability of each process to a debtor will depend on the financial standing of the debtor, assessed on the basis of the following two insolvency tests, either of which have to be met (so as to encourage debtors in distress to seek to restructure at an early stage):

- ***Unpaid Debts or traditional "cash flow" Test*** - a debtor is deemed to be 'insolvent' if it has ceased payment of its debts as they fall due for more than 30 successive days; and
- ***Over-indebtedness or "balance sheet" Test*** - a debtor shall be deemed to be in a status of over-indebtedness when the debtor's assets, at any given time, do not cover the debtor's liabilities.

The Bankruptcy Law places an obligation on a debtor to file for bankruptcy within 30 days of it becoming insolvent under either test or, alternatively, the debtor is able to apply for protection within that period.

Preventive Composition Procedure ("PCP")

PCP aims to facilitate the rescue of a business experiencing difficulties (subject to certain conditions being met, as outlined below) by helping a debtor reach a court-supervised settlement with its creditors. As such it is similar to the so-called "voluntary safeguard proceedings" ("*procedure de sauvegarde*") under French insolvency law in that it provides a legal and judicial framework 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. The below chart sets out an overview of the PCP process, together with relevant timelines under the Bankruptcy Law:



Application. The PCP application can be made only by the debtor (and no other interested parties contrary to a bankruptcy application). PCP is only available to a debtor who is experiencing financial difficulties but is not yet technically insolvent (under either of the tests mentioned above) so long as the debtor has not been in payment default for a period of more than 30 business days. Furthermore, PCP will not be available where the debtor is (i) already subject to such a procedure, or (ii) has already entered formal bankruptcy proceedings.

The court must decide within five business days whether to accept or reject the application on an *ex-parte* basis. The court may then appoint an expert to prepare a report on the financial standing of the debtor to assist with its decision. If the court accepts the debtor's PCP application, the debtor will be placed under the supervision of a court-appointed trustee and all bankruptcy proceedings, enforcement actions and other claims relating to the debtor will then be automatically stayed. Once appointed, the trustee will publish the court's decision and invite creditors to submit their claims within 20 business days.

The procedure allows an initial period of 45 business days from publication of the court's decision for the debtor to cooperate with the trustee to prepare and submit a draft PCP. This period may be extended by application to the court.

The draft PCP should outline the debtor's proposals along with the chances of success and a timeline for implementation which must not exceed three years (extendable for another three years with majority creditor approval).

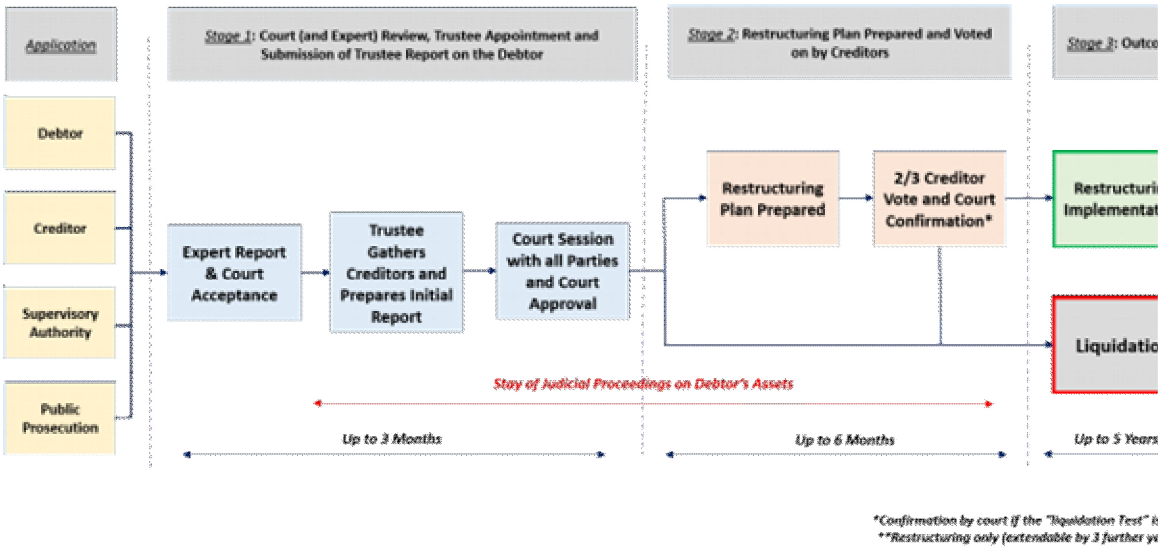
PCP Approval. Once the plan has been reviewed by the court and permission has been granted to convene the creditors' meetings, the plan is then voted on by creditors. All creditors whose debts have been accepted by the court may vote. For the PCP to be approved, a majority of creditors must vote in favor of the arrangement, provided that such majority represents no less than two-thirds of the total debt by value. All unsecured creditors will be bound by the PCP whether or not they participated or took part in the vote for the adoption of the PCP (although such creditors do have opportunity to object to the court). The PCP or restructuring plan does not bind or affect the priority ranking of secured creditors, unless they waive their security in advance, in which case such creditors will be treated the same as and will rank *pari passu* with unsecured creditors. Where the relevant approval threshold is achieved, the PCP is then referred back to the court for final approval. In approving the PCP, 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 so-called Liquidation Test).

During the PCP implementation period, the debtor retains the right to continue running the business under the supervision of the trustee who, if required, has wide powers to act on behalf of the debtor.

Failure by the debtor to comply with the terms of the PCP may lead to an order by the court to convert the proceedings to bankruptcy and liquidate the debtor's assets. Further, the PCP may be annulled in the event of any fraud by the debtor. Otherwise, the PCP ends once the debtor has honored all of its obligations.

Bankruptcy

While there is a finality often associated with companies facing financial difficulties who initiate bankruptcy proceedings, a key difference between the previous regime and the Bankruptcy Law is that such initiation does not necessarily now mean the end of the road for a debtor. Despite the fact that a debtor facing bankruptcy will be in a worse financial situation than those initiating PCP (as noted above, if a debtor is considered insolvent, PCP is not an option and the debtor must proceed with bankruptcy), the Bankruptcy Law obliges the court and others involved to consider the possibility of restructuring before the debtor will be liquidated. The below chart sets out an overview of the bankruptcy process, together with relevant timelines:



Application. An application for bankruptcy can be made by the debtor and in fact, a debtor must file a bankruptcy application if it is technically insolvent (under either of the relevant insolvency tests referred to above). Applications may also be made by the following other parties having an interest:

a. a creditor or group of creditors with an outstanding debt of not less than AED100,000 that has been due and unpaid for 30 successive business days;

b. a competent supervisory authority (if the debtor is subject to supervision by one); and

c. the public prosecution (if making such application is in the public interest).

After the bankruptcy application is submitted, the court, to assist in the evaluation of the debtor's application, may appoint an expert to prepare a report on the financial position of the debtor that shall set out their opinion as to whether (i) a restructuring is possible, and (ii) the debtor's assets are sufficient to cover the costs of the restructuring. The court must then decide whether to approve the application and start bankruptcy proceedings.

If the court decides to commence bankruptcy proceedings, the court will appoint a trustee (or trustees) with broad powers to manage the business of the debtor.

All bankruptcy proceedings, enforcement actions and other claims relating to the debtor are automatically stayed. However, secured creditors must obtain court approval in order to make, or continue to make, claims against the trustee in relation to the specific assets over which they hold security. Once appointed, the trustee will publish the court's decision and invite creditors to submit their claims within 20 business days.

The trustee must then prepare and submit to the court a list of all creditors of the debtor and a report on the debtor's business including his assessment of either restructuring or selling the debtor's business in case of liquidation. If the trustee is of the opinion that there is a reasonable prospect of restructuring the debtor's business, the trustee's report should also be presented to the creditors. The creditors are then given an opportunity to comment on the report and attend a court hearing also attended by the trustee and the debtor. At this hearing the court will examine the report and decide whether to initiate either restructuring proceedings or liquidation.

The court will consider a number of factors to initiate restructuring proceedings, including the debtor's expressed willingness to continue the business and the court's belief that there is a possibility for the debtor's business to be profitable again within a reasonable period.

If restructuring proceedings are initiated, a restructuring report must then be prepared (by the trustee with the assistance of the debtor) and voted on by creditors. For the restructuring to be approved, a majority of the creditors (holding at least two-thirds in debt value) must vote in favor of the arrangement.

The procedural aspects described above in respect of PCP are also applicable to restructuring proceedings but the deadline for implementation of a restructuring is longer – five years which may be extended for another three years with majority creditor approval.

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

Other Important Considerations

Additional Features. The Bankruptcy Law also includes the following additional features that are largely influenced by equivalent provisions in U.S. bankruptcy law:

a. Appointment of a creditor-led supervisory committee to monitor the procedures and implementation;

b. Prevention of insolvency-related contractual termination by the debtor's counterparties following commencement of PCP; and

c. Subject to court approval, the ability to raise new financing including debtor-in-possession (DIP) financing on a secured or unsecured basis in order to allow the business to have sufficient financing to continue during the implementation of the PCP or restructuring plan.

Unwinding Pre-Insolvency Transactions. Certain transactions specifically listed in the Bankruptcy Law (such as security granted for a pre-existing debt or transactions without sufficient consideration) that took place up to a period of two years prior to the commencement of insolvency proceedings may be declared invalid and set aside by the court having considered the interests of the public and *bona fide* third parties.
The court may also declare invalid and set aside any dispositions not listed in the Bankruptcy Law, 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, however, refuse to reverse a 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 reasonably sufficient grounds for the debtor to believe that the transaction would be of benefit to the business.

Debt Repayment Waterfalls. In the context of a PCP or rescue in-bankruptcy restructuring plan, the following debts shall be payable when they are due, in the order set forth below:

- *firstly*, any court fees or costs or any fees or expenses of any court-appointed trustee;
- *secondly*, any court-approved fees, expenses or costs for the purpose of providing the debtor with goods and services, or the continuation of the performance of any contract to the extent that such fees, costs and expenses are beneficial to the debtor's business or assets;
- *thirdly*, any new unsecured court-approved new financing; and
- *fourthly*, payments due to unsecured creditors. As noted above, the PCP or restructuring plan does not bind or affect the priority ranking of secured creditors, unless they waive their security in advance, in which case such creditors will be treated the same as and will rank *pari passu* with unsecured creditors.

If the debtor is to be liquidated, the following order of preference will apply to the distribution of the liquidation proceeds amongst creditors:

- *Firstly*, reasonable fees and expenses incurred in connection with the sale of the secured assets shall be deducted from the sale proceeds before distribution to the secured creditors;
- *Secondly*, the remaining sale proceed will be distributed to secured creditors;
- *Thirdly*, the remaining liquidation proceeds shall be distributed to new financing creditors, unless the original secured creditors agree at the time the new financing is obtained that the right of the new financing creditors should rank higher than or *pari passu* with their rights over the relevant security; and

- *Fourthly*, any surplus after the secured creditors are repaid in full will be distributed among the unsecured creditors.

Preferred Debts. The Bankruptcy Law includes a category of "Preferred Debts" which are expressly stated to rank ahead of all other unsecured creditors but the law is silent, however, on whether all Preferred Debts will rank ahead of secured debts or any new financing (except for trustee fees which are given first priority in bankruptcy, as noted above). Preferred debts are to be paid in the following order: (i) court costs and fees, including trustee's and experts' fees, (ii) the outstanding end-of-service gratuity, wages and salaries of the debtor's employees, which are payable on a regular basis (excluding any allowances or bonuses), provided that the total thereof shall not exceed the wage or salary for (3) three months maximum, (iii) familial claims, (iv) payments due to government entities, and (v) payments approved by the court or the trustee made after the approval of the bankruptcy application.

Industry Oversight of Insolvencies of Financial Institutions

The Bankruptcy Law anticipated the formation of a separate process for financial institutions and indeed just over a year after the entry into force of the Bankruptcy Law, Cabinet Resolution No. 4 of 2018 was published. Such resolution represents a significant milestone as it introduces the novel concept in the UAE of an out-of-court restructuring process, specifically for licensed financial institutions facing financial difficulties (being, a "**Financial Restructuring**").
The Resolution confirmed the formation of a 'Financial Restructuring Committee' (the "**Committee**") and the functions of the Committee, the remit of which shall be to administer the Bankruptcy Law, oversee Financial Restructurings and maintain various registers and rolls of experts under the Bankruptcy Law. More particularly, the Committee's functions are as follows:

a. Review and decide on applications for Financial Restructurings;

b. Ensuring the procedure for Financial Restructuring facilitates agreement between financial institutions and their creditors;

c. Approving the list of experts that may be appointed as part of the procedure, including the requirements of registration of such experts;

d. Setting a schedule of the fees and expenses of the appointed experts; and

e. Regularly reporting of its work to the Minister of Finance.

Applications for a Financial Restructuring by a financial institution may be submitted directly to the Committee if the relevant institution is facing financial difficulties provided it meets the following conditions: (i) it is not insolvent; (ii) it is not already subject to PCP or bankruptcy procedures; and (iii) it has not been subject to Financial Restructuring procedures during the year preceding the application.

If approved by the Committee, an expert will be appointed whose role will be to assess the economic and financial status of the financial institution, facilitate a consensual agreement between it and its creditors; and to provide proposals in order to continue the business and retain employees. In our view, the introduction of a separate process (and the mediation of the Committee) for financial institutions represents a significant step in the right direction to handle the specific challenges typically arising in complex bank restructurings (but ideally should be supplemented by a standalone bankruptcy regime for banks).

Directors' Liability. The Bankruptcy Law has retained many aspects of the previous regime of potential civil and criminal liabilities for the directors, general managers and "shadow directors" where any of them have contributed in some capacity to the insolvency of an enterprise. Fraudulent conduct leading to the bankruptcy of a company, or fraudulent conduct following the entry into bankruptcy proceedings, can result in up to five years' imprisonment and fines of up to AED 1,000,000. A sliding scale of punitive measures is included for other mismanagement or wrongful conduct which the court finds has accelerated the failure of the company or otherwise caused losses to creditors, including in respect of acts which occurred within the insolvency proceedings themselves.
The defenses available to such persons in respect of any of these acts (other than fraudulent acts) shall be: (i) taking all the precautionary measures possible to minimize the potential losses to the debtor's assets and to creditors; and (ii) a director expressing reservation in relation to such acts which was not accepted by the other directors.

The Bankruptcy Law provides that on a liquidation where the company's assets are insufficient to cover at least 20% of its liabilities, the directors may be ordered to pay a contribution to all or part of the company's debts, where their contribution to the losses has been established.

Directors in the UAE will generally have full power to carry out the affairs of a company unless restricted by the company's constitutional documents, a contract or other internal regulations. The overarching principle is for the directors to act in the best interests of the company and to exercise a standard of care and diligence in performing their role that a "prudent" person in a similar position would exercise. This is an objective test on which to measure a director's conduct and quality of decision-making. Again, it is likely that a director of a company in financial difficulty may find that their decisions leading up to a formal insolvency process are very closely scrutinized against this standard.

Finally, directors of insolvent companies or companies undergoing stress should be mindful that the "interests" that the directors require to protect are not just those of shareholders but rather extend to other stakeholders including creditors, suppliers and employees. Against this backdrop, it will be particularly important for directors to ensure that they carefully consider their decisions and sufficiently document their decision-making process.

Bounced Checks. The UAE Penal Code provides that the drawer of a dishonored check (i.e. the individual who signs the check) may be sentenced to detention or fined (it being noted, however, that the public prosecutors have the ability to downgrade the punishment for bouncing a check of low value (AED 200,000 and below), to only a nominal fine without any jail time). Such detention may be for a period not less than one month and not more than three years. The Bankruptcy Law helped to modernize the approach towards dishonored check in the UAE. For example, if criminal proceedings for a bounced check are brought against an individual (who has signed on behalf of a company), and preventative, formal insolvency proceedings have been commenced in respect of that company, the criminal proceedings against the individual will be put on hold pending the outcome of the preventative proceedings.

Conclusion

The Bankruptcy Law represents a significant improvement over the previous regime available in the UAE with a more modern approach focused on the rescue and turnaround of strained businesses (and liquidation being viewed as a last resort after other options have been explored). The success of the new regime, however, will largely depend ultimately on how effectively it is used in practice, especially as it heavily relies on local courts (and the law did not establish bankruptcy courts with a specialized bench) and court-appointed trustees and experts. We also very much welcome the introduction of an out-of-court process for licensed financial institutions (and would support the extension of such processes to other categories of debtors). While the law has generally moved away from the previous approach which criminalized the liquidation process, one area of concern is that directors of the debtor continue to be personally exposed to serious criminal penalties. It is therefore important to take appropriate steps and seek expert advice early before serious difficulties arise.

RECOMMENDATIONS FOR DIRECTORS OF COMPANIES IN DISTRESS:

- Directors of companies under financial stress should:
    - Make themselves aware of the risks involved in taking any action: whether it be to continue to trade, seek a turnaround or file for bankruptcy;
    - Familiarize themselves with their statutory duties, and in particular, the shift of their statutory duties to other stakeholders (employees, creditors, suppliers and not just shareholders) in the "zone of insolvency".
- Directors and shareholders (especially financial sponsors) should retain early on their own legal counsel (in addition to the debtor's own counsel) when difficulties start to arise.
- If a bankruptcy or liquidation of the debtor is ultimately reached the actions of its directors during the preceding period will undoubtedly come under close scrutiny.

RECOMMENDATIONS FOR COMPANIES EXPERIENCING DIFFICULTIES:

- Companies experiencing difficulties should not wait until they are technically insolvent (and have no other choice but to file for bankruptcy) to assess potential turnaround options (including, for example, a sale to a strategic buyer, the sale of non-core assets, out-of-court debt restructuring).

- Companies are advised to have robust financial controls and reporting in place to ensure that: (i) they are not technically insolvent (under either of the insolvency tests under the Bankruptcy Law); (ii) they have not defaulted for more than 30 days on any material payment obligation, or (iii) have not breached any covenant (including financial covenants) under loan documentation.
- **Do not wait until it is too late to assemble a team of experts (lawyers, accountants and financial advisors) to advise the company and its board.**