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Client Alert Commentary

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COVID-19: Managing Financial Difficulties in the United Arab Emirates

Understanding bankruptcy laws in the UAE and DIFC in the context of COVID-19-related financial pressures.

COVID-19 has already caused wide-scale disruption to numerous industries both locally and globally. Whilst efforts are underway to stop the spread and impact of COVID-19, the financial and social impact of the virus will be felt for many months to come. As companies come to terms with working from home arrangements and the new landscape in which they operate, some business inevitably will experience financial difficulties (be it short term or longer term). Governments are releasing stimulus packages which will, no doubt, go some way to assuage some of the impact but given the global impact of the virus it is likely that some businesses will face difficult decisions.

Directors of companies should seek legal advice as soon as possible to plan their response to any financial difficulties. Not only will seeking legal advice allow directors to take advantage of the many options available to them under United Arab Emirates (UAE), Dubai International Financial Centre (DIFC) and, where applicable, international law, but also to understand their own position in their capacity as directors — for example, the UAE Bankruptcy Law imposes a number of offences and penalties that may apply to directors and these penalties can lead to up to five years imprisonment, fines of up to AED1 million and disqualification from being able to act as a director. Directors, therefore, must start planning now. Under both DIFC and UAE insolvency laws, certain transactions (*e.g.*, granting security for existing debt / disposals without adequate consideration) within a two year window may be unwound by the courts and the directors held liable for these transactions. Obtaining legal advice at the onset of financial difficulties is imperative for directors to ensure that they are acting in the best interests of the company and implementing best practices as soon as possible.

This *Client Alert* offers a brief snapshot of the current insolvency laws in the UAE and DIFC.

UAE Bankruptcy Law Overview

The UAE Bankruptcy Law came into force on 29 December 2016, aiming to modernise and streamline the bankruptcy procedures that are available onshore for UAE companies in line with international best practice. The law aims to provide businesses with financial difficulties the means to engage with their creditors whilst ensuring accountability for directors of failed enterprises.

Until this law came into force, the UAE had no single source of law governing bankruptcy procedures. The insolvency regime was spread across multiple sources, was rarely used, and did not reflect the growing trends toward restructuring. Since the financial crisis of 2008-2009, the previous fragmented law had come under greater scrutiny and was criticised for being impractical and outdated. There were calls to make the regime more user-friendly and to promote restructuring.

The UAE Bankruptcy Law applies to corporate entities and individuals trading for profit but does not apply to government bodies or companies trading in free zones (such as the DIFC and Abu Dhabi Global Market (ADGM), which have their own insolvency laws). A Financial Restructuring Committee has been established by the UAE Bankruptcy Law that is responsible for monitoring the implementation of the law — The committee is designed to ensure that the approach taken to restructuring under the new law is commercial, modern, and industry-focussed — responding to specific criticisms of the previous regime.

The regime offers two court procedures:

- First, a court-based distressed company-led process which can be used by a company that is in financial difficulties but is not yet technically insolvent (known as a protective composition)

- Second, a formal bankruptcy that is split into a rescue process (similar to the protective composition) or liquidation

The Protective Composition Procedure (PCP) allows a company in financial difficulties to reach a binding agreement with its creditors as an alternative to filing for bankruptcy — hopefully a positive change that enables companies and directors to deal with declining financial performance as early as possible. The formal bankruptcy includes a rescue process that is similar to a protective composition and liquidation — — *i.e.*, the sale of the assets of the companies to meet the debts due.

The PCP follows the French "sauvegarde" model, where a debtor experiencing financial difficulties but is not yet insolvent, or has been in a state of over-indebtedness, or has ceased making payments for fewer than 30 consecutive business days, proposes a compromise with its creditors. A PCP application can only be made by the debtor or the court; it cannot be made by creditors. Once the debtor has applied for a PCP, the court will appoint an expert to review the debtor's financial condition and determine if the conditions for a PCP have been met and whether the debtor has sufficient funds to cover the costs of the PCP process. If the court accepts the application, a moratorium on creditor action immediately applies (albeit the moratorium does not prevent the enforcement of secured claims which can still occur with the court's permission). The debtor is placed under the control of one or more officeholders for an initial observation period of three months (which may be extended). During a PCP, the debtor continues to manage its business, albeit under the supervision of the officeholder. The debtor then prepares a restructuring plan under the supervision of the officeholder — the law provides that the duration of the restructuring plan should not exceed three years (unless approved by the majority of creditors). Once the court approves the plan, the plan is then put to a creditor vote — approval from a majority representing at least two-thirds in value of each class of creditor is required. Dissenting creditors are still bound by the plan if the requisite majority approves the plan.

Those familiar with the US/UK equivalents will note that there are no cram-down provisions, however there are some features found in the US bankruptcy law:

- Debtor-in-possession priority funding is permitted which may be secured or unsecured
- “Ipso-facto” provisions which prevent contractual counterparties from using insolvency-linked termination provisions provided the debtor complies with its obligations under the plan
- A supervisory creditor committee may be appointed

The formal bankruptcy regime includes (i) a rescue process similar to PCP, and (ii) a formal liquidation process. Bankruptcy may be applied for by the debtor or creditors — once it is applied for, the court appoints an expert to assess the financial condition of the debtor and ascertain whether the conditions for bankruptcy have been met. If the court accepts the application, a moratorium on creditor action immediately applies (albeit, again, the moratorium does not prevent the enforcement of secured claims which can still occur with the court’s permission). The debtor is placed under the control of one or more court appointed officeholders. The bankruptcy process is then made public and creditors are invited to submit proofs of claim to enable voting on any restructuring plans. The officeholder takes over the management of the company with wide powers to preserve assets and manage the business of the company. The officeholder prepares a report confirming whether there is a reasonable prospect of restructuring the debtor, preparing a restructuring plan and detailing whether a sale of all or part of the business as a going concern could be likely if the debtor goes into liquidation. Once the court is satisfied with the report it is provided to the creditors for comment. A hearing is then scheduled where the court will determine whether a restructuring plan should be prepared or whether the debtor should be subject to a formal liquidation. If the court orders a restructuring plan to be prepared, the process above for PCP largely applies, *i.e.*, the plan is then put to a creditor vote — approval from a majority representing at least two-thirds in value of each class of creditor is required — dissenting creditors are still bound by the plan if the requisite majority approves the plan.

Certain transactions (*e.g.*, granting security for existing debt / disposals without adequate consideration) which take place within a two year window prior to the start of insolvency proceedings may be declared as invalid and unwound by the courts if 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 this transaction causes some detriment to other creditors. Directors may have personal liability in relation to such transactions so obtaining legal advice at the onset of financial difficulties is key.

Given the previous regime on insolvency, troubled companies and their debtors typically had few options other than to negotiate a consensual settlement or reorganisation to avoid a stalemate. The UAE Bankruptcy Law tries to establish a more modern framework based on international best practice, however, it is widely acknowledged that the law requires transparent and comprehensive policies regarding its implementation together with appropriate industry expertise being used by the courts — to date the UAE Bankruptcy Law has only experienced a few cases and remains relatively untested by significant sized restructurings. Until the business community is satisfied the new law is to be implemented in a transparent and consistent manner, creditors may continue to seek consensual out of court restructurings before turning to formal legal mechanisms.

DIFC Insolvency Law Overview

On 11 June 2019, the DIFC introduced a new insolvency law (DIFC Insolvency Law No. 1 of 2019 and associated DIFC Insolvency Regulations 2019), which became effective on 13 June 2019.

The DIFC Insolvency Law comes hot on the heels of recent updates to onshore bankruptcy and insolvency legislation in both the UAE and the Kingdom of Saudi Arabia. The law represents a significant advance in insolvency legislation in the Middle East.

The newly enacted law complements the DIFC's commitment to international best practice and aims to balance all stakeholder needs in distressed and bankruptcy-related situations. Facilitating a more efficient and effective bankruptcy restructuring regime will give leading global institutions the certainty, transparency, and predictability they need to operate across the Gulf Cooperation Council (GCC) region. The recent insolvency law adheres to international trends and best practices (practitioners familiar with the US Chapter 11 regime and English law schemes of arrangement will recognise certain elements). Furthermore, the significant focus on restructuring and rescuing businesses, rather than liquidating companies, places the legislation at the forefront of international debt restructuring innovation.

The DIFC Insolvency Law enhances and supplements the restructuring tools available to debtors and creditors. In particular, the new rehabilitation (debtor-in-possession) and administration processes supplement existing procedures — such as company voluntary arrangements, receiverships, and liquidations — which are retained and/or updated in Parts 2, 5, and 6 of the DIFC Insolvency Law. The IFC Insolvency Law also includes provisions providing that certain transactions (*e.g.*, granting security for existing debt / disposals without adequate consideration / preferences) that take place within a two year window prior to the start of insolvency proceedings may be declared as invalid and unwound by the courts. Directors may have personal liability in relation to such transactions so obtaining legal advice at the onset of financial difficulties is, again, a key step.

The four key features of the law are summarised below.

1. Facilitating Cross-Border Coordination

Part 7 of the DIFC Insolvency Law adopts the UNCITRAL Model Law on Cross-Border Insolvency — the provision encourages cooperation and coordination between multi-jurisdictional insolvency proceedings and aligns with the DIFC's overall goal to achieve recognition as an international business hub. The inclusion should help to ensure a more coordinated and predictable approach to multi-jurisdictional restructurings and insolvencies for the many cross-border businesses in the DIFC.

2. Introducing a Rehabilitation Regime

Part 3 of the law introduces a "rehabilitation" regime. Under the law, when a company cannot pay its debts — and a reasonable likelihood exists that the company's creditors and shareholders can reach agreement — the debtor can apply for rehabilitation. The company's directors must notify the court in writing that they intend to make a proposal to the creditors under the regime. Rehabilitation allows creditors to vote on a rehabilitation plan proposed by the debtor with a view to restructuring the debtor's business. Rehabilitation benefits include:

- An automatic stay of 120 days from the date the directors notify the court of the intention to propose a rehabilitation plan

- Protections against contractual termination in respect of insolvency clauses and other terms (noting that the court can order relief from the moratorium for specific creditors in limited circumstances)
- Cram-down mechanics — a popular inclusion in other insolvency regimes (but not included in the recent onshore UAE insolvency law) which allows the court to impose a rehabilitation plan on a dissenting minority of creditors notwithstanding the creditors' lack of consent to the plan

The rehabilitation regime requires the company to appoint an insolvency practitioner as a Rehabilitation Nominee. The directors can continue to manage the company (subject to the Administration regime below), but the Rehabilitation Nominee will be responsible for certain company rights and duties. When the directors are ready to present a plan to the creditors and shareholders, the Rehabilitation Nominee must file a statement with the court confirming that the proposed plan is reasonably likely to succeed, that the company has sufficient funds available during the moratorium, and stating whether the debtor plants to convene creditor and shareholder meetings.

The court then invites creditors to consider and support the plan, categorising creditors into different classes to formally vote on the plan. In certain circumstances, the court may determine that the plan does not impair a class, so will not require a vote from that class. The plan requires both 75% of creditors in each class that are present and voting to support the plan, and the approval of the court. After the hearing and creditor vote, the law requires the court to sanction the plan if the court finds all of the following apply:

- The plan complies with the law and the debtor proposed the plan in good faith.
- The arrangement is not unfairly prejudicial to each class of creditors and to the general body of creditors taken as a whole.
- Either (a) all classes of creditors have voted to accept the plan (or have been deemed to accept the plan) or (b) at least one class of creditors which would be impaired by the plan approves it.
- No creditor is worse off than the creditor would have been in a winding-up of the company.
- The holder of any claims junior to any dissenting class will not be paid out any amount before the debtor pays the dissenting class in full.

Therefore, the court has powers to approve the plan in a range of situations — notably if one impaired class has agreed to the plan but other classes have not. In addition, the court can permit new priority funding during the rehabilitation process. This debt can be unsecured or secured with security over previously unsecured assets, on a junior basis to existing security, or on a senior or *pari passu* basis with existing security (the latter in certain circumstances such as if adequate protection for the secured parties exists). The new funding takes priority over other unsecured debt, but the regime ensures protection of existing secured creditors.

3. Appointing Independent Administration

Part 4 of the DIFC Insolvency Law allows the court to appoint an independent administrator if a debtor files an application for rehabilitation and evidence of misconduct exists.

The appointed administrator, an insolvency practitioner, is authorised to manage the company's affairs, business, and property to facilitate a voluntary arrangement, a rehabilitation plan, or a scheme of arrangement under the DIFC Companies Law.

4. Streamlining Winding Up

Part 6 of the DIFC Insolvency Law updates the existing rules and procedures for the winding up of companies — modernising and streamlining the procedures.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

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