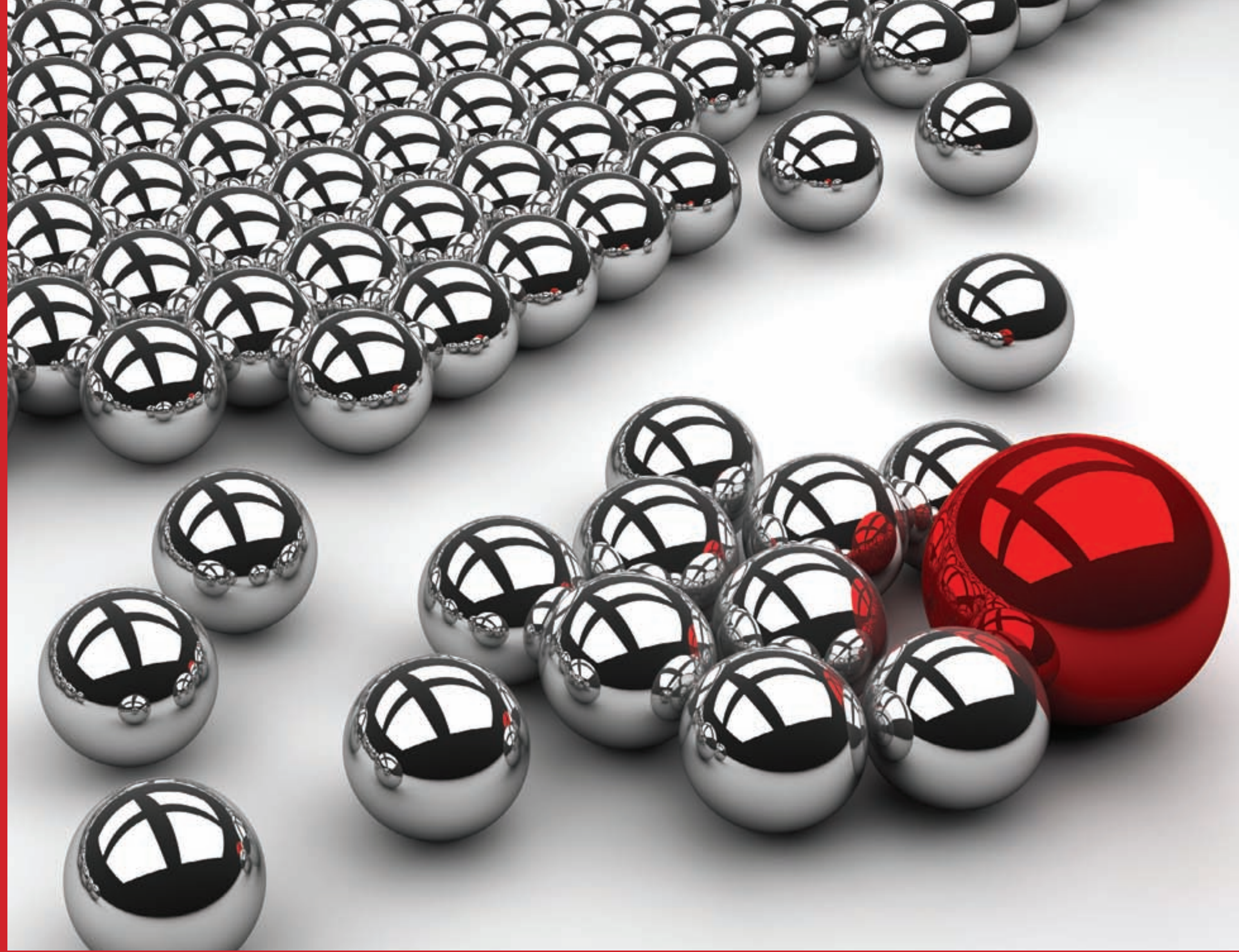

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Recent developments in insolvency and restructuring in the Middle East

by Anthony Pallett, Christopher Hall, Christian Adams and Adam Goldberg, Latham & Watkins LLP

The 2012/13 edition of this *Global Insolvency & Restructuring Review* featured an article by Latham & Watkins LLP addressing insolvency and restructuring law reform in the Middle East. In light of the popularity of the article and its continued relevance today, "*Shifting Sands: Insolvency and Restructuring Law Reform in the Middle East*" is republished on page 134. As a preface to the republishing of its original article, Latham & Watkins highlights two of the most significant recent developments in insolvency and restructuring practice in the Middle East with which it has been involved.

Drydocks World – The first restructuring implemented via Dubai Decree 57 for 2009[1]

On April 1, 2012 Drydocks World LLC ("Drydocks"), a Dubai and Asia-based ship building and repair company that is wholly owned by Dubai World, became the first company to commence a formal reorganisation proceeding in the Special Tribunal related to Dubai World (the "Tribunal"), established by Dubai Decree No. 57 for 2009 ("Decree 57") and avail itself of Decree 57's integrated legal framework. Drydocks stated that the purpose behind the filing was to enable it to implement a rapid debt restructuring based on the consent of a majority, but not all, of its syndicated lenders under a US$2.2bn syndicated term loan facility. Significantly, the syndicate of lenders included a diverse group of traditional financial institutions that ranged from local and international banks to hedge funds based in the region and around the world.

On August 28, 2012, the Tribunal formally approved Drydocks' debt restructuring in the first restructuring approved under Decree 57.

The Tribunal's public approval of the Drydocks restructuring represents the first major regional restructuring concluded through a judicial process with the support of a majority of creditors through an internationally recognised and transparent legal framework. The key terms of the Drydocks restructuring reflected in the public record include:

- Restructuring and amendment of the US$2.2bn syndicated term loan facility, with support of a majority of creditors.
- The single hold-out creditor (a US hedge fund representing approximately 2% of the total claims) was bound by the support of the majority and the approval of the Tribunal.
- Extension of multiple new credit facilities to support the restructuring.
- Sale of Drydocks' operations in Southeast Asia in consultation with, and subject to approval of, a majority of creditors under the amended US$2.2bn syndicated term loan.

Drydocks' ability to bind hold-out creditors to its restructuring plan, based on the consent of a majority of its lenders that agreed to lock-up to the terms of the restructuring prior to commencement of Decree 57 proceedings, represents a dramatic step forward in restructuring practice in the Middle East. The implementation of the Drydocks restructuring via Decree 57 proceedings demonstrates that a judicially-supervised reorganisation procedure based in the Middle East can provide a viable and predictable means to right size the balance sheet of a company experiencing financial distress without the consent of all parties. It remains to be seen whether Decree 57 will be used as a template for law reform in the UAE and the wider region. The success of the Decree 57 regime in the context of the Drydocks restructuring should factor heavily in the minds of the region's policy makers as they contemplate further legal reform.

Arcapita – Chapter 11 can be an option for a Shari'ah-compliant Middle Eastern company

Arcapita Bank B.S.C.(c) ("Arcapita") is an international investment bank based in Bahrain that provides private equity investment opportunities to Shari'ah-compliant investors. On March 19, 2012, certain Arcapita entities filed voluntary petitions under chapter 11 of the US Bankruptcy Code as a means to reorganise their business and restructure over US$2.5bn of indebtedness. Arcapita's chapter 11 process is still ongoing but is already creating a new landscape for Middle Eastern companies to consider when they face restructuring scenarios.

Several key elements of Arcapita's ongoing chapter 11 process demonstrate that a chapter 11 filing can be an effective means of implementing a restructuring

for a Middle East-based company, including procedures to prevent enforcement action by creditors, maintain the debtor's control over its own restructuring and obtain access to new financing needed to complete a restructuring. These key elements can be summarised as follows:

- **Automatic stay**: Arcapita faced threats of aggressive enforcement action from certain of their financing participants. When an out of court deal did not materialise by the time of maturity of Arcapita's US$1.1bn Syndicated Murabaha facility, Arcapita effectively stayed enforcement action and loss of control through concerted filings in the United States under chapter 11 and in the Cayman Islands through a provisional liquidation proceeding.
- **Exclusivity**: As Arcapita's chapter 11 cases have progressed, Arcapita has thus far maintained the exclusive right to propose and solicit a plan of reorganisation. As the chapter 11 cases unfolded past their initial stages, Arcapita reached a settlement with official committee of unsecured creditors (the "Creditors Committee") for terms of exclusivity, which provided that if Arcapita could not obtain an equity commitment by a date certain, Arcapita would propose a wind down plan. This settlement reflects the dynamics of chapter 11 cases that permit the debtor latitude to determine its own fate, subject to the oversight and input of a Creditors Committee and other creditor constituencies.
- **DIP facility**: Arcapita successfully obtained Shari'ah-compliant DIP financing. While the facility was the first known proposal for a Shari'ah-compliant DIP in a large chapter 11 case, the process unfolded using the well-established procedures and practice observed for traditional DIP financing. No party objected to the facility on the basis that it was Shari'ah-compliant.

Arcapita's experience shows that chapter 11 can be used, alongside other international proceedings, in a manner that can be tailored to the strategic needs of Middle Eastern companies. Arcapita is now in the midst of a complex and potentially contentious resolution of a plan of reorganisation. The ultimate outcome of Arcapita's restructuring now depends on resolution among Arcapita's stakeholders of the unique issues presented by Arcapita's business.

Notes:

[1] Dubai Decree 57 for 2009 is discussed in further detail in the Latham & Watkins article "*Shifting Sands: Insolvency and Restructuring Law Reform in the Middle East*", republished on page 134.

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- 2012 Deal of the Year, *The Banker*
- 2012 Middle East Restructuring Deal of the Year, *International Finance Review*

Dubai World Restructuring

- 2011 Deal of the Year, *The Banker*
- 2011 Middle East Restructuring Deal of the Year, *International Finance Review*
- 2010 Restructuring Deal of the Year, *Acquisitions Monthly*

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Shifting sands: Insolvency and restructuring law reform in the Middle East

by Christopher Hall, Anthony Pallett, Christian Adams and Adam Goldberg, Latham & Watkins LLP

The global nature of the financial crisis, liquidity constraints, declining asset values, general market uncertainty and the realisation that insolvency systems in the Middle East have not developed at the same pace as the business environment have placed insolvency and restructuring law reform firmly in the sights of the region's policy makers. This article addresses the availability of liquidity, the stress testing of existing insolvency systems, the increased focus on regional reform initiatives, the United Arab Emirates' proposed new Federal Bankruptcy Law and the key challenges to the successful implementation of any new legal and regulatory framework in the Middle East.

Liquidity crunch

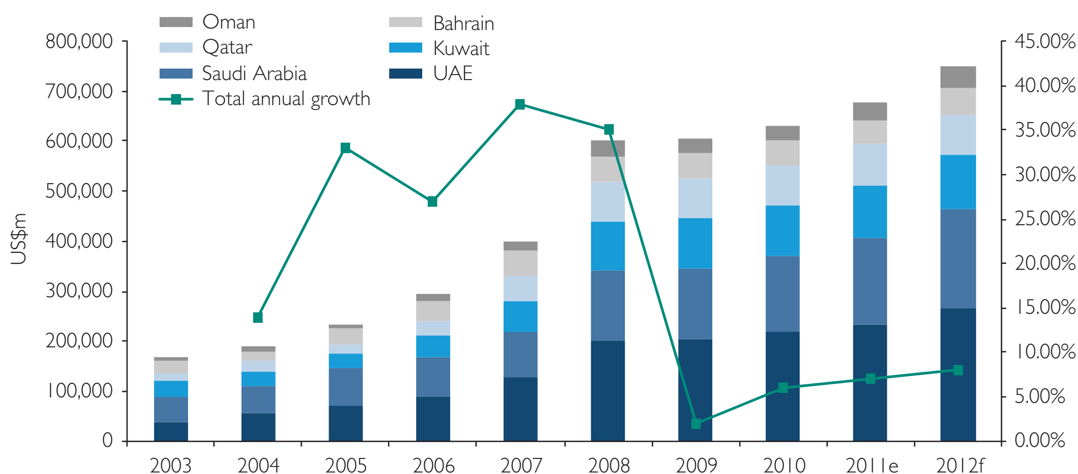
The consequences of the 2008 global financial crisis and, more recently, "*The Arab Awakening*" have disrupted economic activity in almost every country in the Middle East, one of the most significant repercussions being the drying up of market liquidity and the resultant adverse impact on the ability of regional borrowers to meet their short and medium-term debt obligations. Figure 1 highlights the significant reduction in the growth of bank lending across the GCC since 2007. The average annual growth in bank lending between 2004 and 2008 was 29%, reaching a high of 38% in 2007. This rate fell to 1% in 2009 and 6% in 2010; however, growth increased to roughly 7% in 2011 and is forecast at approximately 8.6% for 2012.

The reduction in the availability of external finance, together with declining asset values, falling profitability, political and economic unrest and maturing short and medium-term debt obligations has pushed an increasing number of businesses into a position of financial uncertainty.

Stress testing existing insolvency systems

The significant increase in the number of businesses approaching the "*zone of insolvency*" has sharpened the focus on the options available to financially distressed or insolvent companies under existing bankruptcy regimes – the common theme across the Middle East has been one of limited use and understanding of formal insolvency procedures. For example, while the Federal laws of the United Arab Emirates (the "UAE") provide a formal framework for the reorganisation, liquidation and bankruptcy of insolvent companies and individuals, the regime applicable to companies remains largely untested, as the market has not yet

Figure 1: The growth of bank lending in the GCC 2003-12



Source: Reuters Knowledge

seen a major corporate entity commence insolvency proceedings under the Federal framework. Given the uncertainty surrounding the application of the region's existing legal frameworks, financially troubled corporate entities and their creditors have sought, and will likely continue to seek, consensual out-of-court reorganisations before turning to formal legal mechanisms.

World Bank statistics indicate that an average bankruptcy procedure in the MENA region takes 3.5 years to complete, costs 14.1% of the value of the business and delivers an average recovery rate of 29.9 cents on the dollar. This does not compare favourably to the OECD averages (1.7 years, 8.4% and 68.6 cents), and pales by comparison to international best practice as seen in Japan (0.6 years, 4% and 92.5 cents).[1] The statistics for the UAE (5.1 years, 30.0% and 10.2 cents) reflect the fact that the UAE's insolvency framework has not developed at the same pace as the country's development as an economic and commercial hub. Recent history has witnessed unprecedented economic growth and business expansion in the UAE; particularly in Dubai, where local businesses have evolved into global corporations with multiple sources of finance and diverse investments. Whilst there has been an evolution in the business landscape, certain aspects of the applicable legal and regulatory regime have stagnated and no longer reflect modern business needs.

The increased focus on reform initiatives

During previous financial crises in Russia, East Asia and Argentina, attention turned to the importance of insolvency systems that support the resolution of financial distress,[2] in particular, the accessibility of the relevant laws and the efficiency of the institutions implementing such laws. Recent events in the Middle East have resulted in a similar trend, as policy makers begin to acknowledge weaknesses in the existing legal frameworks and the need for reform to preserve businesses as going concerns, strengthen creditors' rights, improve the overall investment climate and strengthen market resilience.[3] There is also a growing acceptance that law reform by itself is not sufficient; while it is essential to have a robust legal framework in place, true reform requires a holistic approach, addressing the capacity and efficiency of local courts, the training of judiciary and the development of a body of experienced insolvency professionals, all of which are essential elements of effective insolvency systems (see *further discussion below*).

The recent restructurings of Dubai World and its then subsidiary Nakheel in the UAE provide high-profile examples of the value of establishing a transparent, predictable insolvency system based upon international standards recognised by global investors.

Dubai World case study

Dubai World is an international conglomerate encompassing over 200 subsidiaries operating in, amongst others, the real estate development, private equity, retail, hospitality and shipping sectors. In November 2009, Dubai World announced its intention to seek a "standstill" on its debt repayment obligations, amounting to approximately US$24bn spread amongst 95 international financial institutions. Nakheel, then a subsidiary of Dubai World, is a real estate development company that owed approximately US$23.7bn to a wide variety of creditors, including international financial institutions, public holders of Sukuk certificates and trade creditors.

The global financial crisis hit Dubai in Q4 2008, resulting in a crash in the Dubai property market that saw a 47% decrease in the valuation of real estate in the 12-month period from Q4 2008 to Q4 2009, and prompting the November 2009 "standstill" announcement. By the summer of 2011, both Dubai World and Nakheel had successfully restructured their debts on an out-of-court basis, in each case, with the consent of 100% of financial creditors, and in Nakheel's case over 90% of trade creditors. The key factor that enabled the Government of Dubai to execute one of the most complex and large-scale corporate restructurings in recent history was the creation of a bespoke insolvency system based upon international standards recognised by Dubai World's international creditors.

Decree 57: Levelling the playing field for negotiations

Dubai World is a corporation established pursuant to a decree issued by the Ruler of Dubai, and consequently has a unique legal status. Due to its status as a decree corporation, Dubai World was unable to seek to restructure its debts under the existing Federal regime applicable to ordinary companies incorporated in the UAE. As a result, when Dubai World announced its debt repayment "standstill" in November 2009, there was great uncertainty as to how a restructuring of Dubai World's debts could be implemented. The Government of Dubai responded by enacting "*Decree No. 57 of 2009 Establishing a Tribunal to Decide Disputes Related to the Settlement of the Financial Position of Dubai World and its Subsidiaries*" ("Decree 57"), which created a modern legal framework designed to enable Dubai World and its subsidiaries to restructure their debts through a judicially-supervised process.

The regime established by Decree 57 was based on international best practice and a hybrid of English law procedures and substantive restructuring tools proven to maximise value in Chapter 11 of the US Bankruptcy Code. In practice, however, although it provided formal legal procedures through which to implement a restructuring, the major contribution of Decree 57 to the extraordinary result achieved in Dubai was the provision of a "Plan B" against which to negotiate an out-of-court restructuring.

Perhaps most importantly, Decree 57 enables a company to implement a restructuring without the consent of all parties. A restructuring may be approved based on consent of a majority of creditors and equity holders in each class (i.e. binding minority objectors), or provided that specific legal standards are met, without the consent of all classes based on the consent of a majority of creditors in one impaired class (a procedure known as "cram down"). Because of this "cram down" mechanism, no creditor or class of creditors, including secured creditors, could be certain of its ability to unilaterally block a restructuring that had the support of other creditors. In this manner, by depriving individual creditors and classes of creditors of the ability to block the restructuring at their discretion, Decree 57 created a level playing field for negotiations in which no party could seek to extract "hold up value" for its consent. Having such an option provided Dubai World with leverage to reject unrealistic demands and preserve the greatest value available for all constituencies; as a result, all stakeholders were incentivised to work together towards a negotiated solution that reflected the commercial realities of the situation. While Decree 57 does not apply beyond Dubai World and its subsidiaries, and its formal procedures were never actually utilised, the region's policy makers may wish to consider the effect of "the shadow of the law" in motivating creditors to take a seat at the negotiating table.

Of course, not all distressed companies will have the benefit of a new law created to govern their restructuring, and companies in the Middle East in particular regularly face challenges arising from legal regimes that are perceived to be opaque, unpredictable and ultimately ineffective as a means to implement a commercial restructuring on a going-concern basis. Reform efforts are underway in the UAE, and elsewhere, that may provide companies with generally-applicable and more standardised options to bind dissenting parties to a restructuring, as discussed below. In the meantime, companies in the Middle East must work to overcome these challenges through creative planning among management and legal and financial advisors based on an analysis of the particular situation, the needs of the business, the terms of existing agreements and legal procedures that may be available outside of the company's home jurisdiction.

UAE bankruptcy law reform

As noted above, the international markets generally do not perceive the procedures set out in the existing UAE legal framework to be sufficient to provide companies with an opportunity to restructure and reorganise as a going concern through an efficient, transparent and open process. In early 2012, following the successful restructurings of Dubai World and Nakheel, the UAE distributed a draft new Federal insolvency and bankruptcy law that seeks to create new alternatives for companies in the UAE to implement a restructuring without the consent of all creditors. The draft law aims to facilitate corporate rehabilitation by introducing transparency and predictability via internationally recognised best practices. Some of the key features of the draft law are:

- An ability to implement a restructuring based on consent of majority of creditors without consent of all individual creditors.
- A broad moratorium or stay on action by creditors, including secured creditors.
- The opportunity for a debtor to obtain new financing with priority in payment and security over existing debts, including secured debts, subject to a court finding the interests of existing secured parties are adequately protected, based on "debtor-in-possession" or "DIP" financing under the United States Bankruptcy Code.
- The option for a debtor to terminate leases and contracts, akin to the "assumption or rejection" of contracts under the United States Bankruptcy Code.

The draft law is currently undergoing a thorough consultation process and will likely undergo further refinement before being presented to the UAE's Council of Ministers for Cabinet approval and eventual promulgation as Federal law. Based on the concepts already integrated in the draft law, its enactment will represent a dramatic step in the development of insolvency and restructuring practice in the Middle East and a leading example of the reform efforts ongoing across the region.

The need for a holistic approach to insolvency law reform

The success of any new insolvency regime will depend on a number of factors, not just the drafting of the relevant laws. In particular, it should be noted that "the principles of reform must be considered in the context of the unique political structure, legal culture, and economic and social framework of each country.

Considering the political, economic, social and judicial differences between countries, a "one-size fits all" is neither wise nor workable in this area of law".[4] Some of the key issues to be addressed in parallel with the reform of insolvency laws are set out below:

Challenging cultural stigma and criminal implications

Businesses in all countries face negative perceptions or stigmas when they are forced to restructure, especially when a formal bankruptcy proceeding is commenced to facilitate such efforts. In some countries, such as the US, and to a lesser extent in the UK, this stigma has been eroded, as well-known companies have gone through the bankruptcy process, continuing to operate during their bankruptcy and then reorganising and becoming profitable companies once again. Companies, creditors, investors and other interested parties in the Middle East, tend to have a strong negative bias against bankruptcy, which can have a profound effect on planning a successful debt restructuring.

A procedure that authorises a company to restructure specific financial debts without the consent of all creditors and without the requirement that they "file for bankruptcy" or engage in a drawn-out court process could be an invaluable tool for companies in the Middle East to restructure debts while avoiding a perception of "criminal", "fraudulent" or "dishonest" behaviour and preserving the goodwill of their customers and the public. Whilst there is scope for effective insolvency systems to punish those guilty of behaving fraudulently, recklessly or dishonestly, there is also scope for cases of genuine business failure to be treated in a fair and respectful manner.

Building institutional and professional capacity

Court systems play a central role in any effective insolvency regime. It has been widely observed that the current court systems in most regional jurisdictions would find it challenging to oversee complex bankruptcy and reorganisation proceedings, both in terms of the infrastructure of the courts and judicial capacity. The Emirate of Dubai has taken steps to enhance its institutional capacity through, initially, the establishment of the Dubai International Financial Centre ("DIFC") Courts, and more recently the creation of a special tribunal for the restructuring of Dubai World pursuant to Dubai Decree 57. In practice, the effectiveness of the reforms efforts will be dependent on the ability of the courts and judiciary to effectively implement the laws in a certain, transparent and consistent manner. In many respects, institutional capacity building with a special focus on the role of the judiciary, the insolvency professionals and the state agencies represents a greater challenge that reforming the law itself. The region's policy makers might consider creating specialised bankruptcy courts with access to the expertise needed to decide the complex financial issues so often associated with bankruptcy cases – The World Bank's Doing Business Report confirms that recovery rates are much higher in jurisdictions that operate specialised courts.

Similarly, the role of insolvency professionals ought to be considered; insolvency professionals (sometimes referred to as trustees, nominees, administrators, liquidators etc.) play an important role in an insolvency system; however, it is essential to the efficiency and credibility of any process that such individuals have the necessary skills and experience to discharge their duties to the requisite standard. No jurisdiction, other than the DIFC, requires insolvency professionals to have received insolvency-specific training, and many jurisdictions do not regulate insolvency professionals at all.

Revision of laws relating to the creation and enforcement of asset security

The presence of an effective and transparent security regime is a key factor in determining the terms on which banks, financial institutions and other investors are willing to deploy capital in any given jurisdiction – even more so in times of financial uncertainty and low liquidity. Generally speaking, taking effective and comprehensive security in the Middle East is not a straightforward process - the registration, priority and enforcement of security interests is particularly challenging.

The region's policy makers might consider specific reform of the applicable laws, in particular: (i) the types of security interest (i.e. mortgages and fixed charges) available should be clearly distinguishable; (ii) the introduction of the "floating charge" as a means of security over groups of assets that may fluctuate with time (such as cash in a trading bank account, stock or inventory) should be considered; (iii) the priority afforded to each type of security should be unambiguous and identifiable; and (iv) while we appreciate that there are specialist registers for certain classes of asset (specifically real estate, ships and aircraft), the introduction of a mandatory central register of all security interests against companies would create more certainty for lenders and would likely have the overall effect of reducing the cost of borrowing.

Restructuring of Shari'ah compliant financings

Restructurings involving Shari'ah compliant financings raise a series of endemic issues that have not yet been specifically integrated into the region's insolvency laws or received common treatment by courts that have had occasion to consider them. In particular, there are significant questions as to: (i) whether Shari'ah compliant financings should be classified and receive treatment as a claim for debt (as opposed to equity,

which typically may not recover value unless claims are paid in full), or a type of class that is senior to equity but not considered debt in recognition of the intended characteristics of Shari'ah compliant financing; (ii) whether Shari'ah investors are entitled to vote directly in an insolvency proceeding, or whether they must vote through a trustee and have only one vote; and (iii) whether contracts with a debtor that form part of a Shari'ah financing may be subject to assumption or rejection. These and other questions should be considered as part of the reform process given the significance of Shari'ah financing in the region.

Conclusion

The fallout from the global financial crisis has proven that the Middle East is not immune from economic hardship and has highlighted the importance of effective insolvency systems in mitigating the financial impact of such crises. Insolvency systems in the Middle East are generally outdated and unworkable; there is a pressing need to address the cultural stigma and criminal implications associated with bankruptcy, to distinguish between debtors capable of being rehabilitated and those in need of efficient liquidation, to modernise laws in line with the evolving business landscape, and to improve the function and efficiency of courts and insolvency professionals. Through the evolution of the DIFC Courts, Decree 57 and its draft Federal bankruptcy law, the UAE's policy makers have set an example for the rest of the Middle East and laid down the beginnings of a roadmap for regional reform.

Notes:

[1] Statistics obtained from The World Bank / IFC report: Doing Business 2010.

[2] "*Resolution of Corporate Distress in East Asia*" – World Bank Group, Journal of Empirical Finance, 10: 199 – 216.

[3] "*The Challenges of Bankruptcy Reform*" – World Bank Policy Research Working Paper 5448.

[4] "*Corporate Rescue: An Overview of Recent Developments from Selected Countries*" – Gromek Broc K., Parry R., 2006.

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