



# SET-OFF UNDER THE UAE INSOLVENCY LAW

**The new United Arab Emirates (UAE) Insolvency Law (Federal Law No.9 of 2016) (Insolvency Law) was published in the UAE Gazette on 29 September 2016 and came in to force three months later on 29 December 2016. The Insolvency Law is a federal law that applies to all seven emirates comprising the UAE. The initial view from market participants is that by replacing the old insolvency law, which placed a greater emphasis on creditor protections and formal bankruptcy proceedings alongside criminal penalties, the Insolvency Law is an overdue but welcome development.**

The Insolvency Law primarily provides for three mechanisms to assist businesses in financial difficulty:

1. Protective composition
2. Restructuring proceedings
3. Liquidation proceedings

Rather than discussing the new Insolvency Law in general, as has been done elsewhere in considerable detail, this article will look specifically at the Insolvency Law in relation to set-off which is a commonly used procedure where the amount of a claim is deducted from another liability, paying out only the net sum.

In the construction, banking and commodity trading sectors, set-off as a risk mitigation tool is commonly used in the UAE. Set-off has been used in situations where it may be difficult to pursue the other party by legal action or if they are at risk of becoming insolvent. It is preferred and seen as an effective out of court settlement tool.

Where set-off is to be applied between different contracts, there must be a clear provision for it within the contract. However, this is not an unusual situation, where the same parties have entered into more than one contract between them, as in the case of commodity supply contracts or marine fuel contracts.



What is more unusual, however, is where set-off is allowed between different parties to different contracts – for example, where at least one of the parties, and possibly both, to a contract are corporate entities and part of larger groups.

We will look at the following two set-off scenarios under the Insolvency Law:

1. Will my set-off agreement continue to be effective against the other party during a composition proceeding, an insolvency and restructuring proceeding or an insolvency and liquidation proceeding (together an Insolvency Process)?
2. Is there a risk of claw-back for any sums set-off prior to the counterparty entering into an Insolvency Process?

Set-off is covered in Article 183 of the Insolvency Law. This article and the four sub-clauses deal exclusively with the set-off of mutual claims in relation to an Insolvency Process.

#### **Article 183(1) (set-off pre-insolvency)**

This sub-clause provides that any sums set-off prior to the counterparty entering into an Insolvency Process should not be at any risk of claw-back as the Insolvency Law expressly permits this.

#### **Article 183(2) (set-off post-insolvency)**

This sub-clause provides that a debt incurred after the commencement of an Insolvency Process may “*not be offset unless it is based on the scheme of composition, the scheme of restructuring or the Court’s decision.*”

Practically speaking, any attempt to set-off mutual obligations for a debt incurred after an insolvency

scenario may be challenged unless the amount being set-off receives the sanction of the courts. It is unclear what will satisfy the requirement for the agreement to be “based on” the scheme of composition, the scheme of restructuring or the court’s decision. However, the common sense approach would be to construe this as meaning the scheme of composition, restructuring or the court’s decision must expressly provide for or accommodate the agreement to set-off.

There are possible avenues to implement set-off post insolvency which involves the appointment of trustees and then the plan being voted upon by the creditors, but it remains uncertain how this would work in practice, particularly as the Insolvency Law has only recently been introduced.

#### **Article 183(3) (amounts remaining after set-off)**

This sub-clause sets out what happens to any amount outstanding once mutual claims have been set-off against each other under Article 183(2). In summary:

1. If a debt is still owed to the creditor it shall be added to the counterparty’s other debts and shall have the ranking of the original debt.
2. If a remainder is due to the counterparty it shall be added to that counterparty’s assets and shall be paid to any appointed trustee.

#### **Article 183(4) (assignment of debt)**

This sub-clause deals with the assignment of a debt from a creditor to a third party. In such a case any sums set-off between the debtor and the third party will not be valid unless the court finds that it has been set-off in good faith in-keeping with the general requirement of good

faith under Article 246(1) of the Civil Code; namely that it does not abuse the rights of the counterparty, does not cause unjustified damage to the counterparty and is generally seen as being reasonable and moderate.

No mention is made in relation to the timing of such a set-off so it seems that this sub-clause will be applicable both where the debt is set-off pre and post commencement of an Insolvency Process. Again it remains to be seen how the UAE courts will deal with this provision and apparent lack of clarity.

#### **Legislative vacuum**

Whilst providing for a set-off prior to an Insolvency Process and for a debt accrued after the commencement of an Insolvency Process, Article 183 does not expressly deal with an event when a debt is incurred prior to the commencement of an Insolvency Process but an attempt to set-off that debt is made after the commencement of an Insolvency Process.

We are aware that some commentators in the UAE suggest falling back on the previous insolvency law regime (Article 688, Commercial Transactions Law) for guidance. Article 688 provides that set-off of connected mutual indebtedness is allowed:

*“no setoff shall be made between the bankrupt’s rights and obligations, unless a linkage is found to exist between them. The linkage shall, in particular, exist if both right and obligation arise from one cause or if they are combined in one current account.”*

It is not clear in what situations this provision would be satisfied or how often it would arise. In our opinion, reliance on Article 688 is an aggressive interpretation in this instance as this Article has been expressly repealed by the Insolvency Law.



## Conclusion

In summary, the effectiveness of a set-off agreement after the commencement of an Insolvency Process depends on whether such set-off is pursuant to a protective composition scheme, a restructuring scheme or a decision ordering set-off by the UAE courts. Accordingly, any unilateral self-help set-off attempt by the creditor is likely to be challenged by an insolvency counterparty which has commenced an Insolvency Process.

The Insolvency Law does not expressly mention or provide for the continued effectiveness of a set-off arrangement in relation to an insolvency and liquidation scenario so it is possible that such a set-off agreement would be entirely ineffective unless such set-off was ordered by the court in respect of Article 183(2).

Any claims outstanding between a creditor and a debtor should, to the extent possible, be set-off regularly under a set-off agreement and prior to the commencement of an Insolvency Process. This is expressly permitted under Article 183(1) and there should be no risk of any claw-back by an insolvency practitioner under the Insolvency Law.

The Insolvency Law is published in Arabic. There are various translations of the Insolvency Law which are not identical in every respect. Difficulty in interpreting primary legislation is compounded by the accuracy and consistency of the translations.

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