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BANKRUPTCY IN THE UAE

Part 1: Preventative composition as a restructuring tool

As commercial companies in the UAE grapple with increasing inflation and interest rates, constraints to supply chains and labour market challenges, it seems inevitable that the number experiencing financial distress will rise.

With petitioning courts in the UAE for bankruptcy being a daunting proposition, financial distress of companies in the UAE has been historically largely resolved through extensive negotiations with creditors. However, when negotiations with creditors are not fruitful, the relatively new preventative composition procedure established under the Bankruptcy Law¹ may provide some much-needed relief.

In this article, we examine preventative composition as means to implement a successful restructuring strategy and related key concepts.

First things first – terminology

What does bankruptcy mean?

"Bankruptcy" refers to the following proceedings established under the regime of Bankruptcy Law:

- formal restructuring whereby an insolvent company is managed by a court appointed expert with the aim of rescuing the business; and
- insolvent liquidation which focuses on termination of the commercial company and distribution of assets (if any).

The Bankruptcy Law regime for insolvent companies applies to commercial companies incorporated in the UAE (but not the financial free zones that have their own bankruptcy regimes, such as the Dubai International Financial Centre (DIFC) and the Abu Dhabi Global Market (ADGM)).

The Bankruptcy Law sets out clear requirements for companies to apply to the court for bankruptcy when they have **ceased to pay debts as they fall due for over thirty (30) consecutive working days** due to financial distress or insolvency. In addition, public prosecutors, creditors with unpaid and due **debts of over AED 100,000** or the courts may petition for bankruptcy subject to certain conditions.

What does insolvency mean?

"Bankruptcy" is a term which is often used interchangeably with "insolvency". The Bankruptcy Law does not define insolvency. However, it uses the term to generally refer to companies whose assets are not sufficient to cover their liabilities. When accepted by the UAE Courts, such companies may then be declared bankrupt. A company declared bankrupt can only be liquidated in accordance with the Bankruptcy Law.

The concept of bankruptcy and insolvency under the Bankruptcy Law regime should not be confused with that under the Insolvency Law or the provisions for liquidating a company under various company regulations or laws where such company is solvent.² The Insolvency Law applies to physical persons (as opposed to businesses) and defines insolvency as "*facing current or anticipated financial difficulties that render the debtor unable to pay its debts.*"

What is preventative composition?

Preventative composition is a relatively new court-supervised protective arrangement established under the Bankruptcy Law regime. It aims to facilitate settlement between a company and its creditors through the implementation of a restructuring plan, with the assistance of a court appointed trustee and court oversight. The

¹ Federal Decree Law No. 9/2016 on Bankruptcy as amended.

² Federal Decree Law 19/2019 on Insolvency.

goal of preventive composition is to rescue the distressed business.

Throughout the process the company generally continues to run the business, subject to certain preservation powers granted to the trustee.

A company facing financial distress can apply for preventive composition provided it has *not* ceased to pay debts as they fall due for over thirty (30) consecutive working days due to financial distress or insolvency. Therefore, time is of essence for any company seeking to initiate preventive composition. Otherwise, there is a risk of having no option but to file for bankruptcy.

What is the preventive composition process?

The preventive composition process generally consists of the following steps.

Step 1 – Application

Preventive composition can only be applied for by the company itself. The Bankruptcy Law prescribes the documentation that needs to be submitted to the court, which includes the following:

- constitutional documents and corporate approvals;
- a memorandum describing the financial and economic situation of the commercial company, including assets and its employees;
- a report containing cash flow forecasts, statement of creditors and debtors (including their details and securities granted to them) and a statement of moveable and immovable assets (including approximate value and any third-party rights);
- the company's proposal in respect of preventive composition and guarantees of implementation; and
- nomination of a trustee.

A deposit or bank guarantee also needs to be deposited with the court's treasury on a date set by the court. This is to account for expenses and costs of the preventive composition procedures including the trustee's fees.

Provided the application is complete, the court shall decide whether or not to accept it within five (5) working dates from either (i) the date the complete application was submitted; or (ii) the date the deposit or bank guarantee was lodged.

Step 2 – Appointment of trustee

Upon acceptance of the application, the court appoints the trustee to monitor the implementation of the company's plan. This may be one of the experts registered in the roster of experts or, alternatively, another expert if a suitable one in the roster is not found.

Importantly, notwithstanding the appointment of the trustee, the existing executive management of the company continues to manage the business under the supervision of the trustee. However, the trustee is also granted wide powers and may require acts to be taken in order to preserve the interests of the company's creditors.

In addition, the company is required to provide the trustee with any details required by it with respect to the preventive composition procedures, within such time limits as may be specified by the trustee. Therefore, it is advisable that the state of affairs of the company is carefully reviewed and any deficiencies are remedied (where possible) prior to filing the preventive composition application.

Step 3 – Restructuring plan

Upon appointment, the trustee shall prepare:

- an inventory of the company's assets; and
- records of the company's creditors (including the claimed amounts, due dates and preferential rights).

Within 45 days of the acceptance of the application, the company and the trustee shall also draw up and submit to the court a draft restructuring plan (referred to as preventive composition plan).

Within 10 working days, the court should then review the draft restructuring plan. If approved, the trustee shall then invite entitled creditors to a meeting to put the restructuring plan to a vote.

Generally, only unsecured creditors (ordinary ones and those with preferential rights such as employees or certain governmental authorities) whose debt is admitted in accordance with the Bankruptcy Law are entitled to vote. Secured creditors shall not be affected by the restructuring plan. Accordingly, secured creditors are entitled to vote

only if they relinquish their security or unless they are authorised by the court. A secured creditor participating in the vote on the restructuring plan without a court authorisation will be considered to have waived the security.

The restructuring plan needs to be approved by majority of the entitled creditors which hold at least **two thirds of the total amount of its debt**. If approved, the restructuring plan shall be submitted to the court for ratification. As one of the conditions for the ratification, all creditors affected by the restructuring plan shall be in the same (or better) position than they would otherwise have been had the company's assets been liquidated on the date of voting on the plan.

Once ratified, the restructuring plan becomes binding on all unsecured creditors. The preventative plan shall not affect the rights of priority of secured creditors. The implementation of the restructuring plan then continues to be supervised by the trustee. On the other hand, if the plan is rejected, the court may request amendments or decide to directly commence bankruptcy proceedings.

Why should preventive composition be considered?

The key benefits of preventive composition are as follows.

Stay of enforcement proceedings

Enforcement proceedings are automatically stayed upon the court's acceptance of an application for preventive composition (subject to certain exceptions that require court approval) until the earlier of:

- the ratification of the restructuring plan in accordance with the relevant provisions of the Bankruptcy Law; and
- the date falling **ten months from the date the court accepted the application for preventive composition**.

From the date of acceptance of the application for preventive composition until the earlier of the date on which one of the above events described in paragraphs (a) and (b) above falls, the stay of enforcement proceedings also applies to secured creditors. Secured creditors may only enforce subject to court permission. Ultimately, this has the effect of imposing a moratorium on payments to creditors.

Business continuity

The existing management of the company continue to run the business (subject to certain restrictions and preservation powers granted to the court appointed trustee(s) and preservation of the creditors position).

Additional borrowing

Subject to court approval, the company may raise additional debt funding (secured or unsecured).

Accordingly, preventive composition can offer companies on the brink of insolvency some much needed breathing space with the agreement of the prescribed majority of creditors and, importantly, not unanimous agreement. In our experience, creditors may also be more prepared to accept a transparent restructuring plan supervised by a court-appointed trustee in order to avoid lengthy and costly bankruptcy proceedings.

On the other hand, it goes without saying that any application to the court in the UAE in the context of company's financial distresses should not be submitted in haste. This is particularly so, given the exposure of the company's affairs in the process and potential for civil and criminal liability of those in managerial positions of a company if declared bankrupt.

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