

# BANKRUPTCY IN THE UAE

## PART 2: DIRECTORS' DUTIES

### 1. Introduction

One of the most common ways of conducting business within the UAE is through an onshore limited liability company. Commercial companies incorporated onshore in the UAE have a separate legal personality.<sup>1</sup> The company can enter into legally binding agreements in its own name and take on valid and binding obligations.

Actions of the directors of a company, on behalf of such a company, generally bind the company.<sup>2</sup> Generally, any liabilities resulting from those actions are for the account of the company, rather than for the account of the individual directors in their personal capacity.

Being a company director (hopefully) brings in some rewards to the individuals appointed. However, it is crucial to always keep in mind that such an appointment comes with a set of rules to play by. In this context, the term "directors' duties" is often used. The term is used to refer to a set of relatively basic standards that are expected of directors as a minimum under the applicable law.

When we are asked about bankruptcy, insolvency or restructuring of a company in the UAE, one of the key questions is often about the management's potential personal exposure. Actions of individuals involved in the running of a company often become subject to increased scrutiny (whether by its shareholders, creditors or by governmental authorities) during times of financial stress.

As in other jurisdictions, **mistakes and omissions by those in charge of decision-making of a company, which constitute breaches of directors' duties, can have serious personal repercussions. In some cases, such breaches can result in personal civil liability or even criminal sanctions.**

### 2. Who is a director?

Before we examine what responsibilities and duties directors have, it is first important to ask a relatively basic question – to whom do directors' duties in the UAE apply

#### 2.1 Directors and general managers

In the context of onshore limited liability companies, the terms "director", "manager" and "general managers" are often used interchangeably to refer to the person(s) in charge of company's decision-making.

The key piece of UAE legislation governing corporate governance of limited liability companies is the Commercial Companies Law<sup>3</sup>. The Arabic term used in the legislation to refer to "directors" (as we understand the concept under, for example, English law and as used throughout this article) translates into English interchangeably as "manager" or "director".

The Commercial Companies Law entrusts management of limited liability companies in the UAE to one or more of its directors, as determined by the shareholders in the company's Memorandum of Association.<sup>4</sup> If there is more than one director, the shareholders may appoint a board of directors. Generally, the directors have full powers to make decisions on behalf of the company. The Memorandum of Association, special resolutions of shareholders or a POA from the shareholders can then curtail or supplement the authority of the directors.

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<sup>1</sup> Article 21, Federal Decree Law No. 32 of 2021 On Commercial Companies (the "Commercial Companies Law").

<sup>2</sup> Article 23, Commercial Companies Law.

<sup>3</sup> i.e. the Federal Decree Law No. 32 of 2021 On Commercial Companies.

<sup>4</sup> Article 83, Commercial Companies Law.

As a minimum, any company registered onshore in the UAE has to appoint a "general manager" in charge of running the business. The role can be viewed as equivalent to that of a "managing director" in other jurisdictions. In addition, the company can, but does not have to, appoint one or more directors.

It is possible in theory to draw distinction between a director of a company and its general manager. A company's Memorandum of Association can be drafted, so that the scope of each role is separate from each other. However, for our purposes, we are not too concerned with such distinctions as directors' duties set out in UAE legislation will generally apply to general managers as well as any directors.

## 2.2 Shadow directors and controllers

**Just because you are not a general manager of a company listed on its trade licence or a director appointed to the board of directors of the company, does not mean that you can ignore directors' duties as a set of rules not applicable to you.**

It is not unusual for international groups to structure their UAE businesses as limited liability companies, which are then officially managed through a single director. Quite commonly, the same individual may also be appointed as a director of other operating companies and SPVs within the group but in reality, the whole group is run by the management of the parent company or one or more of the UBOs.

The term "shadow directors" is commonly used in some jurisdictions (such as the United Kingdom) to refer to persons who are directing the business decisions of a company without being officially called and appointed as such.

The concept of extending directors' duties to shadow directors is very well established in some jurisdictions but less clear under UAE law. The Commercial Companies Law does not contain a definition of "directors" or "managers" but implies that obligations imposed under the Commercial Companies Law on directors would apply to those appointed under the Memorandum of Association, under an independent contract or otherwise by a general assembly of the shareholders.<sup>5</sup> Therefore, we would argue, that **for an individual to be considered a director under the Commercial Companies Law some form of appointment by or on behalf of the shareholders is needed.** This may be, for example, a services contract or an employment contract.

On the other hand, the position as regards shadow directors is very clear in the Bankruptcy Law.<sup>6</sup> The Bankruptcy Law sets out a number of circumstances in which managers/directors of a company that is found bankrupt may become personally or even criminally liable. Article 196 of the Bankruptcy Law defines managers/directors as "any person working at the entity" and "playing an active role in the decision-making process", including any person "under whose directives and instructions the Managers operate." Therefore, **a person, such as an external advisor may be found to be a director of a company for the purposes of the Bankruptcy Law if it can be shown he or she plays an active role in the decision making of that company.**

In our experience, most directors of international businesses will be broadly familiar with their obligations as directors under the laws of the country where the parent company is domiciled. However, it is important to keep in mind that they also need to be concerned with their duties and responsibilities and potential personal liability under the Bankruptcy Law if:

- (i) they are appointed as a director or a general manager of an UAE subsidiary; or
- (ii) they are effectively directing the UAE subsidiary (even when not officially appointed as a director of that company).

Given the broad wording of Article 196 of the Bankruptcy Law, we believe that there is also a real risk that the UAE Courts may be prepared to find a parent company of a bankrupt subsidiary liable for the debts of that subsidiary, if it can be shown the decision making of the company was done at the parent company level and such decisions were not compliant with the Bankruptcy Law.

In addition to parent companies, **creditors of a bankrupt company may also expose themselves to potential directors' duties and liability risks.** Such risks may particularly arise in the context of financially distressed or potentially insolvent companies, where the largest creditors often drive the attempts to restructure and rescue the company. Creditors need to be very careful not to cross the line in and actually make any decisions for a company.

In summary, **when we ask to whom do directors' duties under the Bankruptcy Law apply, we need to ask who is actively involved in the decision making of the company, rather than just checking who is appointed as the general manager or director.**

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<sup>5</sup> See Article 83, Commercial Companies Law.

<sup>6</sup> See Article 196, Federal Decree-Law No. 9 of 2016 On Bankruptcy.

### 3. Which duties and responsibilities does a director have?

#### 3.1 Sources

The responsibilities of directors are not dissimilar to those found in other jurisdictions (such as the United Kingdom). They derive from multiple sources:

- (i) UAE laws and regulations – in particular:
  - (a) the Civil Code<sup>7</sup>;
  - (b) the Bankruptcy Law<sup>8</sup>;
  - (c) the Penal Code<sup>9</sup>; and
  - (d) the Commercial Companies Law; and
- (ii) contractual arrangements, such as the employment or service contract of the director.

#### 3.2 General directors' duties

The Commercial Companies Law is the key piece of legislation that sets out general obligations and liabilities of directors of onshore UAE companies. The duties are not codified within a single article or section of the legislation. The key obligations include those set out below.

Article 22	The company's managing director is required to <b>preserve the rights of the company</b> and <b>act with due care</b> . He or she shall also <b>carry out all acts that are consistent with the object of the company and within the powers vested</b> .  This duty would extend to the general manager, even if he or she is not a director.
Article 86	A director may not without the approval of the general assembly of the company undertake the management of a competing company or a company with similar objects.
Article 87	The directors of the company are responsible for annual accounts, as well as annual report on the company's activity and financial position (within three months of the end of the fiscal year).

The Commercial Companies Law also contains numerous other obligations in relation to auditing, provision of information to the authorities and calling of shareholders meetings.

Under Article 84 of the Commercial Companies Law, each manager of a company may be **liable towards the company, its shareholders and any third parties** for:

- (i) any fraudulent acts committed by the director;
- (ii) any losses or expenses incurred due to:
  - (a) any abuse of power; or
  - (b) violation of the provisions of applicable law, the Memorandum of Association or the contract of their appointment; or
  - (c) any gross error.

The term "gross error" is not defined. It is generally understood to be based on the objective standard of a prudent person – someone with sufficient experience and commitment to the role.

A director failing to comply with these obligations may be fined and/or, in some circumstances, even subject to criminal sanctions in accordance with the Penal Code.

#### 3.3 Bankruptcy

The Bankruptcy Law imposes several obligations on the management of companies in financial distress and sets out a number of instances where the directors of a bankrupt company may be found personally liable and even subject to criminal sanctions.

The Bankruptcy Law includes the obligations set out below.

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<sup>7</sup> Federal Law No. 5 of 1985 On the Civil Transactions Law of the United Arab Emirates State as amended.

<sup>8</sup> Federal Decree-Law No. 9 of 2016 On Bankruptcy as amended (the "Bankruptcy Law").

<sup>9</sup> Federal Decree-Law No. 31 of 2021 On the Issuance of the Crimes and Penalties as amended.

Examples of Obligations of Directors under the Bankruptcy Law Regime

Obligations	Consequences of Non-Compliance	Recommendations
<p>To apply to the UAE Courts for the formal process of restructuring or bankruptcy when the company has ceased to pay debts as they fall due for over thirty (30) consecutive working days due to financial distress or insolvency.</p>	<p>Directors of a company that failed to file for bankruptcy no longer incurs criminal liability.</p> <p>However, directors may be disqualified from directly operating, managing, supervising or playing any role in the management of any company established in the UAE or exercising any other commercial activity, for a period not exceeding (5) five years.</p>	<p>Exercise due care and diligence in continuously assessing the company's financial position.</p> <p>Ensure the company's accounts are properly maintained in accordance with international accounting practices.</p> <p>Call a shareholders meeting if the company is in financial difficulty.</p>
<p>To maintain commercial books (accounts and records) that are sufficient to reveal the company's financial position.</p>	<p>Up to two years imprisonment and/or a fine not exceeding AED 30,000 if a company is declared bankrupt by a final judgement for managers, directors and liquidators that deliberately did not maintain such commercial books or did not conduct inventory-taking mandated under UAE law with the intent of harming the company or the creditors.</p> <p>Plus, potential disqualification as above.</p>	<p>Ensure board meetings, shareholders' meetings and any decisions are properly justified, recorded and documented (even if this may not have been the case in the past).</p> <p>Exercise good corporate governance. In particular, we would recommend clearly documenting any concerns or reservations regarding decisions taken by the company.</p>
<p>To provide the data required by the trustee appointed under the Bankruptcy Law.</p>	<p>Up to two years imprisonment and/or a fine not exceeding AED 30,000 if a company is declared bankrupt by a final judgement for managers, directors and liquidators that deliberately refrained from providing the data or intentionally provided incorrect data.</p> <p>Plus, disqualification as above.</p>	<p>Fully cooperate with the trustee in respect of any reasonable requests for information and/or documentation.</p>

<p>Not to prefer certain creditors by repayment of their debt (to the detriment of other creditors), even if the intent is to achieve preventative composition or restructuring.</p>	<p>Up to two years imprisonment and/or a fine not exceeding AED 30,000 if a company is declared bankrupt by a final judgment for managers who preferred a creditor after the company's cessation of payment.</p> <p>Plus, disqualification up to 5 years as above.</p>	<p>Seek professional assistance from financial and legal advisors as necessary when attempting to restructure the company's debts.</p> <p>Ensure there is no preferential treatment of certain creditors to the detriment of others, even if certain creditors are driving the restructuring.</p> <p>Carefully consider any conflicts of interests, particularly when appointed as a director or managing multiple companies within a group (and there are inter-company balances) and exercise independent judgement taking into account all creditors of the company. In some circumstances, it may be advisable for certain directors to resign from some appointments.</p>
<p>Not to sell assets at undervalue even if to delay the suspension of payment of indebtedness or declare the company bankrupt.</p>	<p>Up to two years imprisonment and/or a fine not exceeding AED 30,000 if a company is declared bankrupt by a final judgement for managers, if they disposed of assets at an undervalue with bad intent, or resorted to any methods that are detrimental to the interests of the creditors with the intent to obtain money in order to avoid or delay the situation of cessation of payment, adjudication of bankruptcy or termination of the preventative composition or restructuring.</p>	<p>Ensure all transactions are executed on an arms' length basis.</p> <p>Properly and fully document and justify all material transactions, including any related party transactions.</p> <p>Seek shareholders' approval when disposing any assets while facing financial difficulties.</p>

In addition to the risks highlighted above, under Article 144 of the Bankruptcy Law, where the Court finds a company bankrupt and the company's assets are not sufficient to meet at least twenty percent (20%) of its debts, then the Court may compel any or all directors or the managers, to pay all or some of the company's debts, each within the limits of their liability for the debt, if it is proven that they have:

- (i) used a commercial method of "ill-considered risks", such as disposing of assets at undervalue with a view to avoid bankruptcy or delay commencement of bankruptcy proceedings;
- (ii) entered into transactions with a third party to dispose of the company's assets at nil cost or at undervalue without any certain benefit or a benefit that is commensurate with those assets; and
- (iii) fulfilling any of the creditors' debts with the intent to cause damage to other creditors, during the period of cessation of payment or during insolvency.

Article 144 as referred to above has been amended following the aftermath of a landmark decision – the Marka Case. The Marka Case was litigated at the Dubai Court of First Instance, following acceptance by that Court of a bankruptcy application filed by creditors of Marka PJSC. Based on the old version of the Bankruptcy Law, the Dubai Court of First Instance ruled that Marka PJSC's assets were less than twenty percent of its debts and found the company's directors personally liable for all the company's debts.

The Marka Case judgment has been successfully appealed following amendment to Article 144 and, as far as we are aware as of the date of this article, returned to the Dubai Court of First Instance. As amended, the risk of liability under Article 144 became limited to the extent of the directors' wrong-doing referred to in paragraphs (i) to (iii) above. This has a substantial impact, as it significantly reduces potential risks faced by directors and managers where a company is unable to meet its debts. Nevertheless, as the Bankruptcy Law (including the amended Article 144) remain to be fully tested in UAE Courts and as such, we would recommend that a very cautious approach is adopted.

#### 4. Takeaways

The importance of proper decision-making processes and corporate governance practices cannot be overstated. Often, this can make the difference as to whether or not the management of a company is protected against claims relating to breaches of directors' duties in bankruptcy.

Directors of limited liability companies, as well as those in positions of influence over them, need to be aware of the acts and omissions that may result in them being at risk of serious personal liability or even subject to criminal sanctions.

At a very basic level, it is crucial that directors take decisions with due diligence, maintain adequate and sufficiently detailed books and records, reach out to shareholders when the company is facing financial distress and continue to monitor the company's financial situation on an ongoing basis.

We regularly assist creditors, directors of distressed companies as well as liquidators on a range of matters relating to bankruptcy and insolvency in the UAE, including on cross-border matters.

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