

Insolvency UAE

1. Is there any legislation governing trading while insolvent?

The general insolvency legal framework in the UAE is mainly set out in Book Five of Federal Law No. 18/1993 (the **Commercial Transaction Law**).

In addition to the Commercial Transaction Law, certain provisions that are relevant to the UAE insolvency regime can be found in the UAE Federal Law No. 2/2015 (the **Companies Law**). However, not all provisions relating to dissolution in the Companies Law are insolvency related (*i.e.* some of the relevant provisions in the Companies Law relate to solvent liquidation and dissolution of companies with the prior agreement of the shareholders). Hence, the Companies Law is not part of the scope of this article (except for those specific provisions that focus on an insolvency scenario).

The UAE federal laws apply to mainland UAE and to free zones that lack specific insolvency regime. Some free zones have their separate set of insolvency regulations (*e.g.* the Dubai International Financial Centre (**DIFC**) which has its own insolvency regime and laws) which will apply to entities established in said free zones.

It is generally believed by scholars and practitioners that the existing insolvency regime in the UAE is, to a certain extent, outdated and not sufficiently detailed; this implies that the creditors and debtors often seek recourse in arrangements outside the statutory insolvency framework. In this respect, a new UAE insolvency law has been prepared and approved by the Council of Ministers during the first week of July 2015 (the **New Insolvency Law**) adopting a more pragmatic approach, less punitive for the business owners and aimed, to the extent possible, to preserve the company and its running as a going concern. The New Insolvency Law has not come into force yet, as it still needs to be signed and promulgated by the president of the UAE.

There are no explicit provisions under UAE law governing trading while insolvent. However, the Commercial Transaction Law contains some provisions relating to negligent bankruptcy which might be applicable to debtors who knowingly trade while insolvent. In particular, article 649 of the Commercial Transaction Law provides that debtors must file the bankruptcy application within a period of thirty (30) days from the suspension of payment, otherwise they would be considered as a negligent bankrupt. Hence, a debtor who fails from complying with the foregoing and continues trading while insolvent will be considered as a negligent bankrupt.

It is worth noting that a negligent bankrupt is subject to imprisonment for a period not exceeding two years and a fine.

2. Are there any penalties for directors or business owners who knowingly trade while their business is insolvent? How is this evidenced?

- **Business Owners.** Articles 301 and 302 of the Companies Law provide respectively that where the losses of a limited liability company (**LLC**) or a joint stock company (**JSC**) reach half of its capital, the shareholders must decide whether they want to continue operations of the company as a going concern or dissolve the company. However, the Companies Law do not expressly specify whether there is requirement to replenish the company's share capital if the shareholders decide to continue the business and the consequences of the shareholders continuing operations of the company without replenishing the company's share capital. However, shareholders who decide to continue the business without replenishing the company's share capital would be subject to the general provisions of the above-mentioned

article 649 of the Commercial Transaction Law. In other terms, looking at insolvency both from a liquidity test perspective and a balance sheet test perspective, it can be argued that continuing to trade while insolvent under the former test triggers certain penalties (including being subject to a criminal offence); while continuing to trade under the latter test does not *per se* attract express penalties.

- **Directors.** As mentioned above, article 301 of the Companies Law provides that it is the manager who must convene the shareholders for a general meeting to discuss the dissolution of the company when the losses of a LLC reach half of its capital. Similar provisions are found for JSCs in article 302 of the Companies Law which states that, if the losses of a JSC reach half of its capital, it is the board of directors that must convene the shareholders for an extraordinary general assembly meeting to decide whether they want to continue the operations of the company as a going concern or dissolve the company. Furthermore, articles 84 and 162 of the Companies Law provide that directors shall be liable towards the company, the shareholders and third parties for (i) any fraudulent acts; (ii) for any losses or expenses incurred due to improper use of power or breach of the provisions of any applicable law or memorandum of association of the company; or (iii) any gross error. Based on the above, directors who knowingly trade while the company's losses have reached half of its capital and do not convene a general assembly would be considered to be in breach of the Companies Law and will be subject to joint liability towards the company, the shareholders and third parties. It could also be contended that directors who knowingly trade while the company is insolvent are committing fraudulent acts and gross errors and; therefore, their liability exposure would be widened accordingly. It is worth noting that in addition to being liable towards the company, the shareholders and third parties, directors who fail to comply with the provisions of articles 301 and 302 as mentioned above will be subject to a fine.

3. What options does a business in distress have? What options do individuals unable to pay their debts have?

The Commercial Transaction Law sets out two main procedures: "Preventative Composition" and "Bankruptcy".

In light of the foregoing, debtors (whether individual or corporate entities) may initiate insolvency proceedings as follows:

➤ Bankruptcy Procedure

- Article 645 of the Commercial Transaction Law provides that "subject to the provisions of preventive composition, any trader having suspended payment of his commercial debts, at the time of maturity, due to the disruption of his financial position and the unsteadiness of his credibility, may be declared bankrupt". In substantially similar terms, the same regime applies to corporate entities.
- As per article 649 of the Commercial Transaction Law, debtors must file a bankruptcy application to the competent civil court within a period of thirty (30) days from the suspension of payment, otherwise they will be considered as a negligent bankrupt. The civil court competent for bankruptcy procedures is the court in which the commercial establishment is located (the **Court**). In this regard, the debtor must submit to the Court a report showing the reasons for the suspension of payment together with certain mandatory documents relating to the trader (if individual) or the company (if entity), the business and its accounts.
- On the declaration of a debtor's bankruptcy, as per article 656 of the Commercial Transaction Law, the Court must order the sealing of the debtor's place of business and appoint a "receiver in bankruptcy". Additionally, the president of the Court that has decided the declaration of bankruptcy shall be the "trustee in bankruptcy".
- The trustee shall assume control over the administration and proceedings of the bankrupted business and shall take necessary measures to preserve the debtor's assets. He shall convene the creditors for a meeting, summon the debtor to hear the creditors' statements and submit to the Court a quarterly report. Furthermore, the trustee shall appoint one or more controllers from among the creditors.

- The controller must examine the balance sheet and the report submitted by the debtor and shall assist the trustee in exercising control over the receiver's actions.
 - The receiver is appointed to administer the bankruptcy procedures and is subject to the trustee's supervision.
 - Bankruptcy Effects
 - On the issuing of a bankruptcy judgment, the debtor is prevented from operating or disposing of his assets. Article 689 of the Commercial Transaction Law provides that the term "assets" covers all assets owned by the debtor as of the day on which the bankruptcy judgment is issued. However, said term does not cover (i) assets that cannot be seized by law; (ii) assets that do not belong to the debtor; (iii) rights relating to the personal status of the debtor; (iv) indemnities that accrue from valid insurance agreements entered into by the debtor prior to the issuance of the bankruptcy judgment; (v) rights relating to the debtor's person or in his capacity of householder; (vi) rights relating to moral interests; and (vii) profits made by the debtor from his business to the extent deemed necessary by the Court for his and his family's needs.
 - Article 691 of the Commercial Transaction Law states that the issuance of the bankruptcy judgment entails a moratorium and suspends all claims and enforcement proceedings initiated by or against the debtor. However, said article provides for the following exceptions: (i) claims relating to assets which are not covered by article 689 and which can be disposed of and managed by the debtor (as mentioned above); (ii) claims relating to the bankruptcy acts that the debtor is authorized to undertake by virtue of the law; (iii) criminal lawsuits; (iv) lawsuits that are ready for judgment. In this respect, it is worth noting that article 704 of the Commercial Transaction Law states that the judgment of bankruptcy suspends all individual proceedings brought against the debtor by ordinary creditors and the creditors holding general privilege rights. The foregoing entails that secured and privileged creditors may initiate or continue proceedings in respect of the relevant secured asset.
 - Article 696 provides for a "suspect period" during which the following acts taken by the debtor are ineffective *vis-a-vis* the creditors:
 - any donations (except for customary small gifts);
 - settlement of debts before their due date (irrespective of the manner of such settlement);
 - settlement of due debts in a manner other than agreed; and
 - any pledge or other contractual mortgage taken on the debtor's assets in order to secure an old debt.
 - On the issuing of a bankruptcy judgment, a body of creditors (whose rights against the debtor result from a valid cause prior to the bankruptcy judgment) is formed. Within a period of ten days from the issuance of the declaration of bankruptcy, all creditors must submit to the receiver the documents relating to their debts together with a statement of such debts and securities relating thereto (if any). After the expiry of said period, the trustee will make a final list of the debts (which are not subject to objection) (the **List of Debts**).
 - Specific Provisions Applicable to Companies
- Chapter seven of the Commercial Transaction Law sets out some specific provisions applicable to companies' bankruptcy, in addition to the provisions mentioned above (which apply both to individual traders and companies' bankruptcy).
- The manager/director of a company cannot apply for the company's bankruptcy unless he obtains the approval of (i) the majority of the partners (if the company is a LLC); or (ii) the extraordinary general assembly (if the company is a JSC).
 - The shareholders of a company may not file for bankruptcy unless they are also creditors of said company.
 - If it appears that the assets of the company are insufficient to cover at least 20% of its debts, the Court may consider the directors, jointly or severally, liable to pay part or the whole debts of the company in accordance with the Companies Law.

➤ Protective and Judicial Composition

The Commercial Transaction Law provides for two types of preventative compositions: protective composition and judicial preventative composition. Protective composition is initiated by the debtor in order to avoid bankruptcy whereas judicial preventative composition is initiated by the Court following the declaration of bankruptcy.

i) Protective Composition

- Any trader in distress or unable to pay his debts resulting in his cessation of payment can apply for a voluntary protective composition to avoid bankruptcy within 20 days from the cessation of payment, provided that it has been trading for one year preceding the application for protective composition (**Protective Composition**).
- The debtor must show in the application for Protective Composition submitted to the Court the causes for the disruption of the business and provide a proposal for the arrangement provided that said arrangement (i) covers at least 50% of the total debt; and (ii) does not extend the term of the debts for a period exceeding three years from the ratification of the Protective Composition.
- If the Court decides to ratify the Protective Composition, it shall (i) order the commencement of the Protective Composition proceedings; and (ii) appoint a trustee (among the judges at the Court) to supervise the composition and a receiver to initiate and administer the composition proceedings.
- All claims and enforcement proceedings taken against the debtor are automatically stayed, except for secured creditors who did not waive their security to participate in the composition and who may make or continue to make claims against the debtor (via the trustee) in respect of the secured asset.
- The debtor retains control of the business under the supervision of the receiver and can undertake all acts required for the management of the business except for some specific acts which require the approval of the trustee (*e.g.* taking loans and creating pledges etc.).

ii) Judicial Preventative Compositions

- The Commercial Transaction Law provides that, after the bankruptcy has been declared by the Court, the trustee shall convene the creditors whose debts have been accepted to attend the composition deliberations within a period of seven days from the issuance of the List of Debts. Accordingly, the judicial preventative composition (**Judicial Composition**) is initiated by the trustee (*i.e.* the bankruptcy judge) following the declaration of bankruptcy. The trustee shall initiate such composition if the debtor had not previously applied for a Protective Composition prior to the declaration of bankruptcy.
- The trustee shall submit the minutes of the composition meeting to the Court for approval. The Court shall, within for a period of three (3) days from the submission of the minutes, take a decision to annul or ratify the Judicial Composition. If the Judicial Composition is annulled, the Court shall order the sealing of the debtor's assets.
- The Judicial Composition shall become effective once the decision ratifying the preventative composition is issued. The controller appointed by the Court for the bankruptcy proceedings shall assume the function of supervising the implementation of the terms and conditions of the Judicial Composition.
- The Judicial Composition may include a delayed settlement of the debts; reduction of part of the debt (as we will see in the answer to question 8 below) and a guarantee required by the creditors to ensure the implementation of the conditions of the composition.
- Bankruptcy shall cease to have any effect once the ratification of the Judicial Composition is issued by the court. However, it shall not have any effect on criminal prosecution.
- The receiver shall stop from assuming his functions and the debtor may take possession of his assets, books and papers.

iii) Common Provisions

Both composition procedures have several aspects in common including the following:

- In both procedures, secured creditors cannot vote or participate in the composition unless they waive their securities. Furthermore, both compositions shall apply to all ordinary

creditors (even if they did not take part in the composition proceedings). However, they do not apply to secured creditors unless they have waived their securities.

- Both compositions must be approved by a majority of the creditors representing two thirds of the undisputed debts. However, it is worth noting that creditors who did not attend the meeting are not counted in Protective Compositions (as opposed to Judicial Compositions where such creditors are deemed to have rejected the terms of the arrangement).
- If the debtor fails to comply with the conditions of the compositions, such compositions may be terminated by the Court.

➤ **Specific Provisions Applicable to Companies**

Article 813 of the Commercial Transaction Law provides that preventative compositions requires the approval of (i) majority of the partners in a LCC; and (ii) approval of the extraordinary general assembly in a JSC.

4. What options do the creditors of a business in distress have? What options do the creditors of an individual in financial distress have?

- As explained above, the provisions applicable to the insolvency of individual traders are also applicable to corporate entities except for some particularities set out in Chapter seven of the Commercial Transaction Law.
- Article 647 of the Commercial Transaction Law provides that bankruptcy of a debtor may be declared at the debtor's request or at the request of any of its creditors. Furthermore, article 650 of the Commercial Transaction Law provides that (i) any creditor with a commercial and civil debt that has become due may file for declaration of bankruptcy of the debtor provided that said creditor provides evidence showing that the debtor has suspended payment of his commercial debts; and (ii) any creditor with a deferred or conditional commercial and civil debt may file for bankruptcy provided that said creditor provides evidence showing that the debtor has suspended payment of his commercial debts and that the debtor has no known place of domicile in the UAE, has escaped, closed his business; or that he undertook prejudicial acts against his creditors.
- The bankruptcy proceedings, as initiated by the creditor, are the same as those described in paragraph 3 above.

5. Where an individual is in financial distress - are there any rules around the type of property, which can be seized by their creditors?

Article 247 of Federal Law No. 11/1992 (Civil Procedure Law) states that the following assets of the debtor cannot be seized:

- public properties owned by the State or any Emirate;
- the debtor's place of residence;
- personal belongings (*e.g.* clothes, house furniture, kitchen equipment) required by the debtor for his and his family's living and that are indispensable to that effect for a period of six months;
- tools and crops owned by the farmer and the sailor (when the debtor is a farmer or a sailor) required by the debtor for his and his family's living;
- assets donated or inherited by the debtor which constitute a monthly or permanent allowance, pension or alimonies and any other amounts of the same nature ordered by the court noting that if the seizure relates to a pension debt, one quarter of the assets may be seized;
- assets donated or inherited by the debtor (subject to such assets not being seized) which constitute a monthly or permanent allowance, pension or alimonies provided that the

debt of the person making the seizure (being a creditor of the debtor) is created before the donation noting that if the seizure relates to a pension debt, one quarter of the assets may be seized;

- necessary equipment for the debtor's job or profession;
- movable assets accessory to immovable assets provided that the attachment of said movable assets is separate from the attachment of the immovable assets;
- salaries and wages to the extent of one quarter of said wage or initial salary.

6. Are there any specific rules around priority of creditors where there is an individual in distress? Are there any specific rules around priority of creditors where it is a business which is in financial distress?

The Commercial Transaction Law does not establish an explicit distinction between priority rules applicable to individuals and those applicable to corporate entities and does not set out a clear priority of claims. However, article 713 provides that the salaries of the employees which were due within a period of thirty days preceding the bankruptcy judgment have priority over ordinary and secured claims. The Commercial Transaction Law also considers (i) rent due by the debtor to the landlord for one year preceding the bankruptcy judgment and one year following said judgment (**Rent Claims**); and (ii) government taxes for two years preceding the bankruptcy judgment (**Tax Claims**) as preferred claims.

According to articles 718 and 719 of the Commercial Transaction Law, secured creditors will get paid from the proceeds of the sale of assets secured in their favour and will have priority over ordinary creditors. It is worth noting that article 718 of the same law provides that in case the proceeds resulting from the sale of the secured movable and immovable assets do not cover the debts of all the secured creditors, said creditors can participate in the ordinary creditors' general body for the remaining unpaid balance.

It is worth noting that article 717 of the Commercial Transaction Law provides that the trustee may in his sole discretion use the revenues first generated from the liquidation to settle the debts of creditors with securities over movable assets. Based on said article and given that the Commercial Transaction Law is not very clear, commentators have noted that it is uncertain whether the court will give priority to secured claims over Rent Claims and Tax Claims.

7. Is it possible to restructure the debt? If so, what legal procedures generally take place to facilitate this?

It is generally believed that the existing UAE insolvency regime is not particularly well equipped to handle financial reorganization of UAE companies. As a result, most companies often tend to seek recourse in arrangements with their creditors outside of the current legal framework to avoid the cumbersome legal procedure available to parties under said framework. However, the New Insolvency Law aims at providing a clearer path for distressed companies seeking consensual settlement. Said new law provides for a financial reorganization procedure as an out-of-court procedure that affords debtors the option to financially restructure their liabilities without being forced to liquidate or file for bankruptcy.

It is worth noting that when the government-owned company Dubai World was unable to repay its debts in 2009, the Ruler of Dubai issued a new decree specific to Dubai World's restructuring, pursuant to which an independent forum was established, the Dubai World Tribunal responsible

for dealing with financial disputes related to Dubai World's delayed debt payments. Said decree has been drafted closely based on the DIFC insolvency laws and English common law and includes some elements similar to those found in US Chapter 11 such as permitting voluntary arrangements to be approved without the unanimous consent of the creditors in order to support complex financial restructurings. In some respects, the spirit behind said decree has been the basis for the preparation of the New Insolvency Law.

8. Is it possible to waive the debt? If so, what legal procedures generally take place to facilitate this?

Article 773 of the Commercial Transaction Law provides that the preventative composition may include a waiver of part of the debt in favor of the debtor (noting that the debtor shall remain liable for the part that has not been covered by the waiver as a natural debt). However, said law does not address the process and conditions of such waivers. We believe it is left to the parties' discretion (*i.e.* debtor and creditor) to determine the portion of the debt to be waived and the conditions of such waivers.

9. What are the key circumstances in the UAE where security given by a third party could be voidable?

Article 721 of the Commercial Transaction Law provides that the declaration of bankruptcy shall not automatically result in the termination of bilateral contracts in which the debtor is a party provided that such contracts are not based on personal considerations. Furthermore, article 697 of the same law provides that all acts undertaken by the debtor (other than those explicitly mentioned in the answer to question 3 (article 696)) during the suspect period may be deemed void and unopposable to the creditors if such acts caused damage to said creditors and if the third party was aware of the debtor's suspension of payment at the time it entered into the agreement. In light of the foregoing and based on our interpretation of the Commercial Transaction Law, we believe that contracts entered with third parties would only be considered null and void if said contracts caused damages to the creditors or if they were entered based on personal considerations. Hence, securities given by third parties to the debtor after the declaration of bankruptcy would not be, in principle, deemed null and void as said securities do not cause damage to the other creditors.

10. What evidence is required to show third party security has been given?

Under UAE law, there are several forms of securities and we will list here below the most common forms of securities. Security can be evidenced in a number of ways. The manner of evidence usually depends on the type of security and the asset over which the security is created.

➤ Mortgage Over Real Property

As per the UAE Civil Code (Federal Law No. 5/1985), in order to be valid, securities over immovable properties must be registered in the land department in the Emirate where the immovable property is located.

In Dubai, mortgages over real estates are governed by the Dubai mortgage law (Dubai Law No. 14/2008) and the Dubai Real Property Registration Law (Dubai Law No. 7/2006). According to said laws, mortgages over real estate must be registered with the Dubai Land Department (**DLD**). A mortgage is recorded by virtue of a standard form issued by the DLD which must be signed by the mortgagor and the mortgagee. The registration of the security with the DLD is also used as an evidence of said security.

It is worth noting that according to the UAE Civil Code the mortgagor must be the owner of the secured property. Hence, the provisions of the Dubai real estate legislation (including the Dubai Real Property Registration Law) should be complied with and mortgagors who are not GCC nationals can only grant securities over freehold property in the UAE.

In Abu Dhabi, the general provisions of the UAE Civil Code shall apply to the registration of mortgages given that there is no special mortgage law in Abu Dhabi. Therefore, mortgage over real estate would be registered with the land departments of Abu Dhabi. Such registration is also used as an evidence of the security.

Additionally, it is worth mentioning that freehold ownership of properties is restricted to UAE and GCC nationals in Abu Dhabi. Non-UAE and non-GCC nationals can own certain interests in properties (*i.e.* 99 year lease or apartments) in certain investment zones. A practice has developed where said interests in properties are registered with the property developer given that there is no official register for the registration of mortgages held by non-UAE and non-GCC nationals in Abu Dhabi. The validity and enforceability of such “unregistered” mortgages has not been tested by the courts yet. We believe that it is likely that the court would not recognize such “mortgages” given that they are not registered in an official register.

➤ Commercial Mortgage

As per the Commercial Transaction Law, commercial mortgages are taken over “business premises”. Commercial mortgage agreements must specify, *inter alia*, the assets of the business which are covered by the mortgage noting that the mortgage can be taken on all tangible and intangible assets of the company (excluding real estate). If such agreements do not specify the assets covered by the mortgage, it will be deemed to cover intangible assets such as the trade name, the right to let and goodwill of the business. In light of the foregoing, the commercial mortgage does not automatically cover proceeds and revenues generated by the mortgaged assets and will only cover the assets mentioned in the commercial mortgage agreement at the time of registration.

Commercial mortgages must be notarized and registered with the Department of Economic Development in order to be valid. Such notarization and registration could be used as an evidence of the commercial mortgage.

It is worth noting that this form of security seems to be complex for foreigners for several reasons (*e.g.* foreign individual creditors cannot hold directly a commercial mortgage and must appoint a security agent to hold the security on their behalf).

➤ Commercial Pledge by Delivery

As per article 164 of the UAE Commercial Transaction Law, pledges can be taken over moveable assets to secure commercial debts. Such pledges can be evidenced by any means unless provided otherwise in the law; however, they are only enforceable by way of transfer of possession of such assets to the creditor. The pledged asset must be handed over to the creditor in order to prevent the debtor from disposing of the asset. Accordingly, the possession of the asset by the creditor is sufficient evidence of the commercial pledge.¹

¹ It is worth noting that for some assets, commercial pledges can be registered with authorities that are already established for title registration (*e.g.* aircraft, ships or vehicles).

➤ Commercial Pledge over Shares

According to article 210 of the Companies Law, the shares of a JSC may be pledged by the delivery of the relevant share certificates to the creditor.

Furthermore, article 79 of the Companies Law states that a partner in a LLC may pledge the shares to another partner or a third party. This ability has been recently recognized by the Companies Law as opposed to the old companies law (Federal Law No. 8/1984) which did not explicitly prevent pledges over the shares of a LLC but did not expressly recognize such pledges. According to the Companies Law, such pledge must be made in accordance with the terms of the memorandum of association of the company and the Companies Law and must be made in the form of an official document. The pledge is not valid unless it is registered with the commercial register.