

The Court's approach in Bankruptcy cases under existing UAE law

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In on-shore Dubai, the rules and procedures governing bankruptcy are currently set out in Book 5 of the Commercial Transaction Law, Federal Law no. 18 of 1993 ("The Law"). The Law covers the rules and procedures in relation to the bankruptcy of individuals as well as commercial entities. However, the current bankruptcy legislation has not been frequently tested in the Courts. Further, a trend has emerged in that the Courts have been reluctant to apply the bankruptcy law – the tendency has been to circumvent the bankruptcy law and proceed straight to liquidation.

Lawyers and businesses have long been calling for changes to the bankruptcy rules to mitigate financial problems and attract foreign investment.

A draft bankruptcy law designed to support companies in financial difficulties is currently being reviewed before it reaches the final stage of enactment.. This legislation will overhaul how the law deals with businesses and individuals with debt burdens they cannot pay. It is expected that the new legislation will map out a process for the restructuring of debt owed to creditors. The new and less traditional features incorporated in this law will aid in promoting growth in the UAE's economy as it will allow for businesses facing financial hardship to develop frameworks for restructuring which allow them to repay their debt without decreasing their productivity.

This article seeks to give a brief overview of the current law dealing with bankruptcy in the UAE and the salient provisions of the new draft law which is expected to be issued this year. This article also analyses a relevant judgment.

The current legislation regulating bankruptcy

As stated above, the current rules and procedures governing bankruptcy are set out in Book 5 of the Commercial Transaction Law ("The Law").

The Law lacks any definition with respect to the term bankruptcy; rather, it merely highlights the circumstances in which the trader will be considered bankrupt. According to Article 4 of the law a trader is an individual or company carrying out commercial activities.

However, by petitioning the Court to bankrupt a debtor, a creditor avails himself of a set of proceedings and procedures that may secure his debt. The creditor may also benefit from any scheme of settlement with the debtor which will enable him to recover at least some of what he is owed.

Importantly, according to Article 645 of the Law a trader is not regarded as bankrupt unless he is declared bankrupt by the competent civil Court. According to Article 653, the competent Court is considered to be the Court where the trader's commercial office is located, however, if there is more than one office then it shall be for the Court where the principal office of the trader is located. If the trader stops his commercial activity the competent Court shall be considered to be in the country of residence and in case he has no residence in the country the competent Court shall be the jurisdiction in which he has stopped paying his debts.

Article 645 of the Law stipulates that:

- Any trader who is not able to pay his commercial debts on the due dates by reason of his financial instability, may be declared bankrupt;
- Any trader who uses illegal means for paying his debts shall be regarded as unable to pay those debts;
- A trader shall be declared bankrupt only after adjudication by the competent Court.

Articles 647, 649 and 650 of the law specify the persons and government entities entitled to apply for a declaration of bankruptcy. These include the trader, the trader's creditor(s) and the Court on its own initiative. The public prosecution may also make a request for a declaration of bankruptcy.

Article 649 of the Law grants the trader the opportunity to apply to the competent Court for a declaration of bankruptcy if he is not able to pay his debts; however, this is not compulsory for the trader unless 30 days lapse from the date when he ceased payment of his debts. Importantly, in these circumstances it becomes obligatory for him to apply for a declaration of bankruptcy; failing which he will be considered as committing an act of bankruptcy by default. This is a criminal offence under the UAE Penal Code, Law No.3 of 1987. Article 649 also sets out the procedure to be followed by a trader when applying for such declaration for being unable to pay his debts and the supportive documents that should be presented accordingly.

Article 650 of the Law gives the creditor (s) (whether for a civil or commercial debt) or the trader the opportunity to apply for such declaration on condition that:

- they submit the evidence that satisfy the Court that debtor has ceased paying his commercial debts as they fall due;
- they satisfy the Court that the debtor has no residence in the UAE, he has closed his place of business and started the procedure for winding up, or that he has absconded, whereas for the debt not yet due, or he is carrying acts that adversely affect its creditor (s). In this case the creditor(s) will have to prove that the debtor ceased payment of a due commercial debt.

After the bankruptcy application has been submitted to the Court, according to Article 652 of the Law the Court must take all the necessary measures and steps to preserve, protect the debtor's assets and manage them.

After satisfying all the necessary procedures and resolving all disputes and applications concerning the case, the Court will then issue a judgment declaring the debtor bankrupt.

After the Court delivers its judgment declaring bankruptcy, there are certain procedures that must be followed subsequent to that judgment, such as:

- sending a copy of the judgment to the public prosecutor, the Ministry of Economy & Commerce, the trustee/receiver, the Central Bank and the competent commercial registrar (Article 655 (2));
- the Court in its ruling usually specifies an approximate date for the trader to stop payment of his debts (art 655 (1)); however, if the Court failed to specify such date, in this case the date of issuance of the judgment should be considered as an approximate date for the trader to stop the payment of his debt (Article 660 (1)). It should also be noted that Article 659 empowers the public prosecution, debtor, the creditor (s), the trustee and interested third party to amend the temporary date;
- displaying the judgment on the notice board at the Court for a period of 30 days, on the day following its issue. The judgment shall be sent to each Court having jurisdiction over the debtor's place of business or branch or agency or office of the debtor, in order to be displayed on the notice board at such Court for a period of thirty days (art 660 (2));
- once the bankruptcy judgment is issued, the Court shall order the closure of all the trader's places of business and shall appoint a trustee;
- publishing the judgment in a local newspaper by the trustee (art 661);

According to Article 662 of the Law any interested third party may file an objection against the judgment before the Court that has issued it within ten days from the date of the publication of the judgment in the newspapers. If the Court rejects the opposition, the Court decision shall be appealable to the Court of Appeal.

Articles 668-681 of the Law deals with the person (the trustee) who administers the bankruptcy as well as their powers and liabilities. Such persons should have good standing and reputation and should not be one of the bankrupt's creditors or a spouse or a close relative to the fourth degree, or an ex-partner, accountant, agent or employee of the bankrupt).

Moreover, Articles 682-724 of the Law deal with the effect of bankruptcy on:

- The debtor (Articles 682-702);
- On ordinary creditors (703-710) On creditors who have debts secured by moveable/immovable properties (711-720) and
- On legal claims (721-724).

In this section the legislator establishes a rule that individual proceedings shall be suspended in the case of ordinary creditors or creditors holding liens, including individual enforcement proceedings against the property of the bankrupt or their completion if they were commenced before the declaration of bankruptcy, with certain exceptions – where proceedings have been permitted by the judge such as in the case of a sale of property on a fixed date. Pursuant to the principle enshrined under this Section, payment due dates are deemed to be cancelled upon the declaration of bankruptcy

Furthermore, Part 5 of this section sets out provisions dealing with contracts that the bankrupt entered/concluded prior to being declared bankrupt; and reconciles the interests of creditors and the Bankrupt on the one hand and the other parties to the contracts on the other hand by providing that a bankruptcy order does not normally lead to the termination of binding contracts unless it is based on personal considerations. The other party to the contract reserves the right to terminate it if the trustee in the bankruptcy proceedings fails to perform the contract or continues with its performance and any action taken by the trustee, in respect of the contract, is subject to the judge's approval. A contracting party always has the right to participate in the bankruptcy as an ordinary creditor to recover for termination while retaining the lien prescribed by law.

Administration of bankruptcy cases (such as administration of assets, realization of debts and closure of bankruptcy for lack of funds) is dealt with in articles 736-760 of the Law.

However, one of the most important elements of bankruptcy proceedings is the composition or settlement arrangements made between the debtor and his creditors. The importance of such arrangements is that it may allow a debtor to avoid the consequence of an adjudication of his bankruptcy. A composition scheme is a preventive measure which will avoid the debtor facing bankruptcy proceedings and is usually arranged by the debtor before any adjudicating proceedings ("Composition Scheme"). There is also another scheme of composition in which the debtor can participate, which is a simple adjudication composition or settlement that is conducted after adjudicating proceedings ("Judicial Composition").

However, such composition whether Composition Scheme or the Judicial Composition can affect either the:

- debtor (such as avoidance of the threat of bankruptcy proceedings; the maintenance of full power, control and authority to manage his own business; and the payment of his debts according to a deferred payment schedule); or
- creditors (the terms of a Composition shall be binding on all ordinary "unsecured" creditors for all debts accruing before the Judicial Composition or Composition Scheme, irrespective of whether or not they have participated or voted for the adoption of the Composition. However, the Composition shall not apply to secured creditors or for ordinary debts accruing after the Composition application is submitted to the Court.)

According to the provision of the Law a Composition shall be terminated once the debtor has honored all of his obligations. The Composition shall also terminate if an application is made and accepted for its nullification. The Composition may be annulled for any fraud undertaken by the debtor (such as concealment of property or falsification of debts or accounts). The Composition may also be repudiated by any creditor if the debtor fails to honor his obligations under the Composition. The effect on the debtor of honoring the conditions of the Composition is to allow him to resume all his rights and duties as a normal trader whereas the effect of any nullification or repudiation of the Composition restored the parties to their original positions before the presentation of the Composition. The debtor then faces the threat of bankruptcy and its severe consequences.

The Draft Bankruptcy law

The general aim of the new draft law is to create a more modern, debtor-friendly bankruptcy regime, with particular emphasis on the rescue of a debtor's existing business or the restructuring of a debtor's liabilities where the debtor gets into financial difficulties, rather than the existing formal bankruptcy procedures. Some of the bankruptcy procedures described herein draws heavily on existing French bankruptcy laws.

The provisions of the new draft law apply more widely than the current rules and procedures governing bankruptcy in Book 5 of Federal Law No. 18 of 1993. However, the new draft law shall not govern Government authorities and Entities incorporated and licensed to operate in a financial free zone such as the DIFC. It will, however, apply to any company incorporated pursuant to the Commercial Companies Law as well as an individual (any natural or juridical person practicing any activity for profit purposes).

New streamlined rescue procedures for traders and entities carrying on business for profit comprising a 'financial re-organisation' procedure and a 'protective composition' procedure feature in the draft law.

The draft law incorporates provisions for a streamlined bankruptcy process for 'small' bankruptcies; and specific provisions in relation to non-trading individuals where the bankruptcy regime is extended to include a rescue procedure. Furthermore, the concept of set-offs in bankruptcy matters was simplified in the draft law.

Further, the draft law empowers the UAE Council of Ministers to set up a Commission; charged with the administration of financial re-organisation procedures and the preparation of an approved list of bankruptcy experts. The UAE Council will also maintain two registers, the first one for ineligible/incompetent persons that has been formerly judged as incompetent and the second for Court judgments and orders imposing any limits on bankrupts whether permanent or temporal.

The provisions of the procedures of financial reregulation incorporated in the draft law aim to facilitate a consensual agreement signed outside the Court between the debtor and his creditors with the help of an assistant assigned by the committee for this purpose.

Finally, the new draft law sets out provisions related to preventative composition procedures, bankruptcy procedures and preferential treatment of creditors.

A Case study - how the provisions in the current law have been interpreted by the Dubai Courts.

The Facts

A commercial action (the "Commercial Action") was filed on 11 April 2006 before Dubai Court of First Instance by a local company ("the Claimant") against another local company ("the Defendant"). The Claimant requested the Court to:

- Declare the Defendant bankrupt and to confirm the date of 13.5.2004 as the date the Defendant ceased payments;

- to seal the Defendant's premises;
- to appoint a receiver/trustee to oversee the bankruptcy proceedings;
- to take appropriate measures to safeguard and manage Defendant's assets and to collect the fees, costs and advocate's fees out of the proceeds from the realisation of assets; and finally
- Render its judgment with immediate enforcement without the requirement of a bond.

The Claimant submitted that it owed the Defendant an amount of AED 1,179,654 ("the Claimed amount") in addition to any interest accruing from 16 April 2005 pursuant to the final decision rendered earlier in the Commercial Action that bore an executory stamp since 2004 ("the First Court Action").

The Claimant further submitted that the Defendant was a trading company which had failed to pay the amount of the judgment despite having being ordered to make such payment on 27 April 2004 by virtue of the First Court Action. However, the Defendant was not in a position to pay as he was going through financial distress. In addition, there were severe credit issues that put other creditor's claims at risk because of the various Court claims and attachments brought against the Defendant by the Claimant and other creditors.

In light of these facts the Claimant contended that the conditions to declare the Defendant bankrupt were met.

In accordance with Article 61 of the Evidence Law, the Public Prosecution was notified of the case in order to provide an opinion. The Public Prosecution advised the Court to appoint an accountant expert in the case in order to:

- investigate the financial status of the Defendant;
- To reveal whether it ceased payment of its debts, and if so the reason behind this;
- To reveal whether the Defendant was still carrying out commercial activities; and
- to assess its current financial status and its financial status for the fiscal year ending in 31.12.2005.

The Court of First Instance

In light of the Public Prosecution's advice, the Court of First Instance issued its preliminary judgment on 30 January 2007 and decided to appoint an accounting expert to investigate the financial status of the Defendant and to address the question of whether the Defendant had ceased payment of its debts. The expert was also to look at the cause of the ceased payments and to assess its current financial status and during the fiscal year ending in 31 December 2005 and to ascertain whether the Defendant was still carrying out its commercial activities.

The Court appointed expert submitted his report and concluded that:

- the Defendant Company was not carrying on business because its trade license had not been renewed since 14 May 2004. The expert also found that a closure report for the Company was made on 06 November 2006 which confirmed that the company had remained closed for several months;
- The Defendant had no outstanding amounts due except for one payment owing to one company located in the Emirates of Ajman. However, there were claims pending in Court and Defendant had not ceased to pay its debts as some were paid in Court while others were released or waived;
- The current financial status of the Defendant clearly indicated that it had stopped carrying out commercial activity since 12 August 2006;
- That although the Company Director was incarcerated, he had been acquitted and no penalty was imposed; and
- That the Company has ceased business operations and has not had an active premises since 06 November 2006.

The Court of First Instance interpreted the facts of the case in light of Article 645 of the Commercial Transactions Law. The Court decided that the company had been shut down, had not been carrying out

any business transactions for a few years, had no premises since 6 November 2006. It also found that the Defendant had not renewed its commercial license since 14 May 2004. Although its director and partner were still in jail the Court found that the Defendant had not ceased payment of its due debt as some were paid in Court while others were released or waived. It was also found that the last commercial transaction in cash took place on the 12 September 2006.

The Court determined that it is an established principle that to declare the bankruptcy of a trader the latter should have stopped making payments as scheduled. The expert report clearly established that the Defendant did not cease payment of its due debts, meaning that the most important condition to declare the Defendant bankrupt was not met. Accordingly the Claimant's action was found to be devoid of any legal basis and was dismissed. The Court of First Instance directed the Claimant to pay the costs and AED 500 in advocate's fees.

Consequently, the Claimant appealed the judgment to the Court of Appeal on 05.12.07.

The Court Of Appeal

In its explanatory appeal memorandum the Claimant argued that the Court of First Instance erred in its decision. The basis for the Claimant's appeal was that:

- The lower Court incorrectly applied the law;
- The lower Court ignored the documented facts, and failed to articulate its reasoning adequately by dismissing the case despite the conditions for declaring the Respondent bankrupt being met;
- The expert's report, read with the Claimant's evidence, was conclusive evidence that the Defendant was in fact in default of its debts due to severe financial distress which was undermines its credit rating. The Claimant argued that this placed the rights of its creditors (which included the Claimant) at risk. The Claimant made specific reference to the Defendant having failed to pay the debts it owed to the Claimant, which currently stood at over AED 1.2 million.

On 10 February 2008 the Court of Appeal dismissed the appeal and upheld the Court of First Instance's decision. The Court of Appeal relied upon the expert report and the Court of First Instance's interpretation of Article 645 of the Commercial Transactions Law. Again, the Claimant was directed to pay legal fees and AED 1,000 in advocate's fees. Subsequently, the Claimant filed an appeal before the Court of Cassation.

The Court of Cassation

The Court of Cassation interpreted Articles 645 (1), 647 (1), 650 (1), 801 and 802 (1) of the Commercial Transactions Law to mean that the creditor of an LLC company enjoys the right to request the Court to declare the concerned LLC bankrupt in cases where the LLC has ceased paying its commercial due debt as a result of financial distress and severe credit issues.

The Court enounced that it was a settled principle that the non- payment of the debtor of his commercial due debts without any valid reason is a presumption that can be used against him but that it did not equate to an irrevocable conclusion that the debtor had permanently stopped/refrained from payment of his debt(s) because several explanatory situations could be applicable:

- An excusable reason/un-expectable situation that forced him to stop payment despite his ability to continue payment of his debt; or
- The debt amount is contested.

The Court decided that the fact that the debtor ceased payment is a legal point for adjudication by Court of Cassation, and that such point is an essential condition that should be satisfied in order to declare the bankruptcy of any debtor.

Furthermore, the Court decided that in order to declare the trader bankrupt it is not required that the

trader should cease payment of several commercial due debts; it is sufficient to declare the bankruptcy of a trader if he ceased payment of only one commercial due debt.

Moreover, the Court of Cassation decided that the appealed judgment had lacked reasoning as it failed to reply to an essential defence raised by the Claimant who provided evidence in support of it. According to the Court of Cassation such defence would be summarized as follows:

- The Defendant remains, without justification, in default of payment of its commercial debt of AED 921,797 plus interest pursuant to the First Court Action rendered against it earlier;
- a) The Defendant is in financial distress in view of the various attachments granted by a summary judge over its assets and from various criminal cases brought against its Director for issuing cheques without funds and; b) from the fact that its premises remained closed in addition to c) the fact that the Defendant refrained from resuming any commercial activities.

The Court of Cassation held that the Court of First Instance had overlooked these facts, which the Court of Cassation determined led to a finding that the Defendant Company had ceased its payments and put the Claimant's claims at risk.

The Court of Cassation rejected the lower's Court decision that concluded that the existence of its director in jail would prevent the Defendant from running the business.

In light of this the Court of Cassation overturned the lower's Court decision and decided to refer the case back to the Court of Appeal for a new decision under a different panel of judges. This time, the Defendant was directed to pay the costs and AED 1,000 in advocate's fees.

The Court of Appeal (referral Court/remand)

The Court of Appeal decided to reopen the proceedings for further submissions and to question the Court appointed expert on his report.

At a subsequent hearing the Court appointed expert attended and answered the Court's questioning as follows:

- the Defendant is going through a difficult financial situation;
- its license had expired on the date indicated in the report;
- the Defendant is not carrying out any business commercial transaction;
- The Defendant did not cease payment (is not in default) as it had made payments for some of its debt obligations;

The expert confirmed at the hearing that the Defendant had difficulties in paying the balance of the remaining accrued debts and had sought an extension of time to file an additional report based on the Court's enquiries.

The expert submitted his additional report where he concluded that the Defendant had already settled some of the Court claims in connection with 53 criminal complaints but that it had failed to settle the remaining claims. Furthermore, the expert concluded that the Defendant had failed to pay the amount to the Claimant as determined by the First Court Action. The expert concluded that the reason the Defendant had ceased making payment was because of its weak administrative capacity. This was further linked in the expert's view to the expiry of the trade license and the closure of the Defendant's premises. Furthermore, the expert added in his report that the Defendant lacked sufficient revenues to meet its contingent liabilities i.e. Court claims, or to meet periodical and administrative liabilities and general expenses.

Most importantly, the expert concluded that the Defendant was not considered creditworthy in the market and that its current financial status clearly reflected the existence of claims against it in court. The

Defendant was also subject to bounced cheque claims as well as attachments over its assets which had been attached and sold in favor of the landlord on 06 November 2006. The expert also found that the company had no vehicles registered in its name or any funds in its Dubai Islamic Bank account. Finally, the expert concluded his report by stating that “the Defendant had not been carrying out any business transactions in the past year ending in 31 December 2005 but had some commercial transaction in the year 2006”.

In light of this report the Claimant’s lawyer filed with the Court a docket list comprising an original certificate “to whom it may concern” from the Dubai Courts concerning an Execution Action for Dubai Rents filed by the landlord against Respondent whereby its assets were sold through the Court.

In response, the Defendant’s lawyer filed a memorandum commenting on the expert report and requested the Court to return the case back to the same expert and instructing him to meet with the Defendant’s Director in jail to determine its liabilities to third parties.

In support of his commentary memo the Defendant’s lawyer filed a docket comprising:

- Waivers on the part of Complainants in criminal cases in favor of Defendant’s Director.
- Particulars of a case attesting acquittal of the Defendant’s Director in many cases.

The Court of Appeal then decided to reopen the proceedings for further submissions and in order to request the Public Prosecution to advise on the subject matter of the case.

The Public Prosecution advised that the appeal be accepted in form and on the merits. The Public Prosecution also advised that the contested decision be cancelled and that the Defendant be declared bankrupt and the legal procedures to be initiated accordingly.

In view of the above facts, expert reports and the involvement of the Public Prosecution the Appeal Court decided that the Defendant should be declared bankrupt despite the fact its Director had settled some of its debts and the fact that certain complainants waived their claims.

In light of the above, the Court of Appeal overturned the appealed judgment and declared the Defendant bankrupt and fixed the date of 14 May 2004 as the approximate date whereupon the Defendant had ceased payments. The Court of Appeal further decided to seal the Defendant’s premises located in Dubai and to appoint a bankruptcy judge and a receiver to oversee the bankruptcy proceedings including the taking of appropriate measures to safeguard and manage the Defendant’s assets in accordance with the law. The Court directed that the receiver’s fees be paid out of the proceeds from the realization of assets.