

Insolvency in the UAE – Business failure without Bankruptcy Rules

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This article is a case study on how the UAE, a country with two cities which are significant international financial and business centres (namely Dubai and Abu Dhabi), functions without effective insolvency laws; and why this state of affairs is likely to continue for some time.

Whilst it is not strictly true that the UAE has no insolvency laws at all, it is fair to say that no one (debtors or creditors) makes use of the existing laws. A new UAE insolvency law has been drafted, but in the writer's view it will be years before it sees the light.

A BRIEF HISTORY

Before the global financial crisis of 2008, the bankruptcy laws of the UAE were hidden away in the statute books, invisible and unknown. Even today, in the aftermath of four years of major business problems following the financial crisis of 2008, the procedures under this existing law remain almost completely unused.

In the early 20th century, most of the former Trucial States (including Dubai) adopted a comprehensive civil code, based on an older French model adapted for the Arabic world by the Egyptians. This comprehensive civil code always contained within it bankruptcy rules and machinery – but the bankruptcy rules were cumbersome, Court driven and expensive to use. Old Dubai was a business backwater with business activity dominated by pearlers and by fabric, gold and spice traders. They never had much use for bankruptcy laws.

Beginning in the 1970's a major financial and business centre arose from the sands of Dubai. In the years following there was an almost unbroken sequence of positive economic growth which extended all the way to the financial crisis of 2008. Businesses sometimes failed, but insolvency was exotic, rare and confined to small players. No one exercised the bankruptcy laws and no one was aware that they were embedded in the civil code, including many in legal and banking circles who should have known. Then came the summer of 2008.

THE FINANCIAL CRISIS OF 2008 AND ITS AFTERMATH

When the Dubai property bubble exploded in 2008, and the lending cycle halted abruptly, many office towers of the emirate were populated with insolvent enterprises. Newspaper articles and business magazines were full of speculation about how this state of affairs could possibly be managed with no bankruptcy law in the country. In due course, it was pointed out by legal aficionados of the civil code that, in fact, there were, and always had been, bankruptcy laws in the UAE.

Surprisingly, even after the financial catastrophe of 2008 and the revelation that there was no legal void, the bankruptcy laws continued to gather dust. There were many failed property developers and share speculators, but the business and banking community avoided the original bankruptcy laws. The writer is aware of only one significant corporate insolvency which was administered in the UAE under the existing law, the White Bay LLC case which concerned a failed property developer in the Emirate of Umm Al Quwain.

HOW DO THINGS WORK WHERE THERE IS NO EFFECTIVE BANKRUPTCY LAW?

Although the existing bankruptcy laws are not used in practice, there is value in having them on the statute books because they create a baseline of legal rights and rules which define and constrain behaviours in the market. Two examples are:

- the bankruptcy rules recognise a “*pari passu*” principle, which is obviously a starting point in negotiations between creditors and debtors;
- the bankruptcy laws do contain provision for the Court to make personal liability orders against directors and managers where a return to creditors is less than 50%; a provision which provides an incentive for controllers of insolvent companies to negotiate with creditors.

Several avenues are commonly employed for the resolution of insolvency issues, namely:

Informal Arrangements

These are relatively common and whilst sometimes facilitated by outside advisors they are usually negotiated directly. In practice, creditors are usually not treated equally, either because the controllers wish to look after their friends or because some creditors have more leverage than others e.g. they supply essential goods, services or relationships. Unfortunately, informal arrangements usually break down if a significant creditor is not prepared to agree and files a case in Court.

Loan Restructurings

Most of the larger and more conspicuous insolvent companies have undergone insolvent reconstructions camouflaged as refinancing negotiations. These restructurings can be sabotaged where major creditors, financiers or others break ranks and bring legal cases. However, generally these legal cases take a long time to be resolved in Court.

Jailing Debtors

Historically, in the UAE cheque signatories committed a criminal offence when their cheques were dishonoured. It was open to the payee to lodge a criminal complaint against the signatory (even where the cheque is a company cheque). Arrest Warrants were commonplace. Banks and other counterparties often require post-dated cheques to be given as security. This criminal sanction gives banks powerful leverage and they can often extract money from debtors in this way. The law has recently been amended to decriminalise the dishonouring of a cheque given as security where the signatory is a UAE national, but the law is still very important in practice as most of the UAE population (about 85%) is expatriate.

THE PROPOSED NEW INSOLVENCY LAW

Since 2011, work has been proceeding on a new insolvency law and there is a draft circulating. The draft incorporates elements from the French, German and US systems and reflects a debtor friendly and Court-driven process. However, in the writer’s opinion the new law is unlikely to be enacted for some time, probably several years.

Although there have been public announcements which point to an earlier introduction, the pace of legal reform in the UAE can be slow. For example, the revision to the UAE Commercial Companies Law has been under process since 2004 and it is yet to be enacted.

A new insolvency law is unlikely to come into force for some time because:

- comprehensive bankruptcy law reform is one of the most challenging legal reforms which can be

attempted, as it cuts across contractual rights, property rights, banking practices, debt recoveries and even family law. The design of sensible interfaces with the other elements of the local legal system is extremely complex and intricate. I think it will take some time to resolve these issues within the UAE's federal framework;

- there is opposition in some banking circles to the introduction of the new law, partly because it is a debtor friendly regime and also because the recent decriminalisation of the dishonouring of security cheques in cases involving UAE nationals gives the banks less leverage to recover loans; and
- existing economic conditions are buoyant, so the issue of insolvency seems less urgent than it was three years ago.

CONCLUSION

I believe the business and financial community in the UAE occupies the space between existing bankruptcy rules, which no one uses, and a new bankruptcy law which is unlikely to see the light for some time. At times, both debtors and creditors experience difficulties in this legal void, but until we see a modern insolvency law UAE creditors and debtors will be left to find their own way through the challenges of business failure.

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