



The restructuring and insolvency regime in the Dubai International Financial Centre

Our November briefing, *The restructuring and insolvency regime in the United Arab Emirates*, examined the restructuring and insolvency regime applicable to companies operating under United Arab Emirates (UAE) law. In this briefing, we provide an overview of the restructuring and insolvency regime set out in the laws and regulations of the Dubai International Financial Centre (the DIFC).

Introduction

The DIFC legislation provides a framework for a restructuring and insolvency regime that includes company voluntary arrangements (CVA), receivership (including the appointment of administrative receivers) and liquidation (including voluntary winding-up at the direction of the members or creditors of the company or compulsory winding-up under a court order). The legislation places greater emphasis on action to be taken once a company is insolvent than solvent reorganisations and, as is discussed in further detail below, it is possible that a moratorium will not be available to many of the companies operating in the DIFC (see The DIFC below).

This briefing will commence with an overview of matters that will be of primary concern to directors when faced with an impending distressed company scenario and then continue by looking at the voluntary restructuring and winding-up options for a company

in difficulties. The briefing then considers the options available to third-party creditors to take unilateral action, before concluding with an overview of related DIFC law provisions relating to ranking of creditors and the application of DIFC law to entities with a branch office or subsidiary in the DIFC.

DIFC restructuring and insolvency regime

The principal DIFC legislation relating to insolvency is the Insolvency Law 2004 (the DIFC Insolvency Law), the Companies Law 2006 (the DIFC Companies Law), the Insolvency Regulations and the Preferential Creditor Regulations. The board of directors of the Dubai International Financial Centre Authority (DIFCA) is authorised to make regulations for the purposes of the DIFC Insolvency Law. The DIFC published a draft updated insolvency law and related regulations for consultation purposes in November 2008. The consultation period ended on 13 December 2008 and we understand that, subject to any comments or concerns from the office of the Ruler's representative, it is anticipated that the revised law and regulations will be enacted shortly. The draft updated insolvency law and regulations, if enacted in the form published for consultation purposes, would not materially change the analysis of the DIFC restructuring and insolvency regime set out in this briefing.

Generally, the provisions of the DIFC Insolvency Law relating to CVAs, receivership and liquidation apply to 'companies', which is defined under the DIFC Insolvency

The DIFC

- Established as a Federal Financial Free Zone for the Emirate of Dubai in June 2004.
- Exempted from all federal civil and commercial laws within the UAE, except UAE criminal laws, administrative laws and the Anti Money Laundering law.
- Empowered to create own regulatory framework for all civil and commercial matters.
- Has its own judicial system (the DIFC Judicial Authority and the DIFC Court System).
- Any entity operating in the DIFC is required to be incorporated or registered under the relevant DIFC law. All businesses registered at the DIFC are subject to the laws of the DIFC.

Law as any company ‘incorporated under the [DIFC] Companies Law’. The application of the DIFC insolvency regime to branches and subsidiaries of companies incorporated outside the DIFC is discussed in more detail below.

Choice of laws under DIFC law

DIFC law provides for a hierarchy of applicable law for any civil or commercial matter as follows:

- i the laws in force in the DIFC;
- ii the laws of any jurisdiction other than that of the DIFC expressly chosen by any DIFC law;
- iii the laws of any jurisdiction as agreed between the contracting parties;
- iv the laws of the jurisdiction that appears to the court or the arbitrator to be the one most closely related to the facts and the persons concerned in the matter; and
- v the laws of England and Wales.

The DIFC insolvency regime contains a significant number of grey areas, which have not yet been tested by the DIFC court. The only case relating to the DIFC Insolvency Law to have come before the DIFC court to date, *Re Forsyth Partners Global Distributors Limited* (which considered the interpretation of ‘preferential debts’) casts doubt on the use of provisions of foreign law to fill any gap in the DIFC Insolvency Law in circumstances where the legislation expressly provided for such a gap to be filled by additional regulations. However, it did not discuss the merits of using foreign law as a means of interpreting the existing legislation and it seems likely that the DIFC court would consider foreign law (including English law in particular considering the similarities between DIFC and English insolvency legislation) when interpreting the provisions of the DIFC Insolvency Law.

Key considerations for directors – an impending distressed company scenario

Below are some of the key issues for consideration by the directors of a company at that juncture where they are aware that the company is facing potential solvency issues, but before the actual commencement of restructuring or insolvency proceedings.

Liability of directors and officers

The DIFC Companies Law requires that directors and other officers of companies, in exercising their power and discharging their duties, act honestly, in good faith and

lawfully, with a view to the best interests of the company; and that they exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. Directors must not act outside the power of the company and must act within the limits of their powers imposed by the company’s articles of association.

Directors are also deemed to act as fiduciaries to the relevant company under DIFC law. As such, directors have various fiduciary duties to the company. Many of these fiduciary duties overlap with general duties of directors (as described above) but others serve to extend the general duties to cover additional matters, including (for example) the duty to avoid conflicts of interest, the duty not to misuse company property, the duty of loyalty to the company and the duty of confidentiality.

Failure to comply with directors’ duties may result in an individual director being liable to civil penalties under DIFC law (including personal liability and disqualification) as well as potential criminal proceedings under the UAE Penal Code. The position of the UAE Penal Code as applicable in the DIFC is somewhat uncertain but, to the extent that a director remains in compliance with his obligations under the DIFC regime, it is difficult to see how the UAE Penal Code would be applicable in such circumstances.

Fraudulent and wrongful trading

DIFC law imposes penalties for ‘fraudulent trading’ and ‘wrongful trading’.

The DIFC Insolvency law defines fraudulent trading as carrying on the business of the company ‘with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose.’ A person who is ‘knowingly’ a party to the carrying on of the business in such a manner will be guilty of the offence of fraudulent trading.

Conversely, ‘wrongful trading’ applies when in the course of the winding up of a company it appears that the company is in fact in insolvent liquidation, and at a time before the commencement of the winding up of the company one or more directors of the company knew or ought to have known that there was no reasonable prospect of the company avoiding going into insolvent liquidation. The DIFC Insolvency Law is, however, silent on what precisely will constitute ‘insolvent liquidation’.

Although this term could be interpreted to cover any of the four tests of insolvency which determine whether a court may be wound up compulsorily by the DIFC court (for further detail see below under the heading ‘Court-ordered winding-up’), it would seem reasonable to conclude that only those tests that specifically contemplate balance sheet and/or cash flow insolvency would apply in this context.

The DIFC Insolvency Law also imposes sanctions for fraud in anticipation of winding up, transactions in fraud of creditors, falsification of companies’ books, material omission from statement relating to company’s affairs, and false representations to creditors (together, such actions and omissions being, for the purpose of this briefing, Delinquent Actions).

If in the course of the winding up of a company it appears that wrongful or fraudulent trading or a Delinquent Action has taken place, the DIFC court has the power to make such orders as it sees fit in relation to the person conducting the wrongful or fraudulent trading or carrying out the relevant Delinquent Action, including an order to return or pay to the company any money or other property of the company that he has misapplied or retained, or become accountable for; to compensate the company in respect of any breach of fiduciary duty; and to make such contributions (if any) to the company’s assets as the court thinks proper.

The DIFC Insolvency Law does not provide for any defence to the assertion of wrongful trading and, as noted above, following the *Re Forsyth* case there is doubt as to how far the DIFC court will be prepared to go with respect to filling in gaps in the DIFC legislation with provisions from equivalent regimes under foreign law. Accordingly, the prospect of the DIFC court inferring a defence to the wrongful trading regime where the directors take all steps to minimise losses to creditors (as is the case in English law) must be treated with caution.

Transactions liable to be set aside

Transactions at an undervalue

The DIFC Insolvency Law provides that where a receiver or administrative receiver is appointed to a company, or where a company goes into liquidation or a provisional liquidator is appointed, and where the company has at a ‘relevant time’ (as defined below) entered into a

transaction with any person at an undervalue, the DIFC court may, on application of the receiver, administrative receiver, liquidator or provisional liquidator, make an order to set aside the transaction.

Relevant time

The ‘relevant time’ for the purposes of transactions at an undervalue and preferences is:

- two years prior to the onset of insolvency in respect of transactions at an undervalue and preferences involving connected persons;
- six months prior to the onset of insolvency in respect of preferences involving unconnected persons; and
- in the case of transactions at an undervalue and preferences, at any time between the presentation of an administration petition and the making of an order.

Transactions at an undervalue include gifts and transactions where the company either receives no consideration or receives consideration the value of which is significantly less than the value of the consideration provided by the company.

The DIFC Insolvency Law provides a defence to transactions at an undervalue where the company that entered into the transaction did so in good faith and for the purposes of carrying on its business and where there were reasonable grounds for believing that the transaction would benefit the company at the time of entry into the transaction.

Preferences

Where a company has given a preference to a person at a ‘relevant time’ (see definition above) such ‘preferred’ transaction may also be set aside. A company is considered to have given a preference to a person where:

- such person is one of the company’s creditors or a surety or guarantor for any of the company’s debts or other liabilities;
- the company does anything or suffers anything to be done that, in either case, has the effect of putting that person into a position that, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done; and
- provided that the company was influenced to give the preference by a desire to put such third party in a better position than if that thing had not been done.

A company that has given a preference to a person connected with the company (otherwise than by reason

of being its employee) at the time the preference was given is presumed, unless the contrary is shown (for example, by receiving additional material consideration therefore), to have been influenced in deciding to give it by a desire to put such person in a better position than it would have been had the act or sufferance not occurred.

Security interests

The DIFC Insolvency Law provides that a security interest in all or substantially all of the company's property is invalid where:

- the security interest is created in favour of a person connected with the company and was created after a date two years before the onset of insolvency;
- the security interest is created after a date one year before the onset of insolvency and the company either was at the date of the creation or became under the transaction in respect of which the charge was created unable to pay its debts as they fell due; or
- the security interest was created after the commencement of a company voluntary arrangement.

However, this provision does not invalidate a security interest to the extent of the value transferred to the company or liabilities of the company released as a result of the transaction giving rise to the grant of the security interest.

Restructuring options for a distressed company

The following section of this briefing considers the restructuring and voluntary winding-up options available under DIFC law.

Company voluntary arrangement

A CVA is a scheme of arrangement proposed by directors of a company to the members of a company and its creditors. It is available to any company, although a company that is an authorised person (as defined in the DFSA Rulebook Glossary) must obtain the consent of the Dubai Financial Services Authority (DFSA) before commencing CVA proceedings.

The CVA is implemented by an insolvency practitioner (referred to in the DIFC Insolvency Law as a nominee), appointed by the directors. The directors must provide the nominee with a CVA proposal that must include

information on a wide-range of matters including: assets that will be included in the CVA; any security provided by the company; the manner in which it is proposed to deal with liabilities; creditors (preferential, secured and unsecured); and whether the directors are aware of any transactions being classified as preferences, transactions at an undervalue or invalid security interest if the company were to go into liquidation. The directors must also provide the nominee with a certified statement of the company's affairs.

The nominee will call separate meetings of creditors and members to consider the CVA proposal. All creditors whose claim the nominee is aware of should be summoned to attend the meeting. A CVA proposal is approved if at least 75 per cent in value of the creditors voting on the resolution agree to its terms (with or without modification). Given the possibility of the creditors' meeting and the members' meeting producing different results, the DIFC Insolvency Law provides that the DIFC court may determine which of the proposed arrangements is to be treated as the approved arrangement.

The arrangement approved by the DIFC court binds every person who had notice of it and was entitled to vote at the meeting. If the CVA proposal is approved, the court may stay any winding-up or receivership proceedings that are continuing and/or give directions with respect to the winding-up or receivership as it thinks appropriate to facilitate the CVA.

The court sanctioned stay contemplated above is distinct from the right of certain eligible companies to petition for a moratorium simultaneously with the submission of the CVA proposal (either within that proposal or separately) (see 'Moratorium' on following page for further detail on those entities that are not permitted to request a moratorium). The purpose of the moratorium would appear primarily to be to grant a company breathing space to develop, and obtain the approval of creditors to, the CVA proposal, although there appears to be no prescribed restriction on the maximum duration of any such moratorium.

If the directors of an eligible company wish to apply for a moratorium, they should provide the nominee with details of how the moratorium will benefit creditors. After receipt of the details, the nominee must formally

Moratorium

The directors of a company are not permitted to take steps to obtain a moratorium if the company:

- is an authorised person and it effects contracts for insurance, accepts deposits, holds investments, investment entitles for account holders or holds money to which DFSA Rules relating to holding client money apply;
- is a debtor under a financial collateral security interest;
- is subject to clearing rules of an authorised market institution;
- is subject to any form of insolvency proceedings;
- has incurred a liability of US\$20,000,000 or more; or
- is party to a capital market arrangement.

apply to the court for a moratorium and the court can either grant or reject the application. If implemented, the principal effects of a moratorium are that during the moratorium period no proceedings may be taken against a company – for example, no resolution or petition for winding-up may be presented, no application may be made for the appointment of a receiver or administrative receiver and no steps may be taken to enforce security. The company's ability to borrow money, grant security, dispose of property (other than in the ordinary course of business), make payments or grant security is also restricted during a moratorium period.

Voluntary winding-up

The DIFC Insolvency Law contemplates two forms of voluntary winding up: a members' voluntary winding up and a creditors' voluntary winding up. The former assumes that the company is solvent and the directors are prepared to issue a statutory declaration to that effect – it follows that the creditors need not be involved in the winding up process. Conversely, it appears that a creditors' voluntary winding up is designed to operate in the event that it is known at the outset that the company is not solvent (and that the directors will therefore not issue the required statutory declaration) – the company is accordingly required to approach the creditors directly who effectively duly take control of the winding up process via their nominated liquidator. In the event, however, that a members' voluntary winding up is commenced but it subsequently becomes apparent that the statutory declaration was incorrect (and the company is in fact not solvent), the members' winding up becomes a creditors' winding up with minor modifications to the latter procedures to reflect the fact that certain winding up steps will have been commenced.

Note, however, that the commencement of a members' or creditors' voluntary winding-up does not prohibit any person from applying to the DIFC court for a company to be wound-up by the court.

Members' voluntary winding-up

A members' voluntary winding-up is provided for in three scenarios:

- under the terms of the articles;
- where the company so resolves; or
- where the company resolves that 'it cannot by reason of its liabilities continue its business'.

The directors of a company wishing to commence voluntary winding-up proceedings must make a statutory declaration as to the company's affairs. This must include a statement that the directors have formed the opinion that the company will be able to pay its debts in full within a specified period, such period not to exceed 12 months. The company may pass the winding-up resolution on the same date as the statutory declaration is made or at any time before the expiry of five weeks from the date of the statutory declaration – effectively, the statutory declaration is required as a precondition to commencing a members' voluntary winding up and the passing of the requisite resolution. On the appointment of a liquidator to a company undergoing a members' voluntary winding-up, all the powers of the directors cease, except so far as the company in general meeting or the liquidator sanctions their continuance.

Statutory declaration

- If a director makes a statutory declaration without reasonable grounds for believing that the company will pay its debts in full he is liable to a fine of up to US\$20,000.
- Where a company fails to pay its debts within the period specified in the statutory declaration, a rebuttable presumption arises that the director did not have reasonable grounds for the opinion.

Creditors' voluntary winding-up

In the event that the company proposes that it is to be wound-up but the directors have not issued a statutory declaration at such time, the company must call a meeting of the creditors within 14 days of the company passing the winding-up resolution. The creditors may propose a liquidator, who will, if different to that proposed by the company, be appointed the liquidator. The creditors also have the right to appoint a 'liquidation committee' of not more than five creditors whose role is (broadly speaking)

Onerous property

In a creditors' voluntary winding-up or a court ordered winding-up, the liquidator may disclaim the following 'onerous property':

- any unprofitable contract; and
- any other property of the company that is not readily saleable or is such that it may give rise to a liability to pay money or perform any other onerous act.

to act as an interface between the liquidator and the wider body of creditors. All the powers of the directors cease upon the appointment of a liquidator, except so far as any liquidation committee (or, if there is no such committee, the creditors) sanction their continuance.

Third-party insolvency proceedings

The DIFC Insolvency Law provides for third-party creditors of a company in distress to appoint a receiver to the relevant company or present a winding-up petition to the courts.

Receivership

The DIFC Insolvency Law provides for the offices of receivers and administrative receivers. Both receivers and administrative receivers can only be appointed where the company has granted the power to appoint such an office-holder in an instrument. Where the company is an authorised person, the appointment only takes effect after the DFSA consents to the appointment.

As an administrative receiver is appointed over all or substantially all of the undertaking of the company (unlike a receiver, who is appointed in respect of a part only of that company's property), it has wide-ranging powers to essentially do all things necessary for winding-up the company's affairs and distributing its assets. Subject to court approval and certain exclusions, the administrative receiver may dispose of property free of any applicable security interest on the basis that proceeds are to be applied in discharging the amount secured. Notwithstanding the ability of an administrative receiver to resign with minimal notice at any time, within

Receiver and administrative receiver

- A receiver is a person who is appointed to get in and sell any part of the company's property and to apply the proceeds in reduction of the debt due to the person appointing the receiver.
- An administrative receiver is a person who is appointed over all or substantially all of the undertaking of the company.

three months of his appointment an administrative receiver must prepare a report of the receivership and call a meeting of the unsecured creditors to discuss the report. DIFC law further permits the unsecured creditors to form a creditors' committee to assist the Administrative Receiver in discharging his functions.

Once an administrative receiver has been appointed, any other receiver or receivers appointed prior to the date of appointment of the administrative receiver are required to vacate office. Equally, the first administrative receiver in time will prevent any subsequent administrative receiver being appointed (even if the latter enjoys a higher ranking security).

Court-ordered winding-up

A company may be wound up by the court if it passes a resolution to that effect; it is unable to pay its debts; no voluntary arrangement in relation to a CVA has been approved after any applicable moratorium ends; the court makes an order under any provision of DIFC law; or the court is of the opinion that it is just and equitable that the company should be wound up.

The company, the directors, any creditor (including prospective or contingent creditors), or the DIFCA (who is permitted to act only if it is of the view that it is in the interests of the DIFC that the company should be wound up) may present a winding-up petition to the court. If the company intends opposing the winding-up petition at the relevant hearing it must give the court seven days' notice of this intention.

The role of the liquidator is to ensure that the assets of the company are realised and distributed to creditors and/or to the members in the event of a surplus after creditors' claims have been satisfied. The liquidator has the power to do all things that are necessary for the winding-up of the company and distributing its assets and is entitled to access the company's accounts, books and records.

Inability to pay debts

A company is unable to pay its debts if:

- the company fails to pay, or agree terms for payment, within three weeks of a written demand from a creditor in relation to a debt exceeding US\$2,000;
- execution on judgment, decree or order in favour of a creditor is unsatisfied;
- the company is unable to meet its debts as they fall due; or
- the company's current assets are less than its current liabilities.

Creditors are required to prove their debts in a winding-up in writing to the liquidator. Secured creditors must also provide details of their security interest. A creditor may only vote if it has lodged a proof of debt and the claim has been admitted and its debt is liquidated and ascertained (unless an exemption is applied and an estimated value is submitted). Secured creditors may only vote in respect of the balance due to them from the company after deducting the value of the security held and failure to disclose the security interest results in the secured creditor being required to surrender his security interest (unless the court permits otherwise). If a secured creditor realises his security interest he may prove for the balance of his debt or he may prove for the whole if he surrenders his security interest for the benefit of the creditors. A creditor has 21 days in which to appeal against the liquidator's decision to accept or reject a debt. As applies with a creditors' voluntary winding up, the creditors also have the right to appoint a 'liquidation committee' to act as an interface between the liquidator and the wider body of creditors.

The wider picture – related provisions of DIFC law

The following and final section of this briefing touches on two discrete points that, while not necessarily constitutive of the regime described above, are nonetheless relevant to any wider restructuring and insolvency analysis.

Ranking of creditors

The DIFC insolvency regime provides that in the winding up of a company, its 'preferential debts' shall be paid, after the expenses of the winding-up, in priority to all other debts that are unsecured or secured by an interest over all or substantially all of the undertakings or assets of the company. The categories of 'preferential debts' are:

- contributions to pension schemes or end of service gratuities; and
- remuneration of employees (for a period up to four months preceding the date of: (i) the appointment of a provisional liquidator (or the winding up order), if the company is being wound up by the court; or (ii) the passing of the resolution for the winding up, if the company is not being wound up by the court), payments in lieu of notice and compensation in respect of accrued holiday entitlement.

Application of DIFC law to entities with a branch office or subsidiary in the DIFC

As discussed above, the provisions of the DIFC Insolvency Law relate generally to companies incorporated under the DIFC Companies Law. They do not apply directly to entities incorporated in any jurisdiction outside the DIFC (including, for example, the jurisdiction applicable to the parent company of a company incorporated in the DIFC). However, certain provisions of the DIFC Insolvency Law do apply to foreign companies (being companies that are incorporated in a jurisdiction outside of the DIFC) and recognised companies (being foreign companies that have registered to carry on business in the DIFC in accordance with the DIFC Companies Law).

In respect of foreign companies, the application of the DIFC Insolvency Law is limited to assisting the relevant court in the jurisdiction in which such foreign company was incorporated in gathering and remitting assets of the foreign company that are maintained within the DIFC in circumstances where such foreign company is subject to insolvency proceedings in its jurisdiction of incorporation. This is, however, subject to the relevant 'home jurisdiction' court requesting such assistance.

The DIFC Insolvency Law provides for a recognised company to be wound up in accordance with the provisions of the DIFC Insolvency Law with such adaptations as are necessary. As such, a recognised company may be wound up by the DIFC court if the recognised company is unable to pay its debts, has been dissolved or deregistered in its place of origin or has ceased to carry on business in the DIFC or where the DIFC court is of the opinion that it is just and equitable that the recognised company should be wound up. A liquidator of the DIFC court is permitted to exercise any powers or do any act in the case of a recognised company that might be exercised or done by him or it in the winding up of a company. It should be noted that DIFC Insolvency Law provides that a recognised company may be wound up under the DIFC Insolvency Law notwithstanding that it is being wound up or has been dissolved, deregistered or otherwise ceased to exist as a body corporate under or by virtue of the laws in the place under which it was incorporated. A recognised company cannot, however, be voluntarily wound up under the DIFC Insolvency Law.

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