UAE BANKRUPTCY

ON THE HUNT FOR DIRECTORS

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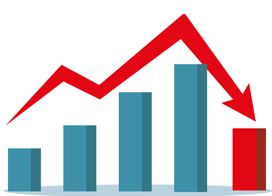
Bankruptcy regimes are essentially a legal framework that generally aims at either restructuring troubled corporate entities with view to allowing them to re-enter the market or ensuring their demise in an orderly manner. A central feature of this framework consists of tools that enable recovery for unpaid creditors through measures that combine the administration and possible disposal of the insolvent debtor's assets.



All of this sounds well and straightforward so long as the insolvent debtor has assets to be administered or disposed of. In practice, in the UAE, except for large conglomerates, most of bankruptcy trustees end up with little assets to administer. This can either be due to the entities designed to be assetless from day one or assets having been removed from the company during the years leading up to the bankruptcy.

In such situations, recovery for creditors becomes a far fetched target and often leads to creditors abandoning the bankruptcy process itself to avoid incurring further costs. What we learned in practice is that to get paid a creditor really needs to catch a director or a shareholder.

But How Do You Do That With That With Most Entities Being Limited Liability Companies?

The simple answer for creditors is not to lose hope so easily due to the simple fact that an insolvent debtor operated as a limited liability company. Due to reasons attributable to historical background and market practices, in the UAE there are many avenues that can be explored to get a shareholder or a director to pay up your debt.

The historical reasons mainly relate to the fact that many small to medium sized businesses did not take the entire issue of proper bookkeeping and financial reporting seriously until the introduction of the most recent legislative changes, namely:

(a) The UAE Federal Commercial Companies Law of 2021;

(b) The UAE Federal Law on Taxation of Corporations & Businesses of 2022.

Prior to the introduction of these legislations, whilst many companies practiced bookkeeping, many shareholders and directors did not really pay much attention to basic concepts that govern issues such as, distribution of dividends, related party transactions, disposal of company assets, shareholders' current accounts and director's renumeration. Because many businesses in the UAE are owned by entrepreneurs and families, the internal accounting practices in many companies were relaxed. This may not have necessarily been because of shareholders or directors acting in bad faith, but rather for the lack of a need to enforce the accounting practices expected under the legislative frameworks. Usually, business owners are focused on growing their businesses. If there are multiple unrelated shareholders then the need for strict accounting and governance rules is more pressing. However, if the company has a single owner or is owned by family members, such need does not seem so obvious until, sometimes, it might be too late.

Under the UAE Bankruptcy Law, the main legal provision which every creditor in the UAE must be aware of is Article 246 (1) of the UAE Bankruptcy Law which provides:

1. If a company is declared bankrupt, the Bankruptcy Court may, upon the request of the trustee, the Unit, where the debtor is supervised by the regulatory authority, or any of the creditors, oblige the members of the Board of Directors, the managers, any person responsible for the actual management of the company or those in charge of the liquidation, in respect of the liquidation procedures executed outside the framework of this Law, to pay an amount proportional to the mistake attributed to the person concerned. The amount shall be used to repay the company's debts if it is proven that any of them committed any of the following acts during the two years preceding the company's cessation of payment:

(a) Using commercial methods, whose risks are not thoughtfully studied, such as disposing of goods at prices lower than their market value in order to obtain amounts with the intention of avoiding bankruptcy proceedings or delaying their initiation;

(b) Entering into transactions with third parties to dispose of assets without compensation or in exchange for insufficient compensation and without a confirmed or proportionate benefit to the company's assets;

(c) Paying the debts of any creditor with the intention of causing damage to other creditors;

(d) If it becomes clear after the company's bankruptcy that its assets are insufficient to pay at least 20% of its debts, as long as it is proven that they failed to manage the company in a way that led to the deterioration of its financial condition.

Whilst paragraphs (a) to (c) of Article 246 (1) of the UAE Bankruptcy Law cover classic conduct which is punishable under most bankruptcy regimes, paragraph (d) provides an interesting opening for creditors. The trigger event in this sub-section does not require the creditor to establish that the director (s) committed any of the acts mentioned in the previous paragraph. It is a standalone ground that is engaged if:

- The company's assets are not sufficient to pay 20% of its debts; and
- The director (s) are found to have managed the company is a way that led to the deterioration of its financial position.

If these conditions are satisfied then the court will have to engage in another assessment to ascertain the extent of loss caused to the company by way of the director (s) mis-management, so as to arrive at a figure of compensation to be awarded against the director (s).

Given that many of the directors in small to mid size businesses are often the shareholders or ultimate beneficial owners, creditors may benefit from this legal provision to apply pressure against the director (s) either to secure an award for compensation or reach a satisfactory settlement.

Outside the UAE Bankruptcy Law, tort action still provide an effective tool for creditors if the conditions of the abovementioned Article 246 cannot be met. In general the UAE Civil Transactions Law provides for the ability to seek compensation for any tort or "harmful" act. Article 282 of the UAE Civil Transactions Law operates on a strict liability basis in the sense that a victim of a harmful act is only required to establish the defendant's responsibility for the underlying act together to a chain of causation to the loss.

In many cases, during the bankruptcy proceedings, bankruptcy trustees request financial statements of the debtor for a number of years dating back to 5 or more years. Because of serious sanctions, including criminal offences, directors or former directors often tend to comply with these requests for financial statements.

These statements sometimes reveal a host of irregularities in relation to:

- The failure to record the debt in question as an outstanding amount in the company's books due to misconceived understandings of legal and accounting principles;
- Distributions of dividends further to questionable accounting practices;
- Drastic changes in the levels of revenue of the company on a year to year basis;
- Unjustified directors' renumerations.

If any such irregularities become evident then it can form the basis to pursue a tort claim against the director (s) outside of the bankruptcy regime.

In order to achieve an advantageous position, under both routes, creditors must be diligent in their analysis of financial data disclosed to the bankruptcy trustee as well as think outside the box. This often requires building a team of both legal and financial professionals with enough experience in contentious insolvency matters.