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Restructuring under Islamic finance

Bashir Ahmed and Aly Shah of Afridi & Angell discuss the UAE's *shariah* compliant regime

Islamic finance is based upon *shariah* principles derived from the Holy Quran and Sunna, its central feature being the prohibition of payment and receipt of interest or *riba*.

Islamic financing in the United Arab Emirates (UAE) is regulated through Federal Law No 6 of 1985 (Regarding Islamic Banks, Financial Institutions and Investment Companies or the Islamic Institutions Law). The Islamic Institutions Law provides that Islamic banks shall be subject to the UAE Central Bank's licensing, supervision and inspection in accordance with Union Law Number 1 of 1980 (concerning the Central Bank, the monetary system and organisation of banking).

In terms of the Islamic Institutions Law, Islamic banks have the right to carry out lending, credit and other financial operations; they also have the right to establish companies and participate in existing or under establishment enterprises provided that activities of the latter are in conformity with Islamic *Shariah*. The Islamic Institutions Law also provides that Islamic financial institutions and investment companies shall have the right to carry out lending, credit and other financial operations. They may also participate in existing or under establishment enterprises, invest their funds in movable assets and receive deposits for investment thereof in accordance with the provisions of Islamic *shariah* law.

There are five essential modes of Islamic financing. These are: (i) *murabaha*; (ii) *ijara*; (iii) *istisna*; (iv) *musharaka*; and (v) *mudaraba*. Generally, all five modes of Islamic financing are offered by Islamic banks in the UAE.

The UAE does not have a law in place which specifically deals with insolvency and restructuring involving *shariah* compliant arrangements. UAE law provides a framework for the restructuring and insolvency of commercial companies and traders, which is contained in Federal Law No 18 of 1993 issuing the Law of Commercial Procedure (Commercial Code). The UAE Federal Law No 8 of 1984 on Commercial Companies (as amended) (Commercial Companies Law) contains provisions for the dissolution of a company. There is no reported instance of the provisions of law relating to restructuring and insolvency having been tested in the UAE and there is little way of telling as to how the UAE Courts would approach same.

Islamic modes of financing

Murabaha, *ijara* and *istisna* modes of financing would result in the bank being a creditor in the event of a default by a customer as well as being the owner in certain cases, while in the case of *Mudaraba* and *Musharaka* modes of financing, the bank is a partner in a project. Given the absence of separate provisions of law dealing with the issue, it is a fair assumption that the provisions of the Commercial Code and the Commercial Companies Law will apply to dealing with the insolvency and restructuring involving *shariah* compliant arrangements. The following discussion on the Commercial Code and the Commercial Companies Law envisages the position of the bank as a creditor or a partner in circumstances where it has extended one of the above mentioned modes of financing and the customer (a company) or venture becomes insolvent.

The Commercial Code

In terms of the Commercial Code, with the exception of share partnership companies, any commercial company (hereafter referred to as a company) may be declared bankrupt (even when a company is in the process of liquidation) if it ceases to pay its commercial debts when they fall due because of the disruption of its financial affairs. The managing director or the liquidator, as the case may be, of a company may, subject to certain conditions, apply for the company to be declared bankrupt. The creditor of a company may apply to have the company declared bankrupt even if the creditor is a partner of a company.

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Declaration of bankruptcy

The Civil Court within the jurisdiction of which the business of the debtor is located has jurisdiction to declare a bankruptcy. A judge is appointed as the bankruptcy judge. Under the Commercial Code, a declaration of bankruptcy may be made where the debtor has a branch, agency or office within the UAE even if the debtor has not been declared bankrupt by a court of a foreign state.

If a bankruptcy judgment does not specify a date for the suspension of payments by the debtor, the date on which the judgment was pronounced is deemed the provisional date for the suspension of payments. The date for suspension of payments may not be referred back to more than two years from the date the bankruptcy judgment is pronounced.

Once the bankruptcy judgment is pronounced, no set-off is permitted between what is owed to or by the bankrupt unless there is a connection between them.

If the debtor becomes capable of paying all debts before final execution of the bankruptcy judgment, the court must cancel the judgment and the debtor must pay the cost of the action.

Administration of the estate

The court appoints a paid agent called the trustee in bankruptcy to manage the bankrupt's estate. The Commercial Code provides a detailed process for matters relating to the administration of the bankrupt's estate, which includes the continuance of the operation of the business of the bankrupt if the general interest of the bankrupt debtor and the creditors necessitates the same.

As soon as a bankruptcy judgment is pronounced, the bankrupt is, with certain exceptions, prevented from administering and disposing of assets, and legal action may not be brought or pursued by the bankrupt or brought or pursued against the bankrupt. After the date of suspension of payments and prior to the bankruptcy judgment, certain specified actions of the bankrupt are not binding on the creditors of the bankrupt.

Creditor impact

As soon as the bankruptcy judgment is pronounced, a group of creditors is established. The group of creditors consists of persons having valid claims on the bankrupt dating from before the bankruptcy judgment. The announcement of the bankruptcy judgment results in the suspension of individual proceedings and actions brought

“The UAE legal framework does not adequately address insolvency and restructuring in shariah compliant arrangements, or in fact otherwise”

against the bankrupt by ordinary creditors or preferred creditors. When a bankruptcy judgment is announced, all monetary debts owed by the bankrupt become payable, whether ordinary or secured by a general or particular charge. However, any interest on ordinary loans due to the group of creditors cease when the bankruptcy judgment is pronounced. Interest may not be claimed on loans secured by a mortgage or lien, except in respect of sums arising from the sale of the assets on which the loans are secured.

The announcement of a bankruptcy judgment does not generally result in the rescission of a contract to which a bankrupt is a party. However, if the trustee in bankruptcy does not perform the contract or will no longer continue to do so, the other party may seek rescission of the contract. In such case, the contracting party is entitled to share in the bankrupt's estate as an ordinary creditor in respect of compensation arising from the rescission.

In the course of bankruptcy proceedings, first priority is given to the following:

- (i) wages and salaries due to workers and staff for the period of thirty days prior to the declaration of bankruptcy;
- (ii) amounts due to a trustee in bankruptcy where the trustee in bankruptcy pays a debt of the bankrupt from his own funds or if the debt is paid by another person, his debt is paid from the first monies to enter the bankrupt's estate;
- (iii) payment of government taxes due from the bankrupt for the two years preceding the announcement of the bankruptcy judgment; and
- (iv) certain rents payments to the owner of premises leased to the bankrupt.

Restitution

Any person is entitled to restitution from the bankrupt's estate in respect of specific items which such person can prove he owned at the time of the bankruptcy judgment. Thus, where for example under any of the Islamic modes of financing the bank continues to own the asset, it will subject to the above, be entitled to restitution.

The Commercial Code sets forth the procedure and timetable for the verification of debts of creditors by the trustee in bankruptcy and the establishment of a final schedule of uncontested debts by the judge supervising the bankrupt's estate.

Following the establishment of a final schedule of



About the author

Bashir Ahmed joined Afridi & Angell in 1988 and became a partner in 1993. For 18 months he was seconded to the regional office on of an international bank as counsel for the Middle East and south Asia operations. He advises clients in cross-border, private equity, licensing and maritime issues. He has extensive experience advising international and domestic banks on a wide range of matters including loan and credit facilities, syndications and regulatory matters and has also advised on a number of mining, refinery and infrastructure projects.

Mr Ahmed is a regular contributor of the United Arab Emirates chapters in leading publications including: PLC Cross-border Handbook: Dispute Resolution; Doing Business in... Handbooks (Lex Mundi and Practical Law Company publication); and The Restructuring Review.

Mr Ahmed is admitted to the New York State Bar Association, the Lahore High Court Bar Association and the International Bar Association.

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uncontested debts, the judge supervising the bankrupt's estate is required to invite creditors whose debts have been finally or provisionally accepted to attend deliberations on a composition. It is not permitted to contract a composition with a bankrupt who has been convicted of fraudulent bankruptcy. A composition can only take place with the agreement of creditors and the fulfillment of the conditions prescribed by the Commercial Code.

A composition may be concluded on condition of payment if the debtor becomes solvent within five years of the date that the composition takes effect. The composition may include granting to the debtor periods of grace for payment of debts and waiver towards a debtor of a part of the debt. The creditors may demand that one or more guarantors be offered to guarantee the implementation of the conditions of the composition. All the effects of bankruptcy are removed with the announcement of the court decision to ratify the composition. However, this does not affect any criminal prosecution.

Union of creditors

The creditors are deemed to be in a state of union by law if a judicial composition is not concluded. After the state of union has been established, the judge supervising the bankrupt's estate is required to invite each creditor to deliberate on the affairs of the bankrupt's estate. The appointed trustee referred to at this stage of the bankruptcy proceedings as the trustee of the union of the creditors is permitted to sell movable property of the bankrupt. The sale of immovable property of the bankrupt is carried out under the supervision of the bankruptcy judge and in accordance with the UAE Law of Civil Procedure (Federal Law No 11 of 1992). The union trustee is not permitted to continue the business of the bankrupt until requisite approvals of the creditors and the bankruptcy judge are obtained.

If six months elapse from the date of establishment of the state of union without the work of liquidation having been completed, the trustee must submit a report to the judge supervising the bankrupt's estate on the state of the liquidation and the causes for the delay in completing it. Whenever the work of liquidation is complete, the union of trustee is required to submit a final account to the

judge supervising the bankrupt's estate. The judge must invite the creditors to discuss the account and the bankrupt must also attend the meeting. The union is dissolved and the bankruptcy proceedings are deemed complete in law once the account has been approved.

It should be noted that after the state of union has ended, each creditor regains the right of enforcement against the debtor to obtain the remainder of his debt.

If during the course of the bankruptcy proceedings, the bankruptcy proceedings are halted because of insufficiency of assets prior to ratification of a judicial composition or establishment of a state of union, the Court may at its own discretion or in accordance with a report from the judge supervising the bankrupt's estate order that the bankrupt's estate be closed. In such instance, each creditor once again has the right to take steps and to initiate individual actions against the bankrupt.

The Commercial Companies Law

The Commercial Companies Law provides for the dissolution of a company (including joint stock companies) in certain prescribed circumstances. This includes, for instance, where the losses to a company amount to half of its capital.

Until a liquidator is appointed they continue to manage the company and with respect to third parties, are deemed liquidators until a liquidator is appointed.

All debts of the company become due and owed upon the company's dissolution. If the company's assets are not sufficient to meet all of the debts, then the liquidator is required to make proportional payment of such debts, without prejudice to the rights of preferred creditors. Every debt arising from acts of liquidation is required to be paid out of the company's assets in priority over other debts.

The liquidator is required to complete his task in the time period specified in his deed of appointment. The liquidator is required to present to the partners or the general assembly of a company, a provisional account of the acts of liquidation every six months.

Upon termination of liquidation, the liquidator must present to the partners or the general assembly a final account of the acts of liquidation. Such

acts end with the certification of the final accounts.

Restructuring

Provisions for a composition to prevent the bankruptcy of a debtor are contained in the Commercial Code.

In terms of the Commercial Code, any trader whose financial affairs are so disturbed so as to lead to a suspension of payments may, within 20 days of such cessation, apply for a composition with his creditors. This option is available to a trader even if the trader has applied to be declared bankrupt. Generally, a composition with creditors may be granted to any company which meets the same conditions as those applicable to a trader. However, such a composition is not available to a company which is in liquidation.

An application for a composition with creditors can be accepted only from an applicant, which has carried on business continuously for the year prior to the application and during this period has complied with applicable provisions pertaining to the Commercial Register and commercial books.

If the Court decides to accept the application for a composition, it orders the opening of proceedings. The Court (which is required to be a Court competent to declare bankruptcy) appoints one of its judges to supervise the composition, and one or more trustees for the composition. The debtor is required to deposit with the Court cashier a determined sum as a bond to meet the expenses of the proceedings. The Court must order the composition proceedings to be cancelled or stopped if the debtor fails to lodge the security within the appointed period. The proposed settlement cannot be less than 50% of the debt and the period for payment must not be more than three years from the date of ratification of the arrangement.

Administration of assets

After the decision to open composition proceedings, the debtor continues to administer his assets under the supervision of the composition trustee and may carry out all ordinary transactions required for his or its business affairs. All actions and enforcement proceedings against the debtor cease. Actions brought by the debtor and enforcement proceedings which he has initiated remain in



About the author

Mr. Shah is a UK qualified barrister (Lincoln's Inn) and prior to joining Afridi & Angell in 2008 he ran his own practice in Pakistan.

He has considerable experience in all aspects of banking and financial services, energy, joint ventures, mergers and acquisitions and privatisations as well as dispute resolution.

Mr. Shah is a regular contributor to leading publications including:

Co-author of United Arab Emirates chapter of Getting the Deal Through, Anti-corruption Regulation, 2010; Co-author of the United Arab Emirates chapter of Getting the Deal Through, Banking Regulation, 2010; Co-author of the United Arab Emirates chapter in The Restructuring Review, United Arab Emirates chapter, 2nd edition, 2009; and

Co-author of Restructuring and Insolvency in the UAE, Asian Counsel Volume 7, Issue 4, May 2009.

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effect with the intervention of the trustee.

After the debts owing to creditors have been verified under the procedure provided for in the Commercial Code for this purpose, a period is designated for the creditors meeting to deliberate on the composition proposals.

The composition may be concluded only with the approval of the requisite majority of the creditors and conditions provided for in the Commercial Code.

The composition agreement may include a condition that the debt be paid in full if the debtor becomes solvent within five years of the date of the composition occurring. The debtor is not deemed to have become solvent unless the value of his assets exceeds the debts incumbent on the debtor. The creditors may demand one or more guarantors to guarantee the fulfillment of the composition conditions.

The composition becomes effective upon the issuing of a decision for its ratification. The Commercial Code sets forth the procedure for ratification of the composition.

Dubai World

The Dubai World debt crisis in 2009 led to the promulgation of Decree No 57 for 2009 (Establishing A Tribunal to decide the Disputes Related to the Settlement Of the Financial Position of Dubai World And its Subsidiaries) (the 'Dubai World Law').

The Dubai World Law contemplates the composition of a tribunal which has jurisdiction to:

(i) hear and decide any demand or claim submitted against: (a) the Corporation, including hearing and deciding any demand to dissolve or liquidate the Corporation, and (b) any person related to the settlement of the financial obligations of the Corporation, including the Chairman and members of the Board of Directors, as well as all the employees and workers of the Corporation; and

“The Court must order the composition proceedings to be cancelled if the debtor fails to lodge the security within the appointed period”

(ii) issue the interim and interlocutory orders and decisions, including injunctions to any person to act or not to act, or other orders as the tribunal considers appropriate.

The term Corporation is defined as Dubai World and/or its Subsidiaries.

The Dubai World Law states that the tribunal shall decide the demands and claims submitted to it by virtue of:

(i) DIFC Law No 3 of 2009 Concerning the law of insolvency according to the amendments stated in the Schedule to the Dubai World Law;

(ii) the regulations issued by the Board of Directors of the DIFCA Concerning DIFC Insolvency Regulation according to the amendments stated in the Schedule to the Dubai World Law;

(iii) DIFC Law No 10 of 2004 Concerning the Court of DIFC, according to the amendments stated in the Schedule to the Dubai World Law;

(iv) legislation in force in the Emirate of Dubai;

(v) commercial custom; and

(vi) principles of justice, and rules of righteousness and equity.

In other words, in terms of the Dubai World Law, any dissolution or liquidation matters relating to Dubai World and its subsidiaries will be dealt with by a separate tribunal and procedure which would depart from the Commercial Code and the Commercial Companies Law.

The present legal framework in the UAE does not adequately address insolvency and restructuring issues pertaining to *shariah* compliant arrangements, or in fact otherwise. The Dubai World Law also does not assist or provide clarity in this regard. Legislation is required which specifically deals with *Shariah* compliant arrangements, including insolvency and restructuring issues arising from there.

IFLR knows how regulators will react to this crisis

“My recommendation is to decouple other voting items from the proxy access debate. There needs to be progress here”

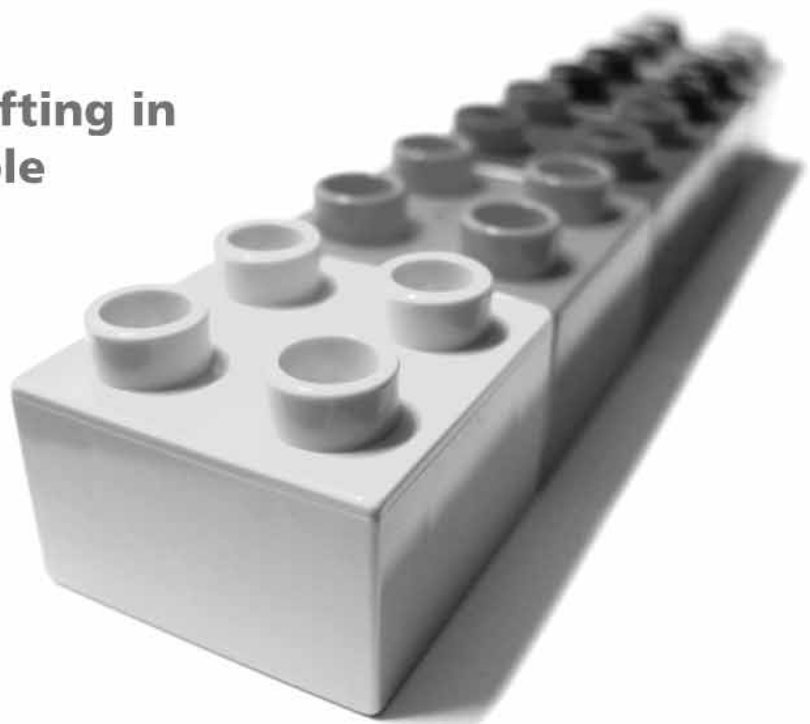
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