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Bankruptcy and Insolvency Law in the Arab World

I. Introduction

The laws of the Arab world draw their principles from three legal systems and traditions: Islamic law, common law, and civil law. Some countries have evolved hybrids. Most jurisdictions reflect one of these systems relative to bankruptcy and insolvency laws. Notwithstanding the nature of the system, the distinctions between the jurisdictions are neither stark nor rigorous. The most striking element is that some laws tinker with a balance of debtor/creditor interest. In practice, they strive to achieve principles of justice, equity and fairness derived from Islamic jurisprudence.

Over the past five to seven years, there has been an effort to harmonize and modernize the various commercial laws of most Arab countries. The urgency arose in response to the accession of many of them to the World Trade Organization[1] ("WTO"), growth of credit markets, entrepreneurship, establishment of securities exchanges, and globalization of business and financial transactions.

Bankruptcy and insolvency legislation remained areas of law that have received little attention. The limited change may be attributed to historic factors that stem from long established culturally embedded practices and principles.

Most bankruptcy/insolvency laws that apply in the Arab countries were introduced by the powers that ruled these jurisdictions as opposed to having evolved over time or having been legislated by necessity. Thus, even today, and to a large extent, these laws are not well tested and are not a priority for the legal reform agenda.

Generally speaking, prevailing bankruptcy and insolvency laws draw from principles incorporated into domestic legislation stemming either from the civil law[2] Napoleonic 1808 *Code de Commerce* and its subsequent mutations in 1865 and 1885 or the common law British-based[3] bankruptcy/insolvency laws of the early 1900s. These two paradigms guided the establishment of bankruptcy principles and law in most Arab countries except those that exclusively adopted Islamic jurisprudential principles. Hybrids[4] emerged mixing Islamic, civil and common law philosophies.

An overview of some prevailing legislation demonstrated that they share similar norms and rules with laws of other jurisdictions including matters related to priority rules,

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[1] These include Saudi Arabia, Jordan, Morocco, Egypt, Bahrain, Kuwait, Oman, Qatar, Tunisia, and UAE; observers are Algeria, Iraq, Lebanon, Libya, Sudan, and Yemen.
[2] Civil Law jurisdictions include Egypt, Syria, Lebanon and the Arab Maghreb countries.
[3] Common Law jurisdictions include, Palestine's Gaza, Iraq, and Sudan.
[4] Hybrid jurisdictions include Palestine's West Bank, Jordan, Qatar, and Oman.

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protection of debtors and creditors, sale or auction of assets and the latitude of statutory powers conferred on judges, receivers, and liquidators.

Another observation is that none of these Arab countries have a stand alone bankruptcy/insolvency law.[5] Rather, almost exclusively, reorganization and personal bankruptcy/insolvency provisions appear in a chapter in the commercial code while corporate liquidation and winding up procedures (voluntary and involuntary) appear in the companies laws. The relevant provisions of these commercial codes provide a forum for the debtor and all of its creditors to collectively adjust their financial relationship under court supervision. Under the commercial codes of the various Arab jurisdictions, and irrespective of legal system (Islamic, common or civil law), a defaulting company is permitted to engage in some form of reorganization.

The more contemporary features of corporate restructuring or reorganization which appear in bankruptcy/insolvency laws of the US, UK and other European countries like Belgium are not options under Arab world legislation. Instead many corporate borrowers and lenders seek informal restructuring of debts[6] while workouts, for example, are not an option.

This paper looks at general features of Arab and Islamic markets and the evolutionary trends of their bankruptcy and insolvency laws. It highlights areas where laws of Arab countries either diverge or converge with their western counterparts. It concludes with suggestions for matters to be considered by the Arab countries once they start reforming their bankruptcy/insolvency laws.

II. Features of the Arab Credit and Corporate Markets.

Arab markets have certain specific inherit characteristics which have shaped the application of bankruptcy/insolvency laws. These salient features are intrinsic to the socio-economic nature of the Arab way of life and underlie their legal systems.

1. Family-Owned Businesses. In most Arab countries only a small elite control corporations. The owners tend to be well established families who have a concentration of the wealth and controlling shares in most companies, even where these companies are listed and traded.[7] They also have controlling shares in lending institutions and may often be one and the same shareholders of borrower and lender institutions. Accordingly wealth revolves in limited small circles and problem loans, which are numerous, tend to be quietly handled.

[5] Only two exceptions exist: (1) Bahrain has a Bankruptcy and Reorganization Law of 1987; and (2) the Gaza Strip (British Mandate) Bankruptcy Ordinance No. 3 of 1936.
[6] More of a mediated approach, again, reflecting, cultural norms as opposed to formal reorganization.
[7] Over 90% of businesses in the Arab world are family owned. As with other family businesses around the world, they face many challenges that threaten their success and sustainability. Only about 30% of family businesses move on to the 2nd generation, 14% to the third generation and only 3% survive beyond the 3rd generation.

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2. Social context. Social pressure is high and the social fabric is tight; honor, reputation and family name are common and strong features even among businesses. In bankruptcy, these features operate as safety nets to prevent public declaration of bankruptcy. Family members and relatives rush to bail the debtor out because they worry about their collective honor and reputation. Being insolvent is regarded with some kind of shameful embarrassment or reproach in most Arab societies, so individuals and businesses alike tend not only to avoid it, but find ways to resurrect non-performing loans. Because the culture does not favor indebtedness,[8] lenders tend to be permissive and seek rescheduling loan repayment[9] terms instead of foreclosing on these debts or filing for bankruptcy against insolvent borrowers.

3. Collateral-Based Lending. Lending is collateral-based, primarily backed by real property[10] guarantees; it is also character-based. Limited lending is facilitated on the basis of the cash flow or the financial position of a given entity. Guarantors (reputed business*men*) are a main feature of lending and they co-sign the loan facility agreements. With this feature, loans are relatively secure and lenders are able to foreclose in the event of default; loans are closely monitored and non-performance is addressed early and long before insolvency is reached.

4. Inefficient Legal Systems. Moreover, the legal systems are perceived as inefficient. There is a lack of confidence in the legal framework, quality of corporate governance, quality of enforcement procedures and institutional capacity. Therefore, there is greater reliance on resolving disputes and addressing them outside the courts which tend to be inefficient, time-consuming and expensive.

5. Informal Businesses. Another feature is the informal nature of the business sector in most Arab countries. A large numbers of businesses are small operations and have limited access to credit. Lacking formal registration, they operate in the informal sector, so lending and borrowing is limited to few large solvent businesses.

6. Risk Aversion. Except for certain limited cases, the credit market in the Arab world is risk-averse and banking practices are prudently cautious. With an approach of risk-avoidance, insolvency is not frequent.

The nature of the markets in the Arab world have not lent themselves to reforming bankruptcy laws. This is not an issue akin to the Arab world alone. Reforming

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[8] In Islam, the deceased estate, if solvent must first pay off debt(s) and the remainder is distributed among rightful heirs.

[9] There are many *hadiths* (statements made by the Prophet Mohammad) urging one to be easy on one's debtors and to give respite if they ask for delay in paying the debts.

[10] Although Arab legal regimes do not have a secured transactions law, a few are in the process of developing one.

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bankruptcy laws is a complex task. According to the World Bank, only 10 countries worldwide undertook reform of its bankruptcy laws in past couple of years.[11]

III. Islamic and Bankruptcy/Insolvency

Islamic banking is a major factor underlying the limited incident of bankruptcy/insolvency. Along with the other features presented in Section II above, they constitute safety valves against borrower insolvency. This is not to say that there are no such incidents, rather, the frequency is limited compared to what is seen in other western jurisdictions especially the United States.

It is important to state that Islamic banking is not about not charging interest. In fact, it is a much larger concept.[12] It is premised on employing monetary resources efficiently and productively. Islamic banking belies the socio-economic-religious construct of the Arab countries.[13] Given this strongly-rooted notion, and without exception, all Arab bankruptcy laws underscore a balance in the rights of creditor/borrower. For this reason as well, incidents of insolvency/bankruptcy are limited since the lender and borrower co-share in the risks and benefits. The concept of "punishing" debtors where penal laws are invoked is not a feature of Arab laws.

Under Islamic rules, any funds employed by Islamic banks should be earned by way of profit from commercial risk where the bank and the customer share the risk. In addition, under Islamic rules, money should be invested in a profitable way to increase wealth. However, the idea that money has the ability to rise in value if used for a period of time is prohibited.[14]

These primary instruments of Islamic banking[15] demonstrate the co-sharing concept:

1. Mudarabah (Profit Loss Sharing). Mudarabah is a form of agreement between a bank ("Mudareb") and the customer where the customer subscribes to a Mudarabah fund at the bank, and the bank invests in an appropriate venture and uses its expertise and professional skills to manage the investment. The profit will be distributed between the bank and the customer according to the agreement. The bank deducts charges and fees for

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[11] See, *Doing Business 2008*, the World Bank, p. 54, www.doingbusiness.org

[12] Islamic banking is based on two principles: (1) the prohibition of usury, i.e., the receipt and the payments of interests, known as "Riba" in Islam; (2) the prohibition of investments in businesses that contradict Islamic rules, known as "Haram" such as alcohol, pork or gambling or any business from which income deprives from any prohibited business.

[13] This notion is further reflected in the extension of an interest-free facility to person in genuine need (*qard Hassan*).

[14] Currency futures or forward trading are prohibited because they regarded as speculative akin to gambling; currency swaps, are allowed.

[15] For a more detailed discussion on Islamic Banking Instrumetns, see Collateral for Microfinance loans in the West Bank and Gaza Strip, Report Prepared for USAID AED/SMART, October 20, 2007.

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managing and controlling the investment. Shares in Mudarabah funds can be traded at stock markets.

2. Murabahah. Murabahah is the cost-plus method which is used commonly by Islamic banks. The basis of Murabahah is that the bank buys assets/goods at the request of the customer and then sells it to the customer with a profit (fee) which will be agreed on in the main agreement between the two parties. The profit is considered as a compensation for the bank for the time and the work it did within the terms of the agreement. In this manner the bank will take the risk of purchasing the goods and will hold the title of the goods until it resells it to the customer. Therefore, it is not prohibited. It is usually used for the purchase of physical assets (equipment, land, etc).

3. Ijarah. Ijarah is the equivalent term for lease or rent. In general Ijarah means the selling of a benefit or use or service for a fixed price. The Ijarah reflects an agreed profit between the bank and the customer, where the bank purchases the asset in question and rents the asset to the customer at a fixed price. All payments of rentals are treated as payments of operating expenses and are therefore fully tax-deductible. Leasing therefore offers tax-advantages to profit making businesses. The lessor is obliged to retain responsibility for maintenance and insurance of the leased asset.

4. Ijarah-W-al-Iktina (Lease purchase contract). A contract under which an Islamic bank leases or rents goods or assets to the customer for an agreed price, and at the end of the lease period, the bank transfers the title of the goods or the asset to the customer. The rentals as well as the purchase price are fixed in such manner that the bank gets back its principal sum along with profit over the period of lease.

5. Istisna'a. An Islamic institution places an order with a contractor to build, say, a factory or other fixed price turn-key project. The Islamic bank then agrees to sell the factory to a project company on deferred payment terms. Typically, the Islamic investor then either continues to own the factory and charges the user fees based on the profitability of the factory, or sells the factory back to the project company on deferred payment terms.

6. Musharakah (Joint Venture). Musharakah is a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in a joint business. With this product, an Islamic banking institution establishes a special purpose company with its customer to finance the new venture. Both parties are entitled to participate in management, but these days Islamic banks generally play little or no role in the joint venture management. There is a risk that the joint venture may fail and there is no guarantee that a profit will be generated. If there is profit, it will be distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.

These are some examples of Islamic banking tools[16] provided for illustrative purposes only and not designed to delve into an analysis of each. What is relevant is that because of such instruments, the traditional risks borne solely by the borrower which are core to western lending schemes are not at play in Islamic regimes. Thus insolvency incidents are not rampant. Further, when insolvency is invoked, the treatment tends to be distributive and rehabilitative in nature.

IV. Rank/Priority of Claims Under Arab Bankruptcy/Insolvency Law

All bankruptcy laws share with companies laws the list of priority claims. All have a strong social component. The laws in the pure Islamic law jurisdiction have even greater social consideration. In all jurisdictions, secure lenders take priority after the statutory list which are: (1) liquidation costs; (2) municipal and government taxes; (3) salaries and compensation of all employees of the debtor; (4) spousal support including alimony and child support; (5) rents due on properties rented by the debtor; (6) secured creditors by the cash collected from the auction of their respective collateral; and (7) unsecured creditors.

V. Market-Based vs. Banking-Based Financing

There is an interplay between bankruptcy/insolvency rules and the nature of the financial system in any given jurisdiction. Depending on the market-orientation, the laws tend to have an inherit bias towards either the borrower or creditor.

1. Market-Based Systems. In market-based systems, most financing is raised or made through the capital market. So, the relationship between creditor and borrower is relatively distant. Information tends to be reliable and available either directly from the financial markets and easily ascertainable making the operation of the capital market efficient and transparent. (The U.S. is an example.) In these market-based systems, **bankruptcy laws include separate treatment of the creditor and debtor and have tended to gravitate in their evolution and reform toward establishing a balance between their respective rights.** The bankruptcy laws of the Arab countries do not reflect these clear distinctions, but in practice have tended to balance the interest and sought to avoid outright bankruptcy.

2. Bank-Based Systems. In bank-based systems, financing is made through banks and other financial institutions. Banks tend to take an active interest in companies and have representatives on the board of directors. Bank 's management has information about each loan but is not as readily available as in the market-based systems. In such instances, they can preempt other creditors and rush against the defaulting borrower (infrequent) in filing for bankruptcy. By the same token, they can avoid potential bankruptcy procedures. (Germany and Japan are examples of the system). In these bank-

[16] Other instruments include, Bai bi Salam (pre-financing), Bai bi Salaf, Musaqat and Muzara'a, Qard Hassan (Good Loan), Muqarada, Wadiah (Safekeeping), and Jialah (fee-based service).

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based systems, bankruptcy law includes a stronger focus on creditors rights. They also tend to favor banks over other financial institutions. **In such systems bankruptcy law reform is moving toward creating greater balance and aim to protect debtors as well.** Since most Arab countries have strong banking traditions and banks take active interests in companies, they do share this same direction with bank-based systems. However, for other considerations mentioned in paragraph 3 below, they do not fit well in this system. Depending on the circumstances, a "good" company may face demise if creditors have the critical votes; or a bad company may be kept going if shareholders have the critical votes.

3. Developing Banking-Financial Markets Systems. In these developing systems, the financial markets and banking systems are emerging. Information is less readily available as the other two systems making it difficult for creditors to file for bankruptcy. In these developing systems, **bankruptcy law reform seek to establish a balance between creditor and debtor interests, but with a stronger bias towards the borrower than in the case of a market-based system.** The limited availability of information in most Arab countries make them fall in this category.

VI. Common Elements of Bankruptcy Regimes in the Arab World

In most Arab jurisdictions and, irrespective of their legal system, there are three ways through which a debtor can file or be placed into bankruptcy proceedings.

1. Voluntary liquidation ("wind-up") in which the debtor agrees to resolve its debts through a court overseen liquidation of its assets and division of proceeds to creditors in a supervised manner – allowing the interests of all creditors to be treated with some measure of equality. When the borrower chooses voluntary liquidation, the lender's main objective is to get its collateral liquidated (sold) as soon as possible, for as much as possible. There are two provisions for voluntary liquidation in Arab laws. One is for individuals or merchants (voluntary insolvency). The other is for companies and partnerships ("wind-up").

2. Reorganization of debts subject to approval of creditors (under the protection of the court) (in – "composition"*)*. If the borrower does choose to attempt a reorganization, the bank faces a number of decisions. First, it must decide whether it wants to support the borrower's reorganization or oppose it. This decision will largely hinge upon the analysis done earlier by the bank on the borrower's restructuring plan: whether the bank believes that the borrower will be able to recover from its problems. If the bank is prepared to let the borrower try to recover, the bank needs to determine how much cash the borrower will need for the restructure. While most collateral remains in the debtor's possession during bankruptcy, the use of cash and cash equivalents are usually subject to the approval of the creditors. The bank may decide to try to get all of its collateral back (under the contention that the collateral is not critical to the

reorganization and the debtor has no equity in it). The key concern of both secured and unsecured creditors is the fact that they may be compelled to go along with a restructuring plan that is not in their interest. Unsecured creditors voting in the minority can always be bound by approval of majority or supermajority of the creditors (and some larger percentage of the total amount of debt in that class). Reorganization for individuals/merchants is covered in the commercial codes. Reorganization for companies is covered in the Companies Laws.

3. Involuntary liquidation in which the court orders the liquidation of the debtor's assets (against the debtor's wishes) for the benefit of the creditors. In some circumstances the bank may decide to put the debtor into involuntary bankruptcy. In most cases, the bank will have exhausted all other remedies, including legal action against the borrower. However, if the borrower remains resistant to either making repayment, providing the bank with its collateral, or filing for reorganization or liquidation -- and if the bank believes that its position is being impaired (for example, it believes that the company may be paying other creditors but not the bank) -- the bank may have no option but to file for involuntary bankruptcy. In Arab regimes, even one creditor may unilaterally file for involuntary insolvency (bankruptcy) as stipulated in commercial codes. If the debtor disputes the petition, the court hears the case. The court may, at the request of the creditors or on its own volition, appoint an interim receiver or trustee to oversee/control the debtor's business assets for the protection of the creditors while the case is being adjudicated.[17]

Based on the forgoing, bankruptcy provides a number of benefits to the debtor as it provides temporary relief from creditors. It provides a "structured bargaining arrangement" in which the company can attempt an orderly restructure of its finances (reorganization or composition) or develop a plan for orderly liquidation under the protection of the court. On the other hand, it has benefits for the creditor as well. It imposes a timeframe and a process for resolution of the dispute. It ensures that the firm will be supervised during the bankruptcy proceedings, thus protecting the bank's position. And it helps to ensure that the priority of credit claims will be respected.

There are elements where the Arab countries diverge on. The common law jurisdictions tend to be or are thought to be biased in favor of creditors (although the courts are often sympathetic to debtors); the civil and Islamic law jurisdictions tend to be unduly protective of debtors. In Arab regimes, bankruptcy regimes need to be updated to provide clear balance between the interests of debtors and creditors.

VII. Elements that would Enhance Bankruptcy Laws in the Arab World

[17] In common law jurisdictions, creditors appoint the trustee to liquidate the debtor's assets; in hybrids, civil and Islamic law, courts appoint and oversees the trustee.

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Legislation in Arab countries could benefit from elements that are features of more developed bankruptcy laws. These include:

1. Moratorium/Stay: The filing of a bankruptcy case imposes a "moratorium" or "automatic stay" on all transfers of property by the debtor and all collection activities by individual creditors until the case is resolved. Modern laws make the moratorium applicable to secured creditors as well as unsecured creditors, generally on the condition that the debtor protects the secured creditor against a worsening of its position during the moratorium. Older laws, like those in the Arab countries, permit secured creditors to take their collateral out of the insolvency proceeding. Since such equipment may be essential to successful reorganization, this may impair the debtor's ability to restructure or even to continue operations.

2. Creditor Democracy: A good insolvency law empowers creditors to organize themselves efficiently, including electing representatives, to protect their interests. Creditors generally have the right to approve reorganization plans and/or influence the disposition of assets in liquidation. Creditor voting rules differ from one country to another. Laws may require separate voting by different categories of creditors, or various percentages of approval of both total debt and total number of creditors.

3. Controls on Debtor's Management: The most frequent cause of insolvency is bad management. Modern insolvency laws provide a number of controls over the debtor's management that benefit creditors. These include comprehensive reporting about company finances and operations, prior approval of certain kinds of decisions, replacement of existing management, and, appointment of a disinterested third party -- variously known as a "trustee," "receiver," or "liquidator" -- to oversee or manage the debtor's affairs during reorganization or liquidation.

4. Binding Dissenting Creditors: A crucial feature of a modern insolvency law is the right of the court or a creditor majority to bind dissenting creditors to a reorganization plan, as long as the plan gives dissenting creditors at least as much as they would have received in a liquidation (which could be nothing).

5. Preference Period: As a business deteriorates, some creditors will be more aggressive than others in collecting their debts. The company may begin "preferring" (or paying) some creditors over others or the owner may begin to transfer assets out of the business for his own benefit. Accordingly, modern bankruptcy laws create a "preference period" that starts a defined period before the bankruptcy was officially opened -- three or six months, for example. Any transfers or payments made during this period immediately before the insolvency proceeding was commenced that unfairly favored one creditor or diluted the assets of the debtor can be undone.

6. Favoring Secured Creditors: Economic growth depends on businesses having access to credit. Accordingly, it is essential that the legal framework protect the rights of

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secured creditors to realize the value of their collateral. Laws which elevate other creditor claims (tax claims, employee salaries and benefits, rents payable, etc) above secured creditors' rights to their own collateral, undermine the confidence of lenders and therefore restrict credit. Modern insolvency regimes protect secured creditors against deterioration of their secured position during the proceeding, and elevate them to first priority for payment to the value of their collateral, subject only to the requirement that they pay for administrative expenses.

VIII. Conclusion

Bankruptcy reform, both theoretical and empirical, has taken place over the decades. Little work reached the Arab world or stemmed from these jurisdictions. A country's institutional structure, socio-economic conditions and its legal traditions are factors that affect the development of its legislation and certainly, there is no "one size fits all". This is very true of the Arab bankruptcy/insolvency laws. Further, bankruptcy reform should not be seen in isolation, it would be necessary to combine it with legal and other reforms, e.g., the training of judges, improvements in corporate governance and the strengthening of investor rights, and possibly even changes in the financial system. It may require legislative reform including of the laws related to civil procedure and execution of judgments.

In many countries creditors recover nothing and the same can be true of Arab countries. So, there is general worldwide consensus that good bankruptcy regimes are essential and they must therefore be efficient. As Arab countries seek to reform their bankruptcy laws, they should design them well and aim to reflect these principles:

- minimizing the cost of the proceedings and provide for rehabilitation where possible;
- ensure preservation and ranking of secured creditor rights and provide equal treatment of all other creditors where a company cannot be saved;
- facilitate liquidation whenever creditors receive information indicating that liquidation is optimal;
- prevent excess liquidation by creditors;
- provide managers with incentives to liquidate the firm voluntarily when creditors fail to discover that continuation would result in inefficiencies;
- structure the distribution of the cash flow in liquidation to maximize the ability of the firm to finance valuable projects.

They also should consider lessons learned from other jurisdictions. For example, under the U.K. amendments of 1986, an insolvency practitioner runs the company during bankruptcy. France enacted in 1985 a bankruptcy law which allows the court, through an administrator (having relatively more power than in the U.S. or U.K) to accept a reorganization plan without the approval of creditors, provided it ensures employment of workers and the repayment of creditors.

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Other considerations include inclusion of structured bargaining as opposed to cash auction options. Some Arab laws permit bargaining, but is it not well developed and tends to be informal. The idea behind the structured bargaining is that the company's creditors are encouraged to bargain about the future of the entity, i.e., if it should be liquidated or reorganized and how its value should be divided up--according to predetermined rules. The leading example of a structured bargaining procedure is Chapter 11 of the U.S. Bankruptcy Code; however, U.K. administration is based on similar ideas, as are procedures in France, Germany, and Japan. This is a preferred tool over the simpler procedure of the sale of a company's assets, supervised by a trustee or receiver through cash auctions. Often the assets are sold piecemeal, in other words, the firm is liquidated (having been closed down). Sometimes, however, the firm is sold as a going concern. Whichever occurs, the receipts from the sale are distributed among former claims according to absolute priority (usually secured debt, then various priority claims, then unsecured debt, then subordinated debt and finally equity). There are critics of Chapter 11 because it tends to be time-consuming, costly, and even too friendly to debtors. So, Arab reformers need to bear such short-comings in mind.

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Annex I

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