

THE BUTTERFLY EFFECT Proposed Amendments to the UAE's Company Law

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With in excess of 30 Free Zones Dubai has developed an extremely successful Free Zone industry with many of Dubai's Free Zones held up internationally as examples of how such trading Zones should operate.

Generally speaking, Free Zones are established as transit points through which goods can be transported and stored prior to distribution, avoiding the imposition of customs duties and charges, which would apply if goods were brought directly into a mainland jurisdiction. Therefore they are often aimed specifically at export oriented industries

There can be little doubt that Dubai's Free Zones have enjoyed prodigious success. Jebel Ali Free Zone (JAFZ) one of Dubai's longest standing Free Zones is recognised as a market leader and contributes in a substantial manner to the nations GDP. Currently in excess of 6,500 companies are based in JAFZ.

The reasons behind the success of Dubai's Free Zones are complex and must be considered in light of the broader commercial landscape. The attractiveness and success can not simply be attributed to sector specificity, well planned infrastructures or exemptions from customs duties.

A closer look reveals additional factors at play, principally the opportunity to establish a corporate entity in the UAE and in which majority ownership is afforded to investors.

In addition to the retention of 100% ownership, Dubai Free Zones afford foreign entities establishing therein the opportunity to avail of UAE residency visas for employees and shareholders thus allowing them to reside in Dubai.

From a legal perspective however, Free Zones are treated as if they were, in fact, offshore locations and Free Zone Authorities are entitled to create their own governing regulations, including the ability to offer corporate entities with characteristics unavailable under current UAE company's legislation. For example many Free Zones offer the opportunity to establish a Free Zone Establishment with one shareholder and benefiting from limited liability, a structure which does not exist in the mainland UAE.

Dubai's economy is suffering. The global economic crisis has impacted in a profound manner. An economy that was until recently one of the fastest growing in the world is predicted to experience a negative growth rate this year.

Levels of Foreign Direct Investment ("FDI") have fallen sharply and the Government is currently working towards implementing an extensive program to increase the attractiveness of the emirate to foreign investors.

One issue, long stated as an impediment to attracting FDI is the current restrictions placed on foreign ownership of UAE based corporate entities. Currently amendments to Federal Law No 8 of 1984 ("the Companies Law") are in the final stages of review and are awaiting approval before the UAE's Federal Counsel.

Article 22 of the Companies Law deals with foreign ownership restrictions for corporate entities established in the UAE. All corporate entities established in the UAE must have a local UAE shareholder, being a UAE national or a company wholly owned by UAE Nationals. The local shareholder must hold at least 51% of the share capital of a UAE based

entity.

For many potential foreign investors considering locating in the UAE this represents an unacceptable loss of control and many have started to look to other GCC states in the alternative.

Other GCC states have taken steps to liberalise their commercial market places, offering foreign investors majority or total corporate ownership in many sectors. Bahrain, Saudi Arabia, Kuwait and Qatar have all taken strides in this direction, with proven results. Bahrain for example allows 100% foreign ownership in all but a few sectors, According to the Heritage Foundation/ Wall Street Journal Index of Economic Freedom 2010, Bahrain has the world's 13th most freely accessible economy, ranking ahead of many western nations including the Netherlands and Luxembourg. Saudi Arabia which allows full foreign ownership in many sectors has been widely liberalised, with the exception of oil and gas concerns. Foreign Direct Investment in Saudi Arabia amounted to circa US\$35 billion in 2009 according to figures published by UNTAD.

The UAE on the other hand has fared relatively less well, in the period from 2007 to 2009 FDI has fallen from US\$14.2 billion in 2007 to US\$4 billion in 2009.

The foregoing figures are evidence of the pressing need for the UAE to relax foreign ownership restrictions. The pending introduction of a new Companies Law will almost certainly deal with this issue.

The amended legislation will undoubtedly serve to benefit mainland Dubai's economy however the direct benefits to Dubai's many Free Zones are not so clear.

Under the current regulatory framework for all of Dubai's Free Zones, no entity established therein can carry on business directly in the UAE. Essentially this means that a Free Zone entity may carry on business with parties located inside its Free Zone, with parties located in other Free Zones or with parties located outside the UAE.

This requirement is in place to prohibit circumvention of the current 51% to 49% foreign ownership restrictions as mentioned above. To allow a Free Zone Company to carry on business directly in the UAE would be in direct contravention of the existing Federal legislation.

The only legal alternative for Free Zone Companies wishing to carry on business in the UAE is to appoint a mainland UAE agent or to establish a mainland branch of the Free Zone Company. In both cases the local UAE agent must be a UAE national or a company wholly owned by UAE nationals. Both options present practical difficulties and additional expense for Free Zone entities wishing to enter the UAE marketplace.

A branch company or local agent may carry out services or sell goods on behalf of the Free Zone Company, this can be a costly and, particularly in the case of service providers, where human capital is involved, an impractical and difficult model to operate.

The attractiveness of this option would diminish markedly if alternative solutions were to present themselves. A change in the relative ownership requirements for foreign investors in mainland Dubai corporate entities would most certainly present such an alternative.

It remains to be seen whether 100% foreign ownership will be introduced, it may only be applicable to limited economic activities and will almost certainly not affect strategic sectors such as the oil and gas industry. It is more likely that a compromise will be reached; with foreign investors receiving in excess of 49% but less than 100% in the non core sectors.

For many foreign investors a majority stake in a mainland Dubai entity offering the possibility of carrying on business throughout the GCC including the UAE and with the benefit of operating from mainland Dubai as opposed to a particular Free Zone may present a commercially viable and attractive alternative.

This will place Dubai's Free Zones at a competitive disadvantage and will present them with serious challenges in attracting new FDI as well as difficulties retaining existing clients.

In an effort to remain competitive, many of Dubai's Free Zones have introduced wide ranging reforms to attract further foreign investment. Measures taken include sweeping cuts in set up costs, comprehensive reviews of regulatory framework and increased spending on infrastructure. This will certainly stand them well in light of potential future challenges.

A continued effort by Free Zone Authorities to implement change has led to clear results. Evidence of the continued commercial success of Dubai's Free Zones is borne out by available data. Dubai Silicone Oasis, which represents Dubai's answer to California's Silicone Valley, is a good case in point. Published results show that in the first half of 2010 profits grew by 131% while revenues were up 148% as compared with the same period in 2009.

Dubai Airport Free Zone was recently ranked second in FDI Magazine's Global Free Zones of the Future Survey. Three other Dubai Free Zones, Dubai Knowledge Village, DuBiotech and Dubai Media City were also ranked in the top ten. In addition to this published figures available for Dubai Airport Free Zone show that revenues for 2009 were up 30% over 2008 levels.

Whether or not such impressive growth levels can be maintained is doubtful if legislative amendments to foreign corporate ownership restrictions are introduced.

Dubai's Free Zones currently represent an attractive alternative for many foreign investors seeking to establish a base in the UAE. The relative effect a liberalisation of foreign ownership requirements is likely to have on Dubai's Free Zones will ultimately depend on the appetite of existing companies and new investors to deal directly into the UAE and the levels to which foreign corporate ownership is liberalised.

Their ability to offer specialised, industry specific benefits to clients which outweigh the positive aspects of having a mainland Dubai base with full or majority control and the ability to carry on business directly in the UAE will also be a key determinant.

A liberalisation of foreign ownership requirements will present opportunities for companies currently operating from Free Zones and utilising agency relationships or branch companies to carry out business in the UAE. It will also serve to offer potential entrants with an alternative option. There can be no doubt that those wishing to use a Free Zone as a distribution point for the region and wishing to benefit from the customs exemptions offered will remain in the Free Zones.

Changes to foreign ownership requirements are most likely to affect those Free Zones not located adjacent to transportation hubs and those where investors have located primarily to gain access to the UAE while retaining a majority ownership interest in their commercial venture.

With the pending introduction of a revised Companies Law, this is an issue which will need to be given serious consideration if all of Dubai's Free Zones are to remain viable.

Previous drafts of the new Companies Law have not dealt with the consequential affect such changes will have on Dubai's Free Zones.

The proposed amendments to the Companies Law will have far reaching and mainly positive effect on many aspects of commercial life in the UAE. It is imperative that law makers consider the wider consequences that such amendments will engender. This is an issue which will need to be dealt with sooner rather than later; failure to do so will result in seriously adverse consequences for many of Dubai's Free Zones.

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