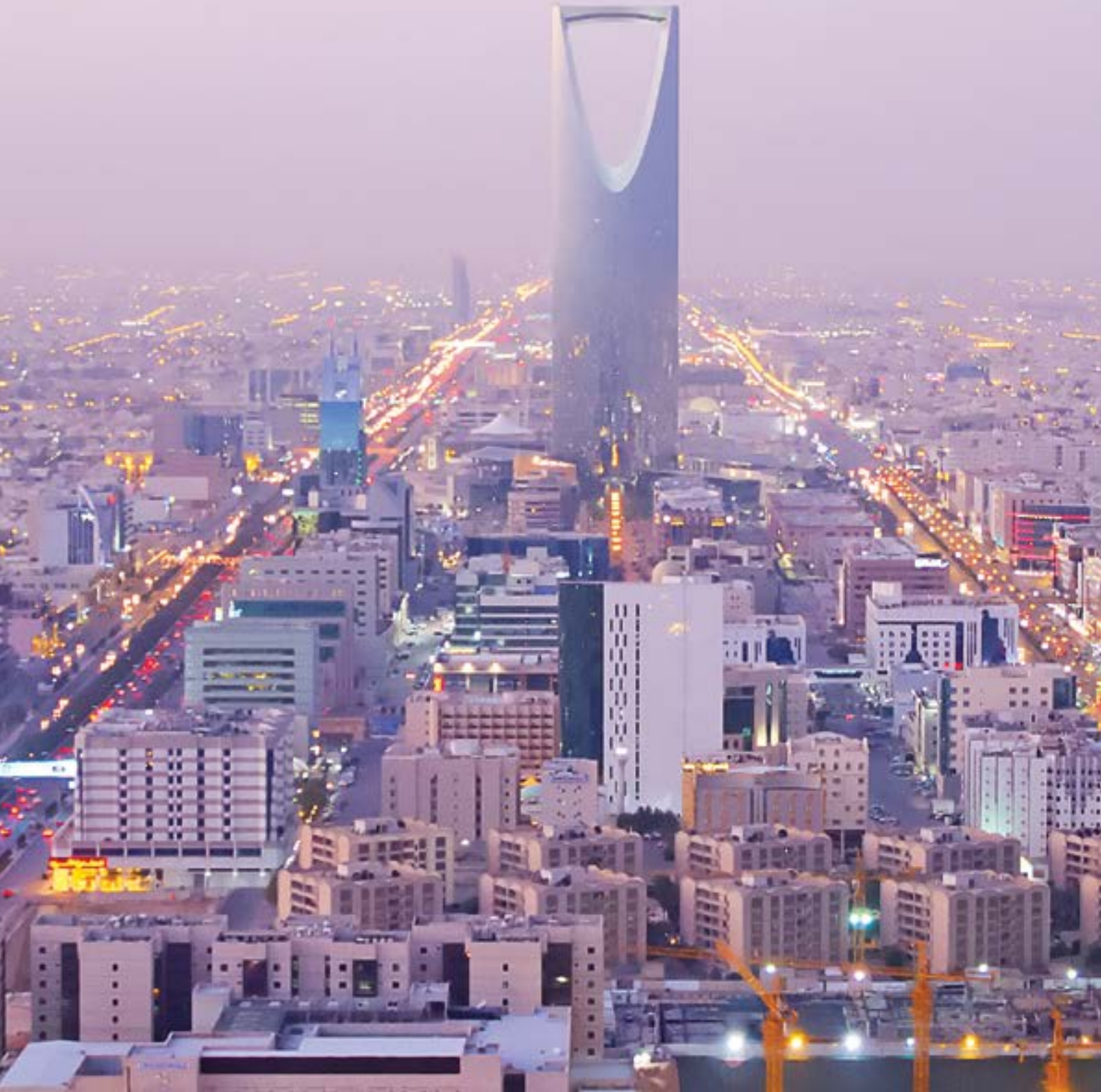
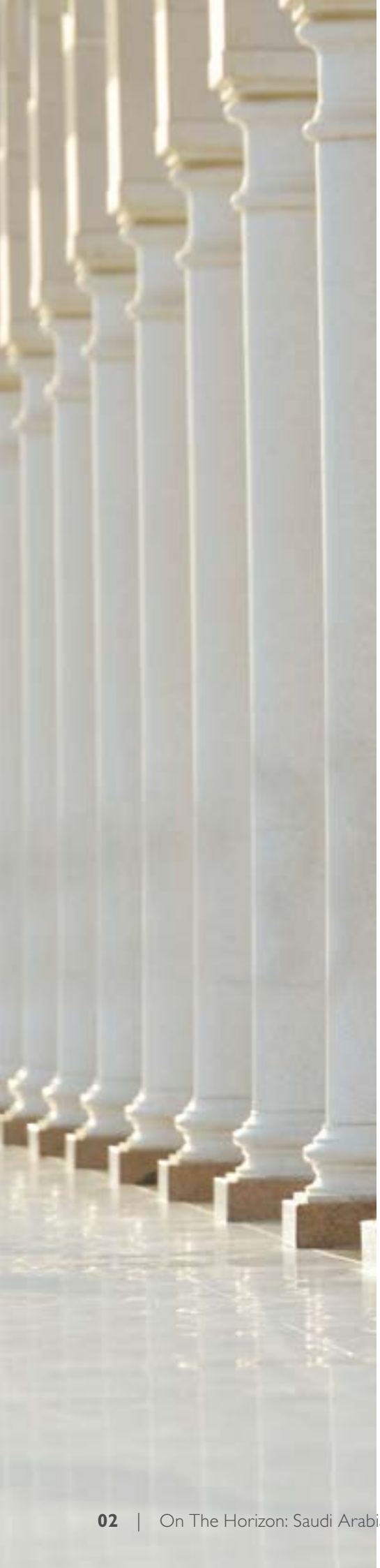
DLA PIPER

ON THE HORIZON

SAUDI ARABIA'S PROPOSED NEW INSOLVENCY LAW AND COMMERCIAL PLEDGE LAW





The pace and scale of current regulatory change in Saudi Arabia is remarkable. 2015 alone saw the long awaited Qualified Foreign Investors regulations open the Tadawul (Saudi stock market) to non GCC investors and the even longer awaited announcement of the new Companies Law, as well as a major overhaul of labour regulation.

Full implementation of other recent enactments (such as the 2012 mortgage law and the 2011 arbitration law), has led to an understandable focus by commentators on what we have seen already, rather than what is in the pipeline. However, the pipeline of proposed reform is equally eye-catching.

Specifically, this briefing focuses on two proposed reforms, details of which were announced in 2015, but neither of which have received the coverage they perhaps deserve, at least outside Saudi Arabia itself:

- the policy paper published by the Ministry of Commerce and Industry (MOCI) in respect of a proposed new insolvency law for Saudi Arabia; and
- the draft new Commercial Pledge Law published by MOCI.

INSOLVENCY LAW REFORM

WHY IS IT IMPORTANT?

Good insolvency laws have good economic effects. In the commercial arena, liquidation of viable businesses that could have been saved destroys value for both creditors and debtors. In circumstances where liquidation is inevitable, effective processes recycle capital back into the economy as efficiently as possible so that it can be redeployed more productively.

Various studies positively correlate effective insolvency laws with everything from entrepreneurship to labour productivity[1]. Policy choices and trade-offs inevitably figure, but the benefits from having a system that works are universal.

WHAT DO WE HAVE NOW? AND WHAT IS WRONG WITH IT?

It is more a case of what there isn't, rather than what there is.

Traditionally, Saudi Arabia has lacked a single, comprehensive insolvency code. Instead, there is an ad hoc layering of different sources, which are not always easy to reconcile, and which leave some of the most basic questions which insolvency laws tend to address difficult to answer clearly (e.g. the lookback period over which a liquidator may challenge transactions prior to the declaration of insolvency, and the criteria for doing so).

The basic guiding principles are of course Shari'ah ones, as is generally the case in the Kingdom. On top of that we have a civil law influenced but archaic Commercial Court Law (the "**CCL**") from 1931 dealing with the insolvency of traders[2]. There are then the bankruptcy protection settlement regulations, similar in some respects to what English lawyers would call a voluntary arrangement[3], but rarely (if ever) used because, unlike a voluntary arrangement, they effectively involve handing over the company to the court which is possibly the one thing that debtor and creditors can agree they don't want[4]. In addition, there are other pieces of legislation which affect specific things, such as the State Revenue Act which alters the insolvency waterfall by preferring state debts, and the Companies Law which covers certain aspects of corporate liquidation.

WHAT HAPPENS IN PRACTICE?

In practice, formal insolvency processes are very rare. To initiate the process is hard; the CCL posits a hybrid balance sheet (negative equity) and cashflow (can't pay debts) test to determine insolvency, but to satisfy that test a creditor generally requires an admission or a final court judgment against the debtor[5]. So, a long and tough court battle may await an unpaid creditor to unlock a procedure which itself is then very uncertain.

Legal enforcement tends to be on a first come first served basis with creditors seeking to identify and attach assets through the Kingdom's powerful enforcement judges. Outside of litigation, local banks also have powerful leverage against debt delinquency through, among other things, the Saudi Arabian Monetary Agency ("**SAMA**")'s B-listing process which can effectively shut defaulters from

[1] See at a general level, various literature from the World Bank and OECD: http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/VP328-Saving-Businesses.pdf.

[2] Civil law legal systems, unlike common law ones, often have a distinction between traders and non-traders for whom different rules apply. Note traders can be individuals – it is not the same as distinguishing between natural and juristic persons.

[3] We hesitate to use the expression "Company Voluntary Arrangement" or "CVA" as traders may be individuals.

[4] Particularly as the debtor initiating the process might in theory find themselves imprisoned if the court ultimately concludes they are a negligent or fraudulent bankrupt, and sanctions such as travel bans are common.

[5] For example, we are aware of one case where the Board of Grievances refused an insolvency position brought by a bank with a SAMA judgment on the basis bank debt was not commercial. Though it may be this view would not prevail if tested to the highest level, it is indicative of the difficulties faced and the rarity of actual insolvency proceedings.

the banking system. The SAMA Committee has proved a sensible forum for resolving banking claims – including for foreign banks – and for getting to the stamped judgment stage prior to enforcement (or proof in a notional insolvency), albeit it takes time.

Notwithstanding the lack of a formal mechanism to deal with dissenting creditors, the market over the past six or seven years has been able to achieve consensual work-outs in certain high profile cases.

However, makeshift approaches make for inconsistent outcomes, and they are less accessible to foreign capital providers – whom the Kingdom is keen to encourage. The lack of an ultimate resolution to two very large defaults dating back to 2009 remains a cautionary tale for many institutions in the international lending markets.

From a systemic perspective, clearer, positive rules on netting and financial collateral could make access to the international financial markets cheaper for the banking sector and Saudi business generally; particularly in an era where the rules applying to Western bank counterparties require a minute assessment of the adequacy of the regulations in counterparties' jurisdiction.

WHAT IS PROPOSED?

Essentially, the current proposal is to fill the current vacuum with what would be, if enacted, a fully functioning best-in-show insolvency law. The proposed new law follows an extensive exercise identifying policy choices for the new law and a benchmarking exercise against seven jurisdictions (US, England and Wales, France, Germany, the Czech Republic, Singapore and Japan).

The policy paper envisages three processes:

1) **Enhanced Protective Settlement:** this is a process, initiated by the debtor, where creditors and debtors attempt to reconcile out of court, but with some help from the law. Conceptually, this is similar in some ways to the existing bankruptcy settlement regulation (hence "enhanced"), although with the key differences being that the debtor remains in possession, and a short stay on enforcement proceedings is granted to allow the creditors and debtor to reach a settlement. The court would have to bless the final settlement and would also be empowered to authorise new finance for the debtor.
2) **Rehabilitation:** this is the more formal bankruptcy process. The initiator does not need to be technically insolvent, but needs to be in financial difficulty. An insolvency practitioner would be appointed to manage the debtor. The court would have to bless the final settlement and would have the power to cram down creditors (that is, to impose settlements on different classes of creditor).
3) **Liquidation:** which has heavier involvement of an insolvency practitioner as opposed to the court. It is therefore hoped that this will be more efficient then current liquidation processes.

There would be no distinction between traders and non-traders and a simplified version of each of the three procedures would be available for small debtors (i.e. those with low value estates), along with an administrative process for no value estates.

Creditor use of *ipso facto* to cancel contracts in accordance with the terms purely because of the fact of the financial condition of the company would be restricted in circumstances of the conciliation and settlement procedures.

Netting would be permitted and financial collateral – similar to the position in EU jurisdictions – and would be exempt from the moratoria on enforcement outlined above; hence the possibility of a GCC jurisdiction emerging where positive netting opinions can be given – previously something so implausible it seemed close to an oxymoron.

There would be scope for subordinate legislation to be drafted, making separate provisions for regulated entities such as banks, investment companies, payment and settlement systems, insurance companies and private utility companies.

THE PROPOSED NEW COMMERCIAL PLEDGE LAW

WHY IS IT IMPORTANT?

The ability to take effective collateral is a central consideration in most economic contexts where finance needs to be raised. Which is to say, nearly always.

WHAT DO WE HAVE NOW? AND WHAT IS WRONG WITH IT?

For moveables (that is, not land) the main legislation in Saudi Arabia is the commercial pledge law (the "**existing CPL**"). While not as venerable as the CCL it is showing its age (though some issues were addressed by amendments in 2004).

The basis for taking security in Saudi Arabia is the pledge or *rahn*. This is sometimes translated as "mortgage" or "lien" in English (depending on the context and often going with market usage in the English language – e.g. real estate "mortgages") but the essence is pledge – that is possessory security based on the security holder (or a security agent) taking – and keeping – possession.

The existing CPL tantalisingly hints at something which approaches constructive possession by indicating that the requirement for the pledgee or security agent to have possession shall be satisfied if the pledged asset is put at their disposal in such a way as to make others believe that the property is in its possession.

This opens the door (when dealing with pledges over physical equipment and inventory) to various solutions involving name plates, segregated areas on work sites and in warehouses to effect security, though the practicality and physical vulnerability of such arrangements render them bespoke solutions generally approached on a case by case basis by institutions already comfortable doing business in or into the Kingdom.

The Unified Center for Lien Registration ("**UCLR**") opened in 2011 allowing pledges to be registered. The consequences of non-registration are not set out however, it is not currently searchable, and mixed experiences in terms of contactability, opening hours, staffing and procedural requirements have confused the market. A successful registration is still more like a legal campaign than an administrative formality.

Few would confidently argue that the mere fact of registration would be sufficient to trigger notice to the world.

Security over cash accounts is another technical problem area (in fairness, a problem which is shared with some civil law influenced jurisdictions) as a change to the possessed subject matter – that is a fluctuation in the balance of the account – could release the pledge.

Self-help is not in theory permitted; an order of the "competent court" is required to enforce a pledge. This creates an apparent[6] contradiction between the existing CPL and applicable Saudi securities regulation (not to mention operational systems and market practice dealing with listed securities where margin calls and enforcement are commonplace)[7].

[6] Note there is a counter argument that the removal of securities from the implementing regulations means the existing CPL should only be deemed to apply to certificated shares (i.e. closed joint stock companies) – for which there are express requirements including UCLR registration – and not listed shares, but it is only an argument. The UCLR has indicated they don't register listed share pledges.

[7] Margin lending in Saudi Arabia both in terms of margined transactions with CMA authorised persons and Lombard lending where the AP is security agent are a large topic outside the scope of this briefing. For various reasons market participants get comfortable notwithstanding the (arguable) contradiction between the CPL and aspects of the securities rules, but it would clearly be helpful to resolve the anomaly here.

In more general practice, self-help abounds[8] as once the facts on the ground have changed and (solvent!) set off is effected against the debtor, there is little for them to argue about, provided the asset was sold at a fair price, any excess proceeds are returned, and the debt is uncontroversial.

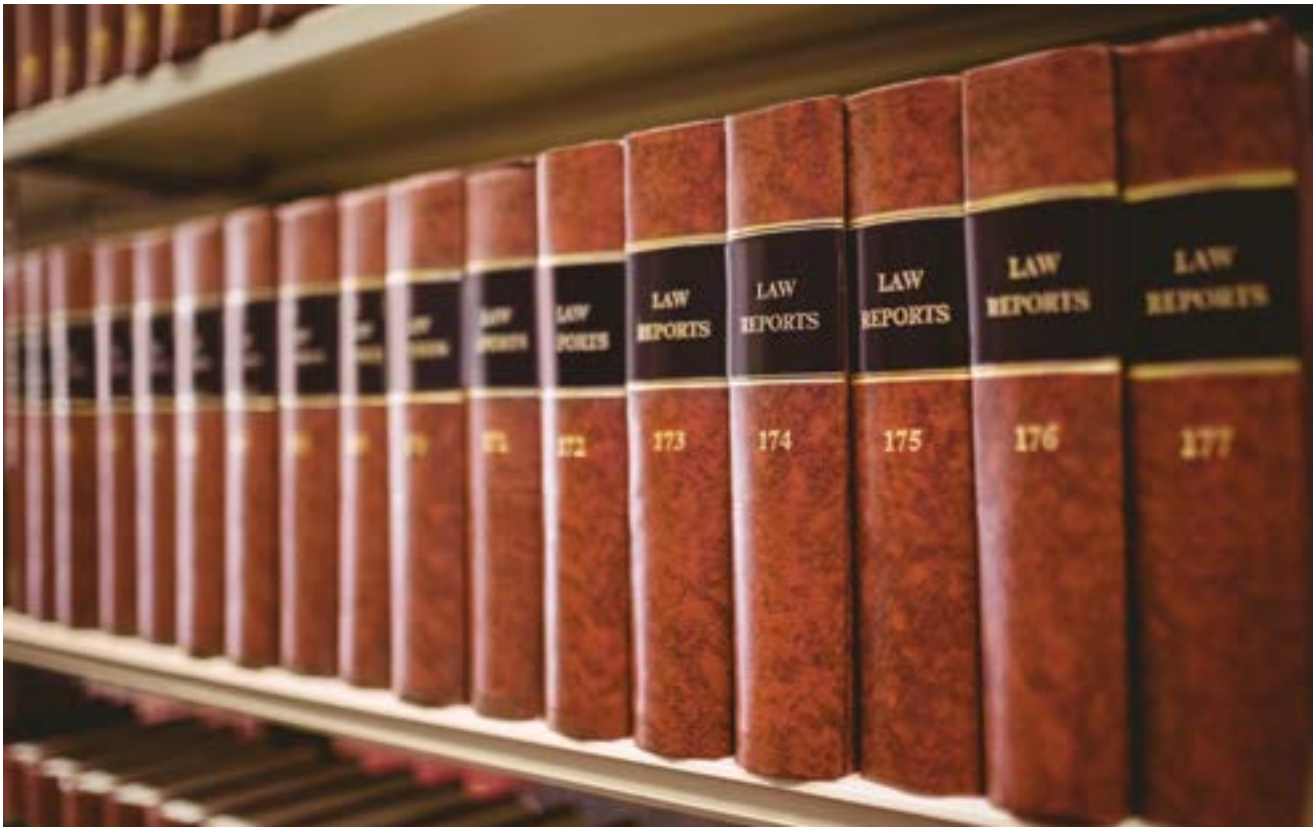
WHAT IS PROPOSED?

The preamble to the proposed new law (as well as the articles themselves) makes clear that one of the key issues that the proposed new law will address is to provide expressly that registration will be sufficient to give notice of possession to third parties. Hence, physical possession ceases to be the prime or even a necessary criterion to establish a pledge, provided registration has occurred.

Other aspects include the following:

- performance guarantees are specifically authorised as well as guarantees of a debt;
- future items (e.g. under construction) and future debts not yet payable to the pledgor may be covered by the pledge;
- pledged property may be traced into the hands of third parties;
- current, deposit and investment accounts may be pledged with notice to the account bank;
- more than one pledge may exist over the same asset (allowing for second, third etc. ranking pledges);
- self-help is expressly permitted where provided for in the contracts[9] (though the procedures relating to it will be subject to the implementing regulations to follow), and in other circumstances a registered mortgage document may be treated as an enforcement instrument which may be taken directly to an enforcement judge; and
- floating security over assets generally[10] are expressly permitted; and
- the priority of secured debt is expressly acknowledged (and through actual possession may still establish a pledge, first in time registration will take priority).

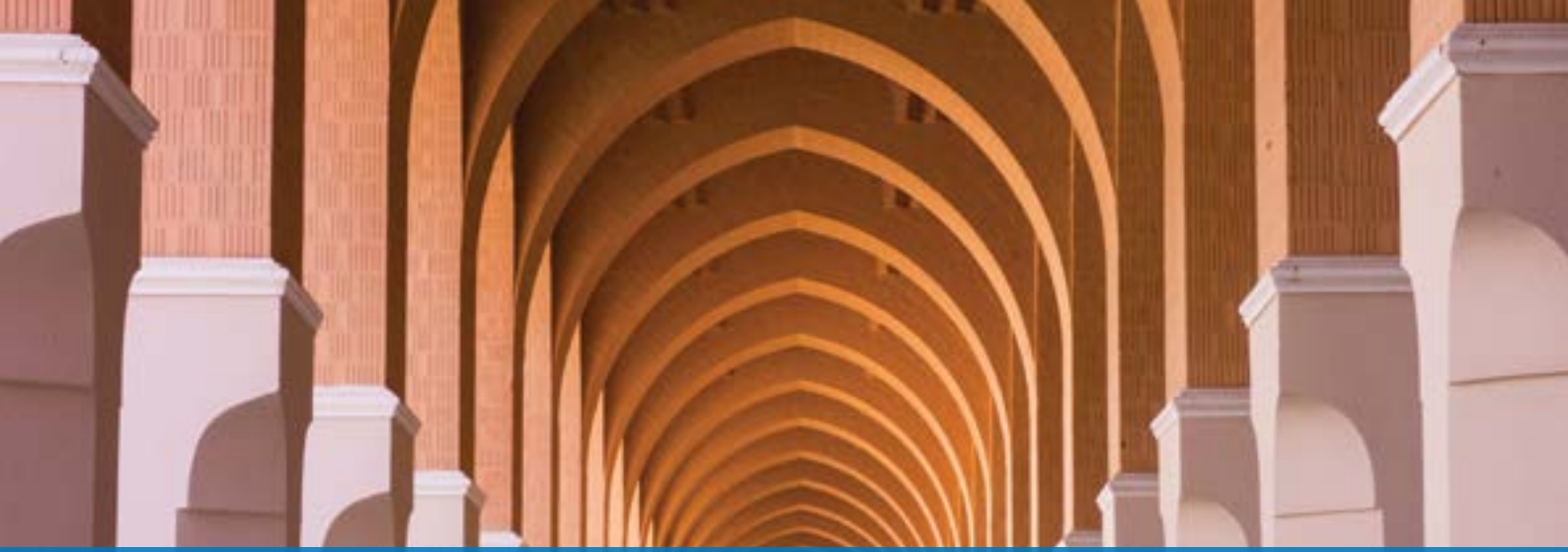
MOCI shall establish a general directorate for the UCLR in order to establish and manage the register referred to in the law, and may authorise subsidiary entities to undertake this task.



[8] Though not within the scope of the commercial pledge law, the most obvious example in the local debt market is the continued very widespread use of *ifragh* or title transfer to take de facto security over plots of land.

[9] Subject to priority rights, given multiple pledges are allowed.

[10] Analogous to a UK floating charge.



CONCLUSION

While commentators may be forgiven for refraining from over excitement given long experience in the region of growing significantly older waiting for proposed enactments to become enacted enactments, it is hard not to be impressed by the ambition of the proposed reform.

There are also reasons for optimism in the case of these proposed reforms. There is an express drive by policymakers to diversify the economy and to encourage investment in the Kingdom, not to mention widespread recognition that a modern and consistent regulatory platform is a key part of achieving this. While the Kingdom's ambition would exist with or without these current macroeconomic considerations, they do add impetus.

There is also now a track record for delivering legislation. The new Companies Law is a major psychological as well as legislative milestone marking the end of what was a long road.

SO WHERE TO FROM HERE?

The Saudi consultative process will involve a focus on Shari'ah compliance. This analysis can be complex to work through, but the resonance between the aims of proposed reform (to achieve fairness for both creditors and debtors and to benefit society) and Shari'ah principles should, it is hoped, leave the way clear for scholarly consensus and support for what the Kingdom's legislators are seeking to achieve. Saudi government certainly appears to have done a considerable amount of homework across different ministries to ensure the proposals are compliant.

At a practical level, the impact of letters in the official gazette and real world outcomes will depend on real world implementation. Properly trained insolvency practitioners familiar with their proposed new roles, to take one example, and an operable registration system needs to be in place for security registration to work. In that context, as with other reforms, it is probably best not to view the act in itself as the beginning or the end of the story, but rather as part of a process. However, enactment of the laws as envisaged would mark a major step forward.

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The author of the client briefing participated in the drafting of the insolvency policy paper, but the views expressed are wholly private ones which cannot be imputed to any other organisation or government.

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