

Securing Saudi

Saudi-Arabia's New Financial Collateral Structure

LEGAL BRIEFING (17 May 2020)

Securing and collateralizing debts has been a significant legal issue in the Kingdom of Saudi-Arabia (KSA) for a long time. Covered by more prominent topics, due to the current COVID Crisis, the Kingdom has enacted a far reaching reform based on Royal Decree M/94 dated 15/08/1441 H. (08 April 2020) with deep implications on a number of businesses from banking and financial services to trade and commerce. It has opened doors to tackle one of the major problems of doing business and investing in the Kingdom and can be expected to have a significant impact on the country's economic structures.

1. What has been the Issue with Securing Claims in the Kingdom yet?

KSA's legal system is founded on direct application of Islamic Law (Shari'a). This is complemented by a number of written laws enacted by Royal Decree, which formally are derogated by overruling Shari'a law and dogmatically specify and interpret Islamic Law. Shari'a principles are largely restrictive to speculative elements in contractual arrangements. Due to this restriction, securing and collateralizing debt obligations has been problematic. Whereas Shari'a acknowledges the concepts of guarantees and pledges (the first one being personal, the second one related to real property), these have been subject to strict conditions and have proven largely inflexible and not suitable for the demands of a modern economy and society.

The legislator has been tackling this challenge over time by issuing several laws regulating collaterals in the Kingdom, most notably the Law on the Pledge of Registered Real Estate (REPL) enacted by Royal Decree M/49 dated 13/8/1433 H. and

the Law on the Commercial Pledge (CPL) M/86 dated 8/8/1439 H.

2. What are the Major Changes to Collaterals in the Kingdom and what Implications do they cause?

On 10 April 2020 the Royal Decree M/94 dated 15/08/1441 H. (Decree) was published in the Official Gazette. This Decree does not only enact new legislation, i.e. the Law on Guaranteeing Rights by movable Property (LGMP) but also significantly amended the CPL (following another amendment to the CPL just six months earlier). This recent legislative activity opens the door for securing and collateralizing debt more flexibly and gives KSA a more modern collateral structure in order to align with international needs and standards.

a. The Law on Guaranteeing Rights by Movable Property (LGMP)

Persons – both, the guarantor (e.g. borrower) and the beneficiary of the guarantee (e.g. lender), can be any natural or legal person. The guarantor must not necessarily be the debtor of the underlying

obligation. Rather, the guarantee can also be provided by a third party.

Collaterals can be any movable material or immaterial asset as well as present or future rights. They can be owned by the guarantor, the beneficiary of the guarantee or any third party. Collaterals can be

- Rights and receivables which are due in the present or in the future,
- bank accounts (savings and current, excluding investment accounts),
- written documents that are transferable by delivery or endorsement, which prove the entitlement to an amount or ownership of goods, including commercial papers, bank certificates of deposit and bills of lading (excluding securities listed in the financial market),
- vehicles (excluding ships and airplanes),
- working materials or instruments,
- inventory (excluding goods deposited in public warehouses unless the right of security has been decided before filing),
- animals and their products,
- agricultural products,
- property by allocation minerals, even before extracting them.

Trademarks and funds with ownership records in which the security rights are recorded are excluded.

Each collateral can be used to secure more than one obligation.

Underlying Transactions to be

collateralized can be all types of contracts or transactions including but not limited to:

- commercial pledges,
- sale of movable property under a contractual condition of re-claiming it or buying it back,
- transferring ownership for security purposes,

- sale under retention of title,
- guarantee by transfer of rights,
- sale of rights in receivables.

The LGMP does not apply to transactions regarding the transfer of the right for the purposes of debt collection and purchases of a debt that is part of a (real estate) project ownership agreement.

The collateral/security transaction must be in written form (incorporated into the underlying contract or separately). The guarantor must be entitled to collateralize the collateral. The secured obligation must be described in a general or specific description, including its the maximum amount secured by the guarantee. The consideration for the collateral must be specified.

It is required for guarantees to be **Valid against Third Parties**, that the guarantee must either be

- publicly announced with consent of the guarantor by registering it (electronically) in a specific public register administered by the Ministry of Commerce including names and details of the concerned parties, or
- the collateral must be in possession of the beneficiary of the guarantee (directly or indirectly through real or legal transfer), this is especially relevant in case of bank accounts or certain commercial papers.

Third parties who have rights in the collateral must be informed for the guarantee to become effective against them.

The guarantee will remain valid in case the object of the right is separately attached to another object.

Priority Rights between several beneficiaries of the same collateral have been outlined in the LGMP:

- rights valid against third parties have priority over rights not valid against third parties,
- publicly announced collateral relations have priority over those not publicly announced,
- several rights on one collateral shall have priority to the proceeds as per the date of their public announcement,
- in case of the collateral in possession, priority of proceeds shall be given to the possessor having taken it into possession earlier,
- for rights not valid against third parties, proceeds shall be distributed in accordance with their establishment.

Any publicly announced collateral relationships shall have priority even over employees' outstanding claims against the employer or claims of the state.

The guarantor may not **Transfer Ownership of the Collateral**, except with the consent of the beneficiary of the guarantee unless such a transfer falls within the framework of acts seen as customary from the guarantor's side. In case of non-adherence with these provisions, the beneficiary may enforce his rights vis-à-vis the new owner.

Regarding **Enforcements of the Guarantees**, guarantor and beneficiary may agree on enabling the beneficiary to non-judicial enforcement of the guarantee (e.g. by way of selling the collateral by auction or directly) in the event of a breach of the secured obligation, provided that this agreement is in writing and before a breach of the secured obligation occurs. Enforcement (judicial or non-judicial) releases the collateral from any (further) guarantee on it. If the proceeds of

enforcement are not sufficient to fulfil all the underlying obligations, they shall be distributed as follows:

- on expenses of taking the necessary measures to repair the collateral, improve it, and prepare for sale,
- enforcement expenses
- distribution in accordance with the priority rights (see above).

In a non-judicial enforcement, the beneficiary of the guarantee is required to return to the guarantor the amount of security enforcement which exceeds the amount of the secured claim.

b. Amendments to the Law on the Commercial Pledge (CPL)

The Decree has amended the CPL in not less than 16 points to align it with the newly enacted LGMP. The most vital amendments are:

- The application of the Law is not limited to economic debt (i.e. those of a commercial transaction);
- Future pledges are eased in their conditions to be pledged;
- Economic establishments can be pledged without registering this in the commercial register;
- The formal requirements of the pledge contract is in line with the stipulations of the LGMP;
- Maintenance, and exchange possibilities are simplified;
- The enforcement system is adapted to and unified with the enforcement system of the LGMP. This includes especially the usage of special accounts to hold proceeds in case of execution.

3. How does the New Regulation Benefit Businesses?

The new LGMP can be expected to have a significant impact on the Saudi economy, most notably concerning commercial

businesses as well as the banking and finance sector.

a. Commercial Businesses

Effects on commercial businesses:

- The legal reform now recognizes a number of transactions that have not been codified yet, e.g. sale of movable property secured by a condition of re-claiming it or buying it back, transferring ownership for security purposes, sale under retention of title, guarantee by transfer of rights. The aforementioned transactions that can be frequently used to secure future payment obligations have now been officially incorporated into the canon of written laws of KSA. Moreover, the law provides for clarity with regard to formal requirements. This facilitates the drafting of security agreements and their acceptance in courts.
- The limited possibility to transfer ownership in secured assets strengthens the position of the beneficiary of the guarantee (i.e. banks as lenders).
- Potential assets that are eligible as collateral have become more diverse (bank accounts, inventories, commercial papers, e.g. bills of lading).
- future assets can be collateralized in a largely eased manner.
- Enforcement of securities has become easier, faster and more predictable for secured payment claims. This could ultimately contribute to an increase in payment discipline, something that is often criticized in KSA.
- A claim secured by a guarantee valid towards third parties would be amongst the highest-ranking claims in case of insolvency.

b. Banking and Finance

Many of the aforementioned advantages also apply to the banking and finance sector, whereby the LGMP offers a multitude of different development possibilities in this regard:

- Consumer (not only business) obligations have now become subject to the LGMP and the CPL, giving an additional possibility to accept diversified collaterals for these debts with clear procedures.
- Immaterial rights have become an increasingly recognized and regulated object of transactions, be it as the underlying transaction or as the object of the guarantee. The pledging of rights (inc. payment obligations) is now standardized by law covering a significantly widened scope. Especially in many finance transactions (be it corporate or project finance) the possibility to grant loans and receive appropriate collateral has risen considerably, leading to increased opportunities for banks to develop new, diversified and more tailor-made financial products in and for the KSA market.
- Especially the new possibilities of extra-judicial enforcements possibilities alongside shorter enforcement procedures encourages lenders to accept collaterals. Ultimately, debtors benefit from these rules as they can now tap into more (international) funding sources.

4. Conclusion

In many aspects the new legislation initiative - especially the 29 short Articles of the LGMP - can be considered as a game changer for commercial and financial transactions and foreign direct investments in KSA. The new legislation overcomes

certain structures that have long been criticized as an obstacle for a more dynamic market development. This is in line with KSA's Vision 2030, striving to make KSA an economic powerhouse.

It remains unclear how these changes will be applied in practice and whether these

rules will lead to an increased engagement of international lenders, foreign investors, trade partners and suppliers in KSA.

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