Insolvency
Saudi Arabia

Introductory Note: The general insolvency legal framework in the KSA is mainly set out in:

(i) Saudi Arabia Royal Decree No. M2/1970 dated 23rd March 1970 also known as the Commercial Court Law (the **CCL**); and
(ii) Saudi Arabia Royal Decree No. M16/196 dated 25th January 1996 also known as the Bankruptcy Preventative Settlement Law (**BPL**).

In addition to the CCL and the BPL, Saudi Arabia Royal Decree No. M6/1965 dated 22nd July 1965 also known as the Saudi Companies' Law (**SCL**) includes certain provisions that are relevant to the KSA insolvency regime. However, the SCL primarily sets forth provisions governing the solvent liquidation of companies with the prior agreement of the shareholders. Hence, the SCL should be deemed outside the scope of this article (except for those aforementioned relevant provisions that focuses on an insolvency scenario).

It should be noted that the existing insolvency regime in KSA as set out in the aforementioned laws is not sufficiently detailed, resulting in the creditors and debtors often seeking recourse in arrangements outside the legal insolvency framework.

1. Is there any legislation governing trading while insolvent?

Article 106 of the CCL provides that "*a negligent bankrupt is a merchant who pays fund improvidently, conceals from the creditors the inability to pay his debts, and who continues his commercial activities until his capital is finished*". Therefore, pursuant to said article, a debtor who continues to trade while insolvent will be construed as a 'negligent bankrupt'. Article 137 of the CCL provides that a negligent bankrupt shall be subject to imprisonment for a period ranging between 3 months and 2 years.

2. Are there any penalties for directors or business owners who knowingly trade while their business is insolvent? How is this evidenced?

- **General Provisions for Business Owners**. For business owners (individuals or shareholders of corporate entities) who knowingly trade while their business is insolvent, article 106 of the CCL (negligent bankrupt) shall apply (as explained in question 1 above).

- **Specific Provisions for Business Owners.** Article 180 of the SCL provides that where the losses of a limited liability company (**LLC**) reach half of its capital, the shareholders must decide whether they want to continue operations of the company as a going concern or dissolve the company. If the shareholders decide to continue business of the company as a going concern, they must do so by unanimously passing a shareholders' resolution by virtue of which they undertake to contribute towards the company's liabilities on a *pro-rata* basis

and recapitalize the company. If the shareholders continue operations of the company without replenishing the company's share capital, the shareholders shall be jointly liable for the payment of all debts of the company. Such provisions are generally viewed as setting in place a 'safety-fuse' sort of mechanism to prevent the occurrence of insolvency scenarios. Similar provisions relating to the losses of joint stock companies (**JSCs**) are found in their standard bylaws (**Standard Bylaws**) as published by the Ministry of Commerce and Industry (**MOCI**), which provide that where the losses of the company reach three-quarters of its capital, the directors of the company must convene an extraordinary general meeting of the shareholders in order to take a decision as to whether they want to continue operations of the company as a going concern or dissolve the company. However, the Standard Bylaws do not specify whether there is requirement to replenish the company's share capital if the shareholders decide to continue the business and the consequences of the shareholders continuing operations of the company without replenishing the company's share capital.

- **Directors**. Article 180 of the SCL and the Standard Bylaws provides for an obligation on the directors of LLCS and JSCs respectively to convene the shareholders for an extraordinary general meeting for the reasons explained in the paragraph above. Any failure to convene such meeting would result in a breach of the SCL and Standard Bylaws. In this respect, it is worth noting that according to articles 76 and 168 of the SCL, directors of JSCs and LLCs are jointly liable towards the shareholders and the creditors for losses resulting from any breach of the SCL or the company's memorandum of association; their mismanagement of the company's business; or any mistake in the performance of their role as directors. It could also be contended that directors who knowingly trade while the company is insolvent are mismanaging the company's business.

3. What options does a business in distress have? What options do individuals unable to pay their debts have?

Debtors (corporate entities or individuals) in distress or unable to pay their debts have three options: amicable settlement, preventative settlement; and filing for bankruptcy.

a) Amicable Settlement: The first option available for debtors in financial distress is to file for amicable settlement with the Chamber of Commerce and Industry (**COCI**).

Amicable settlements are not often used in practice. Therefore, we will only set out below some main characteristics relating to amicable settlement procedures, noting that both amicable settlement and preventative settlement procedures (as we will see in paragraph (b) below) have several aspects in common.

- Article 1 of the BPL provides that a debtor, whose financial position is precarious in a manner threatening the payment of his debts, must file for an amicable settlement with the competent committees at the COCI (the **Committee**) in accordance with the Implementing Regulations of the BPL (issued pursuant to the Saudi Arabia Ministerial Decision No. 12/2004 dated 30 August 2004) (the **Implementing Regulations**).

- Article 1 of the Implementing Regulations provides that "*the amicable settlement shall be conducted by Committees formed pursuant to a decision issued by the MOCI. Each Committee shall be formed of three members and an alternate member*[1]".

- In order to file for amicable settlement, Article 5 of the Implementing Regulations states that debtors should meet the following requirements:

[1] According to article 1 of the Implementing Regulations, one of those members, who must be familiar with Islamic provisions and the relevant statutory procedures, will be appointed as chairman of the Committee.

- it has been trading for a period of not less than 3 years;
- it must be practicing trade at the time of filing the petition requesting the bankruptcy preventive settlement; and
- the precariousness of the financial position of the debtor must not be caused by actions negligent or *mala fide*[2]. An additional requirement seems to be imposed on individuals whereby the debtor must be known for his honesty, credibility, and sincerity, and have complied with the commercial laws and practices.

- Originally, paragraph (j) of article 4 of the Implementing Regulations provided that the amicable settlement applies only to the creditors who approve such settlement (as opposed to the preventative settlement which applies to all creditors even those who did not approve the settlement). However, said paragraph has been amended by paragraph (k) of Article 4 of Saudi Arabia Ministerial Decision No. 267/8/1/1814 (the **Amendment**) which provides that, if a majority holding two thirds of the undisputed debts participated in the settlement procedures and approved such procedures, the amicable settlement shall apply to all the creditors.

- It is worth noting that the Committee must request the relevant judiciary authority for the suspension of the enforcement proceedings taken against the debtor (paragraph (k) of article 4 of the Implementing Regulations and paragraph l of the Amendment) as opposed to bankrupt preventative settlement where claims and enforcement proceedings are automatically suspended once the decision granting the preventative settlement and/or bankruptcy is issued by the Board of Grievances (the **BOG**)).

b) Preventative Settlement: Debtors in financial distress have the option to file for a preventative settlement arrangement with their creditors.

- Article 2 of the BPL states that if the debtor and the creditor cannot reach an amicable settlement, the debtor must apply to the BOG requesting the issuance of a bankruptcy preventive settlement decision. The BOG, also known as *Diwan Al Mazalem* is an independent judicial committee that has, over the years, inherited jurisdiction to deal with a number of commercial disputes. The application to the BOG must be accompanied with (i) a detailed statement of the debtor's movable and immovable properties and the book values of such properties; and (ii) a list of the names of the creditors with their corresponding debts and rights respectively.

- In order to file for preventative settlement arrangement, debtors should meet the same requirements as set out in Article 5 of the Implementing Regulations (as stated above in paragraph a).

- As per article 3 of the BPL, it is up to the BOG to decide whether or not to grant the bankruptcy preventive settlement, by way of a decision, and allow such a settlement by appointing its members responsible for initiating and supervising the settlement process. It is worth noting that under such a procedure, the business is allowed to continue as a going concern and the debtor remains in charge of it under the BOG's supervision. Article 11 of the BPL states that the BOG's decision to commence preventative settlement entails a moratorium and suspends all claims and enforcement proceedings.

[2] The non-use of commercial books, issuance of dishonored checks, concealment of the debts, non-entry in the commercial registration, or practice of fraud and deceit in the dealings shall be considered *mala fide* (article 5 of the Implementing Regulations).

Furthermore, article 4 of the BPL provides that, until the BOG decides whether or not to issue the bankruptcy preventive settlement decision, the BOG may order that the necessary arrangements be taken to administer or preserve the debtor's assets.

- As per article 7 of the BPL, the settlement arrangement must be approved by a majority of the creditors representing two thirds of the undisputed debts and, if approved shall apply to all creditors whose debts are ordinary (*i.e.* unsecured), even if they did not participate in or approve such a settlement. As mentioned in the answer to question 6 (below), secured creditors assert their rights through the proceeds of the sale of the secured assets.

- Pursuant to article 12 of the BPL, the creditors have the option to petition the BOG to rescind the settlement arrangement if the debtor does not implement its conditions. Also, the creditors may request the BOG to rescind the settlement if, after the settlement is certified by the BOG, they discover an act of fraud [3] on the part of debtor and may file a petition in this regard to the BOG, within a period of one (1) year from the date in which the act of fraud was discovered. If the BOG decides to rescind the settlement arrangement, such decision entails the declaration of the debtor's bankruptcy.

c) Declaring Bankruptcy: The CCL primarily contains insolvency procedures for individuals and does not specify whether they apply to corporate entities as well. However, in practice, provisions of the CCL are applied to both individuals and corporate entities. Article 103 of the CCL defines a bankrupt debtor as "*as a person whose debts exceed all his funds, hence declaring his inability to pay such debts*". Therefore, debtors who are unable to pay their debts fall under the bankruptcy regime. In light of the foregoing, creditors and debtors (whether individual or corporate entities) may initiate insolvency proceedings as follows:

- As per article 108 of the CCL, debtors must file a bankruptcy application to the commercial court at the MOCI (the **Commercial Court**). In this regard, please note that the Commercial Court is not established yet and it is generally thought that it will be established in the next few months. Therefore, any references to the jurisdiction of the Commercial Court in the CCL (as set out below) lies with the BOG.
- Article 109 of the CCL provides that such an application must be accompanied by the financial books of the debtor, his starting capital when he started the business, his closing capital at the time of the application and the total amount of loss suffered. The debtor must also provide MOCI with a 'bond of debts' that sets out the amount of debt owed by the debtor to each individual creditor.
- As per article 110 of the CCL, it is up to the Commercial Court, to declare the debtor bankrupt after reviewing the documents submitted by said debtor, including its financial books and bond of debts.
- Upon the declaration of the debtor's bankruptcy, as per article 112 of the CCL, the Commercial Court must appoint a member of the Commercial Court as the Secretary of the Board (the **SOB**).
- In addition to the SOB appointed by the Commercial Court, the creditors need to appoint a member who shall act as the Creditors' Trustee (the **CT**) and represent the creditors during the proceedings. The SOB and the CT shall then investigate the debts of the debtor and, according to article 114 of the CCL, shall be responsible for the seizure and the sale of the debtor's assets at a public auction in order to settle his debts, after obtaining the approval of the Commercial Court.
- In this regard, please note that the SOB represents the debtor and is responsible for the rightful distribution of the debtor's assets. As for the CT, it represents the creditors and

[3] As per article 12 of the BPL, concealment of properties, fabrication of debts, and exaggeration in the assessment of the value of the debts shall be considered fraud.

has the interests of the creditors to ensure they get the maximum cent on the dollar. The SOB and CT enter into negotiations to achieve the best possible outcome.

- Upon the declaration of bankruptcy of the debtor, the Commercial Court shall further advertise the debtor's bankruptcy, including the publishing of the debtor's bankruptcy in the Official Gazette, in order to notify the debtor's creditors. Finally, the debtor (depending on whether he acted negligently or fraudulently) may face criminal actions and be imprisoned as per articles 136 and 137 of the CCL.

d) Reorganization Proceedings: There are no explicit provisions in the KSA insolvency legal framework regarding reorganization proceedings. Legal scholars and practitioners generally contend that the current KSA insolvency regime should be amended to provide for comprehensive reorganization proceedings aimed at guiding financially troubled individuals/entities out of their financial distress.

4. What options do the creditors of a business in distress have? What options do the creditors of an individual in financial distress have?

- As explained above, the CCL does not distinguish between individuals and corporate entities that face insolvency. As such, the protection that is afforded to a creditor of an insolvent business or an individual is the same. Article 108 of the CCL provides that any creditor may apply to the Commercial Court for the declaration of bankruptcy of its debtor.

- The bankruptcy proceedings, as initiated by the creditor, are similar to those described in paragraph 3 above.

5. Where an individual is in financial distress - are there any rules around the type of property, which can be seized by their creditors?

- As stated above, pursuant to article 114 of the CCL, the SOB and the CT shall be responsible for attaching all movable and immovable properties owned by the bankrupt debtor and selling such properties at a public auction after obtaining the approval of the Commercial Court. In light of the foregoing, both movable and immovable properties belonging to the debtor can be seized. However, this is subject to certain prohibitions set forth by the attachment procedures contained in article 570 of the CCL. The properties of a bankrupt debtor that cannot be seized are the following:

    - any property required by the debtor for his and his family's living and that is indispensable to that effect (*i.e.* including clothes and house furniture);
    - products and equipment necessary for the debtor's job or profession;
    - the tools of the farmer and the peasants, *i.e.* cows, seeds, crops not stored in his warehouse; (unless the debt arises specifically in respect of the consideration of the above listed assets); or
    - the house owned by the debtor and the personal belongings of his wife and children**.**

Additionally, article 568 of the CCL provides that creditors may seize the debtor's assets if said assets are dividable and only to the extent of the necessary amount to cover the debt and the related expenses.

It is also worth noting that article 572 of the CCL confirms that it is possible to seize the estate and immovable properties and that such seizure prevents any debtor from the sale or mortgage or any disposition of said properties.

6. Are there any specific rules around priority of creditors where there is an individual in distress? Are there any specific rules around priority of creditors where it is a business which is in financial distress?

It is worth noting from the outset that the KSA law does not establish an explicit distinction between priority rules applicable to individuals and those applicable to corporate entities. The priority of claims under the CCL is as follows:

- first, the costs and expenses arising out of the liquidation process in compliance with the SCL;
- second, all amounts due to employees in compliance with the KSA Labor and workmen law;
- third, all amounts due to the delay of the payment of contributions to the General Organization for Social Insurance in compliance with the KSA social insurance law;
- all amounts and tariffs in respect of goods located at the customs in accordance with the rules and regulations of the Saudi Customs; and
- finally, ordinary creditors (*i.e.* unsecured).

As far as secured creditors are concerned, they will get paid from the proceeds of the sale of the assets secured in their favour and will have priority over general creditors.

7. Is it possible to restructure the debt? If so, what legal procedures generally take place to facilitate this?

As mentioned in paragraph 3 above, there are no procedures set forth in law to enable a business to restructure its debts. Despite this, there have been debt restructurings in the past that were executed based on the mutual agreement of the parties as opposed to any backing of the courts. The Al Ittefaq Steel Products Company and the Saudi Cable Company debt restructurings are examples of such debt restructurings in the KSA. It is recommended that such mutual agreements be registered with the court for any future disputes and in case one of the parties does not comply with said agreement.

8. Is it possible to waive the debt? If so, what legal procedures generally take place to facilitate this?

Article 8 of the BPL provides that the agreement to settle the debt may include provisions for the payment of debt in installments; postponement of the maturity dates of the payment; exemptions of debt; or a combination of these options. In other words, creditors may waive part of the debt due to them by the debtor as part of the settlement process. It is left to the parties' discretion (*i.e.* debtor and creditor) to determine the portion of the debt to be waived and the conditions of such waivers. In practice, it is recommended to have such waivers duly evidenced *vis-a-vis* the BOG or the Committee (as applicable) in order to enable them to verify the legal capacity of the creditor who waived part of the debt. There are no other legal procedures required in this respect (*e.g.* signing before the court and/or notarization) as the law is not very detailed in this regard and does not address the process and conditions of such waivers.

9. What are the key circumstances in the KSA where security given by a third party could be voidable?

A security given by a third party can be set aside when the security was entered into following the declaration of bankruptcy or the passing of the preventative settlement decision. In this regard, please note that KSA law does not determine any 'suspect period' during which securities granted by third parties are automatically void or voidable. Additionally, a security may be deemed void when it was given *mala-fide* or in contravention of the general laws regarding the rules of obligations and contracts.

Apart from the above circumstances, we are not aware of any events that might trigger third party security to be deemed voidable.

10. What evidence is required to show third party security has been given?

Under the KSA law, security can be taken over a number of assets, including, *inter alia*, land, shares in a Saudi company; and bank accounts. Security can be evidenced in a number of ways. The manner of evidence usually depends on the type of security and the asset over which the security is created.

As per the Registered Real Estate Mortgage Law issued in 2012 (**Mortgage Law**), securities over land by way of mortgage are perfected by the notary public who records the security on the property title documents. In such a case, the registration of the security on the property title documents could be used as an evidence of said security. However, notary publics are weary in not allowing any mortgages that have provisions for interest, as it is not compliant with the Sharia law. Therefore only mortgages that do not contain any direct or indirect reference to interests can be registered before the notary public. In this respect, it is worth noting that a practice has developed in the KSA know as the 'Ifragh' model which requires the debtor to transfer the title to the property to a special purpose vehicle of the creditor till such time that the creditor has not been fully paid. To complete the 'Ifragh' arrangement, the parties must sign the relevant documents before the notary public who will certify the transfer of the property on the title deeds and register said transfer. In such a scenario, the title deed and any other documents signed before the notary public could be used as an evidence to prove the security. This mechanism is not advisable given that is not in compliance with the Mortgage Law which requires the registration of real estate mortgages.

As for evidence of securities over moveable assets, it is worth noting that article 6 of the Commercial Pledge Law issued by Saudi Arabia Royal Decree No. M75/2004 dated 14th January 2004 (the **CPL**), governing security over moveable assets, states that the creditor must be given possession over the pledged asset. Further, article 7 of the CPL provides that in order to prove possession, the pledged asset must be provided to the creditor in his disposition in such a manner as to induce third parties to believe that the pledged asset is in the creditor's possession. If possession is not duly transferred the pledge will be considered invalid.

Accordingly and with respect to pledges over shares, the delivery of the original share certificate to the creditor could be used as an evidence of the pledge in accordance with articles 6 and 7 of the CPL. It is also worth noting that according to article 8 of the CPL pledges over shares must be recorded on the share certificate and the company's share register. Furthermore, article 8 of the ministerial resolution No. 6320 (the **Ministerial Resolution**) [4] provides that the pledgor and the creditor must register pledges over shares at the Unified Center of Lien Registration (**UCLR**) if

[4] Ministerial Resolution No. 6320 dated 5 August 2004 amending the implementing regulations of the CPL (as amended by Ministerial Resolution No. 267/8/1/1812 dated 3 February 2010) established the UCLR.

there is not, for the pledged asset, a competent authority [5] responsible for issuing the pledge deed. However, such requirement is not complied with in practice as only very few creditors register their pledges with the UCLR. Although, the consequences of non-registration of the pledge with the UCLR are not particularly clear, it is recommendable for the creditor to register such pledge as a means to evidence taking security over the debtor's pledged asset.

Regarding pledges over bank accounts, it is worth noting that there are no specific perfection and/or registration requirements. Accordingly, pledge agreements recording the pledge over bank accounts could be used as evidence of said pledge. Additionally, the pledge shall only be valid on the amount that was in the bank account on the day the pledge was made.

Finally, unlike other jurisdictions that permit the creation and perfection of floating charges, KSA law does not recognize this mechanism as it is contrary to the Sharia principle prohibiting Gharar (*i.e.* uncertainty).

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[5] Competent authority refers to authorities which are already established for the registration of pledges (*e.g.* aircraft or ships).