

Saudi Arabia

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Taking Security in the Kingdom of Saudi Arabia

Introduction

The Kingdom of Saudi Arabia is a nation with a vast and growing population of over 30 million people and significant requirements for soft and hard infrastructure. Historically, the responsibility for procuring this infrastructure has been borne by the Government, but the oil price decline and reduction of hydrocarbon export revenues, which has resulted in the development of the Kingdom's vision for social reform and economic diversification away from dependence on hydrocarbon export revenues (Saudi Vision 2030), has forced the Kingdom to rethink how it will meet its infrastructure requirements in the future.

As well as calling for a greater focus on the development of non-oil and gas related industries (which creates additional infrastructure demand in and of itself), Saudi Vision 2030 calls for greater participation by the private sector (i.e., through the use of "public private partnerships" and other models where private sector participants bear funding responsibility) in developing the Kingdom's infrastructure. This increased participation by the private sector can be expected to result in a spike in the use of limited recourse debt finance.¹ Although many limited recourse debt financings have been successfully closed in the Kingdom,² the laws of the Kingdom have, historically, presented some challenges for lenders seeking a robust security package in connection with limited recourse debt financings that is comparable to security packages seen in other jurisdictions.

¹ Limited recourse debt finance is seen by private infrastructure developers as the optimal financing model because recourse to developers is restricted to their ownership interest in the applicable infrastructure project (although, in exceptional circumstances, developers may be required to provide additional support) and it enables developers to borrow up to 80% of the development cost of the applicable infrastructure project (thereby maximising a developer's return on equity). Under a limited recourse debt financing, the borrower is a special purpose vehicle (the Project SPV) that is established to develop the applicable infrastructure project. As a condition to making the debt financing available to the Project SPV, the lenders will typically obtain a 'security package' comprising each developer's shares in the Project SPV (typically effected through a 'pledge of shares') and the assets of the Project SPV (which will include security over the Project SPV's (a) fixed assets, plant and machinery; (b) local and offshore bank accounts; (c) rights under contracts; and (d) rights to receivables under insurance and reinsurance policies).

² Lawyers from Shearman & Sterling LLP have worked on many of the most high profile limited recourse debt financings in the Kingdom, including the financings of the Sadara Integrated Chemicals Project, the Ma'aden/Alcoa Aluminium Joint Venture, the Fadhili IPP, the Rabigh IPP and the Marafiq Jubail IWPP.

This article examines some of the key issues that are typically faced when taking security over assets in the Kingdom. It begins with a quick overview of the Saudi legal system³ and then sets out the key issues with respect to movable tangible assets, real estate, intangible assets and shares. The article also discusses assignment under the laws of the Kingdom and the role of powers of attorney in taking security.

Laws of the Kingdom

Granting and taking security in the Kingdom is governed by statutory provisions and general Shari'ah principles. The laws of the Kingdom are based on Islamic law (Shari'ah). The two main sources of Shari'ah are the Qur'an and the writings detailing the Prophet Mohammed's sayings and actions (known as the Sunnah). Shari'ah is the basis of the Kingdom's constitution. In Shari'ah there are four main schools of jurisprudence, namely: Hanbali, Hanafi, Shafai and Maliki. The Kingdom's courts and judicial committees generally follow the Hanbali school.

The Kingdom's government, from time to time, issues rules and regulations with the objective of supplementing the provisions of Shari'ah when the need arises. As a result, in addition to provisions of Shari'ah, several statutes address pledging of shares in joint stock companies, taking security over registered trademarks and mortgages over real estate and movable property.

Taking Security Over Movable Tangible Assets

General

Under the Hanbali school, it is permissible to create a security interest known as a 'rahn,' a term which means 'mortgage' as well as 'pledge,' in respect of collateral, from which it is possible to obtain payment or satisfaction of a debt. Additionally, the Law of Commercial Lien⁴ (the LCL) and the Implementing Regulations for the Law of Commercial Lien⁵ (the IRLCL) address mortgages of movable property that may be validly or properly sold.

³ For more detailed analysis, you may wish to refer to our separate article entitled 'Introduction to the Legal System of the Kingdom of Saudi Arabia.'

⁴ Enacted by Royal Decree No. M/75, dated 21/11/1424H (13/01/2004G)

⁵ Issued by Ministerial Resolution No. 6320, dated 18/06/1425H (04/08/2004G)

The LCL, in line with the general Shari'ah principles, confirms⁶ that a mortgage or pledge of collateral is validly created only by delivery of actual possession and control of the collateral by the mortgagor/pledgor to the mortgagee/pledgee or to a security agent (on behalf of the mortgagee/pledgee) jointly designated by the contracting parties. The LCL further states⁷ that a person shall be deemed in possession of collateral if the collateral was placed in such person's possession in a manner that makes others believe that the object is in his possession, or where such a person has received a deed to the mortgaged/pledged property, provided such a deed grants that person an exclusive right to receive the property.

Where the mortgagee/pledgee or the security agent fails to obtain, ceases to have, or is deemed by a court of the Kingdom or other adjudicatory body to have failed to obtain, or ceased to have, possession of the collateral, such mortgagee/pledgee will be treated as an ordinary creditor, whose payment claims against the mortgagor/pledgor will rank *pari passu* with all other unsecured obligations of the mortgagor/pledgor.

Concomitant with obtaining possession or deemed possession of the property, the LCL imposes the following obligations upon the mortgagee/pledgee:⁸

- taking necessary measures for the safekeeping of the mortgaged/pledged property;
- where the mortgaged/pledged property is a commercial instrument, following all the necessary procedures required by law to protect the right established therein and collect its value on the date of maturity;
- not benefitting free of charge from the mortgaged/pledged property without the permission of the mortgagor/pledgor; and
- upon the request of the mortgagor/pledgor, exploiting the mortgaged/pledged property and exercising all rights relating to it for the benefit of the mortgagor/pledgor and receiving its price, profits and other sums resulting from it on their due date,

with any administrative, safekeeping and other usual expenses associated with the above requirements being deducted from any benefit received from the mortgaged/pledged property and any remaining balance being deducted from the debt secured by the mortgage/pledge.

⁶ Article 6, LCL

⁷ Article 7, LCL

⁸ Articles 12-13, LCL

Additionally, the LCL stipulates⁹ that any loss or damage to the mortgaged/pledged property is automatically assumed by the mortgagee/pledgee where such damage or loss is caused by the mortgagee/pledgee.

In order for tangible movable property to be pledged, it must be capable of being sold. As such, it must be in existence at the time of execution of the pledge agreement, have a quantifiable value and be saleable and deliverable.¹⁰ For example, it is not possible to create a pledge over goods manufactured in the future.

There should be written documentation evidencing the pledge over tangible movable property and the taking of possession of the collateral by the pledgee (or the security agent on its behalf).¹¹

Pledges and mortgages can only be enforced via an application to the enforcement judge and upon obtaining an order to that effect. The sale of the mortgaged/pledged property is carried out by way of a public auction at the time and place determined by the enforcement judge in accordance with the procedure set out in the Enforcement Law¹² and its Implementation Regulations.¹³ The enforcement procedure may take two to three months.

Registerable Movable Assets

Where a mortgage or a pledge is granted in relation to assets capable of registration, such as air or sea vessels, the LCL requires¹⁴ that the grant of a mortgage/pledge is duly recorded on the ownership register for such assets as well as being noted on the ownership deeds/documents. In respect of such assets, possession takes place on delivery of the duly notated ownership deed/document to the mortgagee/pledgee or the security agent.

Taking Security Over Real Estate

The Registered Mortgages Law¹⁵ (the RML) governs the grant of mortgages over real estate in the Kingdom. The RML provides¹⁶ that, to be effective

⁹ Article 14, LCL

¹⁰ Article 2, LCL

¹¹ Articles 2, 3 and 8, LCL

¹² Approved by the Resolution of the Cabinet of Ministers No. 261/1433 dated 12/08/1433H (02/07/2012G)

¹³ Approved by the Resolution of the Cabinet of Ministers No. 9892/1434 dated 27/04/1434H (09/03/2013G)

¹⁴ Article 8, LCL

¹⁵ Enacted by Royal Decree No. M/49, dated 13/08/1433H (03/07/2012G)

¹⁶ Article 1, RML

and enforceable against third parties, the mortgage agreement must be in writing and be duly registered by notation on the deed of ownership as held by a court or notary public.¹⁷ The real estate must be in existence, owned and capable of sale by the mortgagor or his duly authorised agent.¹⁸ The mortgage must be in respect of a specified debt amount or up to a specified maximum amount of debt to be incurred in the future.¹⁹ As such, it is not possible to use the 'all monies' formulation as a reference to the underlying debt obligation. The mortgagor may not dispose of the mortgaged property, unless agreed otherwise, and such agreement is documented in the deed and register of such mortgaged property.²⁰

Where the mortgagor is not able to meet, upon maturity, his debt obligations secured by the mortgage, the mortgagee obtains the right to request the sale of the property²¹ and the right to appropriate proceeds from any such sale in order to satisfy the mortgagor's debt obligations.²² For any unpaid balance of the debt obligation, the mortgagee's claim will rank at least *pari passu* with the claims of all other unsecured and unsubordinated creditors of the mortgagor, other than those whose claims are mandatorily preferred by law applying to companies generally (such as (a) payments due to employees; and (b) payments due to the Government of Saudi Arabia, such as unpaid zakat, taxes and contributions due to the General Organisation for Social Insurance of Saudi Arabia).

Importantly, notaries public in the Kingdom have historically refused to notarise mortgages over real property in favour of banks and financial institutions on the grounds that such lenders charge interest which is a violation of Shari'ah principles. It has therefore been the practice in the Kingdom to utilise an alternative *Ifragh* structure for securing debt obligations over real estate. The *Ifragh* structure requires the borrower to transfer legal title in favour of the lender's special purpose vehicle until the debt is repaid, with an agreement to retransfer title once the amounts outstanding have been repaid. It should be noted that on 22 May 2017, the Saudi Arabian Monetary Authority (which is the Central Bank of the

¹⁷ The RML provides for alternative provisions for properties registered on the Real Estate Register. However, as of the date of this article, the Real Estate Register has yet to be formally implemented and, currently, real estate property records are kept and administered by notaries public in each locality.

¹⁸ Articles 2, 3 and 4, RML

¹⁹ Article 9, RML

²⁰ Article 11, RML

²¹ As noted above, the sale of the secured property will be carried out by way of public auction.

²² Article 18, RML

Kingdom) issued a circular stating that the *Ifragh* structure would no longer be permissible and that all security over real estate would have to be registered as a mortgage under RML. It remains to be seen how the registration of mortgages over real property will be implemented in practice, especially if the mortgagee is a foreign lender without a legal presence in the Kingdom. We understand that some local banks have been successful in registering mortgages over real property.

Taking Security Over Intangible Assets

Intangibles Assets Incapable of Registration

Security over intangible assets incapable of registration is not able to be effected by a pledge since, given the fact that such an asset is intangible and therefore not capable of being in possession of, and delivered to, the pledgee, the legal requirement of possession or deemed possession for an effective pledge cannot be satisfied. For example, it is not possible to take an effective pledge over intellectual property rights such as goodwill and customer lists.

Trademarks

Trademarks are intangible assets capable of registration. The pledging of trademarks is governed by the Trademarks Law²³ (the TL) and its Implementing Regulations (the IRTL).²⁴

The TL allows for a trademark to be pledged.²⁵ The pledge becomes effective vis-à-vis third parties once it has been entered into the Trademarks Register and the notice of the pledge has been published in the Official Gazette.²⁶

Taking Security Over Shares

Participation Interests of a Limited Liability Company

Under the laws of the Kingdom, it is not possible to grant an enforceable pledge or other security over the participation interests of a limited liability company because such interests are not distinct, identifiable assets

²³ Enacted by Royal Decree No. M/21, dated 28/05/1423H (07/08/2002G)

²⁴ Ministerial Resolution No. 1723 dated 28/07/1423H (corresponding to 05/10/2002G), issued by the Minister of Commerce and Investment

²⁵ Article 31, TL

²⁶ Article 32, TL; Articles 19, 20 and 22 of IRTL

capable of sale or possession and there is no legal instrument evidencing such shares (e.g. share certificates).²⁷

Shares in Unlisted Joint Stock Companies

Taking a pledge over shares in a non-listed joint stock company (the NJSC) is governed by the Regulations of Non-Listed Joint Stock Companies²⁸ (the RNJSC) and, more generally, the Companies Law.²⁹

A registered shareholder of an NJSC is permitted³⁰ to pledge its shares, provided that:

- where the shareholder is a corporate entity, all required regulatory approvals from the authorities which exercise regulatory supervision over the corporate entity and internal corporate authorisations for such pledge have been obtained; and
- the pledge agreement meets the statutory requirements set out below.

In order to meet the statutory requirements, a pledge agreement must:³¹

- be in written form, setting out the names of the pledging shareholder, pledgee and beneficiary creditor (if different than the pledgee), their identification numbers (i.e. ID number for individuals and commercial registration number for legal entities) and their addresses;
- set out the number of pledged shares and their nominal value, the name of the issuing company and its commercial registration number;
- set out the amount of the debt secured by the pledge or the maximum debt amount permitted by the pledge;
- set out the name of the debtor (if the debtor is different from the pledging shareholder), his/her identification number and his/her address;
- state the date of the pledge agreement;
- state the conditions and terms of releasing the pledge; and
- set out any other conditions agreed upon by both parties.

²⁷ It should be noted that it is not uncommon for security packages used in limited recourse debt financings in the Kingdom to include a pledge of LLC shares. This could be described as a 'belts and braces' approach given the concerns regarding the enforceability of such a pledge under the laws of the Kingdom

²⁸ Enacted by Decision of the Minister of Commerce and Investment, dated 25/02/1438H (25/11/2016G)

²⁹ Enacted by Royal Decree No. M/3, dated 28/01/1437H (10/11/2015G)

³⁰ Article 24, RNJSC

³¹ Article 26, RNJSC

To be effective vis-à-vis third parties,³² the pledge must be registered. Registration³³ consists of registering the pledge in the company's shareholder's register and including a note on the relevant share certificates to reflect their pledged status.

Upon perfection of the pledge over NJSC shares, the pledgee may receive the dividends due from the pledged shares and enjoy all rights attached to such shares, unless agreed otherwise in the pledge agreement.³⁴ Such rights are subject to not being able to attend or vote at the general assembly or special assembly meetings of the company.

Shares in Listed Joint Stock Companies

Taking a pledge over shares in a listed joint stock company (the LJSC) is governed by Regulatory Rules and Procedures issued pursuant to the Companies Law relating to Listed Joint Stock Companies.³⁵ The legal requirements for pledging shares of a LJSC are the same as those relating to pledging NJSC shares. The perfection of the pledge is carried out by noting the existence of the pledge on the share certificates of the pledged shares, delivery of a certified copy of the pledge agreement to the Saudi Stock Exchange (Tadawul), (acting in its capacity as the Securities Depository Centre) and registration of the pledge in the company's register of shareholders held at Tadawul.

Assignment

It is a general Shari'ah principle that assignments of rights under a contract are not effective against the counterparty to the contract unless the consent of the counterparty to such an assignment is explicitly obtained. This principle is subject to statutory exceptions set out in the Real Estate Finance Law,³⁶ the Finance Leases Law³⁷ and the RML.

Typically, the counterparty to the contract being assigned joins an agreement with the assignor and the assignee relating to the assignment. Such an agreement is regarded as being effective and binding under Shari'ah as a matter of contract. However, such assignments create only

³² Article 28, RNJSC

³³ Article 27, RNJSC

³⁴ Article 112(2), Companies Law

³⁵ Issued by the Board of the Capital Market Authority pursuant to Resolution No. 8-127-2016 dated 16/01/1438H (17/10/2016G), based on the Companies Law enacted by Royal Decree No. M/3 dated 28/01/1437H (10/11/2015G), and as amended by Resolution of the Board of the Capital Market Authority Number (5-33-2017) dated 24/06/1438H (23/05/2017G)

³⁶ Enacted by Royal Decree No. M/50, dated 13/08/1433H (03/07/2012G)

³⁷ Enacted by Royal Decree No. M/48, dated 13/08/1433H (03/07/2012G)

contractual rights and obligations between the parties to the agreement rather than security interests valid against other parties (such as unsecured creditors), and would not defeat the interests of any unsecured creditors of the assignor.

Statutory exceptions cover:

- real estate financing contracts, which are required by legislation³⁸ to expressly provide a right for the lending entity to transfer its rights to third parties on the secondary market without the consent of the borrower;
- hire-purchase and asset lease contracts, in respect of which the legislation³⁹ permits the lessor to assign his rights under the contract without consent of the lessee unless agreed otherwise in the lease contract. Such assignments are subject to the following mandatory conditions: (a) the assignment must not be detrimental to the lessee of the asset; (b) the assignment must be recorded in the contract register maintained by a company licensed by the Saudi Arabian Monetary Authority (SAMA) to provide such registration services;⁴⁰ (c) the assignment does not relieve the lessor from its obligations under the contract; and (d) the changes in payment details are only enforceable from the date of notification of such change to the lessee; and
- registered real estate mortgages, in respect of which the RML⁴¹ permits the mortgagee to transfer his right to recover the debt and allows a third party to guarantee the mortgage, unless agreed otherwise in the mortgage contract, and provided that the assignment of such right is duly recorded on the original mortgage document and the property register.⁴²

³⁸ Article 16 of the Implementing Regulations of the Real Estate Finance Law

³⁹ Article 4 of the Implementing Regulations of the Finance Leases Law

⁴⁰ Article 18 of the Contract Register of the Finance Leases Law

⁴¹ Article 17, RML

⁴² Article 22, RML

Power of Attorney by Way of Security

It is not uncommon to see provisions in loan or mortgage agreements where a borrower/mortgagor purports to grant the lender/mortgagee the authority to take an action on its behalf which might be deemed to amount to an agreement creating a relationship similar to that of a power of attorney or agency. In practice, powers of attorney granted by Saudi Arabian persons or entities for use in the Kingdom are made before a competent notary public using the standard form power of attorney. Under the laws of the Kingdom, it is not possible to grant an irrevocable power of attorney. Therefore, even if expressed to be irrevocable, the grantor of a power of attorney may revoke it at any time. A power of attorney may not be enforceable under the laws of the Kingdom if it is construed as a security mechanism or as a self-help remedy in the absence of legal proceedings authorising the same.

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