Saudi upstream loans and guarantees

Key issues

- Saudi Arabian upstream loans
- Saudi Arabian upstream guarantees

Are they allowed?

A question we are frequently asked is whether Saudi Arabian companies can lawfully provide upstream loans and guarantees.

Banks providing a corporate financing to a group of companies might well, for example, require that the subsidiary entities accede to the finance documents as guarantors. The question almost invariably arises in the case of leveraged acquisition financings where target group companies are required to accede as guarantors where possible, post-acquisition. In other contexts, group-wide cash pooling/treasury arrangements may require upstream loans to be made by subsidiaries or require outright cash sweeps.

The issue has proved to be a controversial one, with different law firms in the market taking different positions as to the answer. The debate turns on the correct construction of Article 8 of the Saudi Arabian Companies Law.

The aim of this briefing note to is set out the competing views and to consider some practical methods for avoiding the potential restrictions.

Article 8 of the Companies Law

Article 8 of the Companies Law provides as follows (translated from the Arabic):

"*Without prejudice to the provisions of Articles 106 and Articles 205, it is not permitted to distribute dividends to partners [shareholders] other than out of net profits. If fictitious (unearned) profits are distributed to the partners, the company's creditors may request each partner, even though he may have acted bona fide, to refund such fictitious profits as he may have received.*"

Article 229(9) of the Companies Law further provides that "*Any manager or director who receives or distributes among the partners or third parties fictitious (unearned) profits*" shall be subject to imprisonment of up to one year and/or a fine of not more than 20,000 SAR. We note that though the provision applies to directors or managers, in Saudi law it is possible to aid and abet criminal offences and by such means to become criminally liable.

The competing views

One view (the "**Restrictive View**") is to interpret Article 8 as being an outright ban on upstream loans to shareholders other than out of net profits as these would constitute a prohibited distribution. To the extent upstream loans are not permitted, it follows that unrestricted upstream guarantees are not permissible either as, if the guarantee were called and the subsidiary were required to pay out under the guarantee, that subsidiary would effectively making a distribution to pay off its shareholders' debts (which, in circumstances where the subsidiary had a right to reimbursement from the relevant shareholders, would put it economically in the same position as a lender to those shareholders); in other words an upstream guarantee would constitute a contingent promise to perform an unlawful act.

This view has been supported by the Ministry of Commerce and Industry ("**MOCI**") and has been communicated separately at senior level to Al-Jadaan & Partners Law Firm and at least one other well-known firm in the Saudi market of which Al-Jadaan & Partners is aware. We further note MOCI's Legal Memo. 283/11 dated 3/4/1400H as cited in the "The guidelines regulating the procedures of companies" dated 1415H (1994 Gregorian) produced by the Companies Department of MOCI, which states as follows:

"*Shareholders of limited liability companies may not take loans by withdrawing funds from the company's capital in the form of loans.*

If, in violation to this provision, the shareholders do that, the shareholders must return these funds to the company otherwise such act will be considered as a violation which entails referring the company to the Commercial Disputes Settlement Committee (replaced by the Grievances Board) to consider imposing the relevant penalties provided for in paragraph (9) of article (229) of the Companies Act. If such *violation persists, the Companies Department may request from above mentioned Committee to dissolve the company subject paragraph (7) of article (15) of the Companies Act.*"

This citation is in the section relating to limited liability companies (LLCs), but there seems no reason why the principle would not extend to joint stock companies (JSCs).

An alternative view (the "**Liberal View**") is that, properly construed, Article 8 would not prohibit an upstream loan or upstream guarantee in circumstances where such loan or guarantee was demonstrably for the corporate benefit of the lending subsidiary.

Proponents of the Liberal View would argue that a loan is not a dividend or distribution as it is required to be repaid (there might be circumstances where a loan could effectively constitute a distribution, but it is not automatic). Furthermore, the provision in the Companies Act appears similar in nature and form to equivalent provisions in many civil codes/companies laws in other jurisdictions (including, for example, the UK and France), but the equivalent provision is not held to constitute a blanket prohibition on upstream loans or guarantees in those jurisdictions. These jurisdictions may have outright bans on financial assistance (now substantively repealed in the case of the UK) but this is something which is very specific and different.

In practice, proponents of the Liberal View argue, upstream loans and upstream guarantees are granted very frequently in Saudi Arabia and may even be apparent on accounts which are filed with MOCI. MOCI's legitimate concern was (or is) upstream loans which constitute distributions in disguise, not all upstream loans.

Who is right?

A definitive answer will probably not be possible unless the issue is tested before the Saudi courts or there is further legislation.

We are anecdotally aware that there certainly companies in the market who have simply "taken a view" (or, in some cases, not been aware) and agreed to grant upstream guarantees.

However, given the penalties involved and the express views of MOCI on the matter, others might regard it as too risky to enter into an agreement potentially in breach of Article 8 (or which, by means of an upstream guarantee, undertakes to make a payment potentially in breach of Article 8).

The remainder of this briefing note is therefore devoted to methods for avoiding the risk of offending against Article 8, where the transactional context requires that an upstream guarantee or other promise to upstream cash be granted.

Context may play a role in this decision; Article 8 exists to protect creditors, so the parties might feel more comfortable to take a Liberal View on upstream guarantees in a structured finance context where the relevant companies were special purpose vehicles and the finance parties requiring the guarantee were the only creditors than might be the case dealing with an operating company with multiple "real world" creditors.

What can parties do to avoid the risk of acting unlawfully?

Limitation language can avoid the Article 8 issue, though at the price of a less valuable undertaking from the subsidiary (from the perspective of the beneficiary). An upstream guarantee granted by a subsidiary in relation to its parent's debt could, for example, be limited as follows:

- The subsidiary's liability to its parent's creditor under the guarantee could be limited to money or assets it actually receives from the creditor (whether directly or indirectly via the parent), and the value of cash or other assets which the parent has lent or supplied to the company. Note that the indebtedness of the subsidiary to the banks under the guarantee would replace rather than exist in parallel to any upstream indebtedness to the parent (i.e. the subsidiary Client briefing Saudi upstream loans and guarantees couldn't be required to pay both the parent and the parent's creditor), though it could be reinstated in favour of the parent to the extent that the parent pays off the third party debt; and
- To the extent greater than the amount above, the subsidiary could be liable to the extent of its net profits in the relevant financial year of payment under the guarantee.

A different approach would simply to limit the guarantee or obligation to make an upstream payment such that applies to the maximum extent permitted by Saudi law (or some equivalent formulation). In a sense this defers dealing with the question (but carries the "upside" that if the liberal view were to prevail the guarantee would be unlimited), but it may be a bankable solution in some leveraged contexts where the outcome in relation to the Saudi guarantees and security is not necessary critical to banks' credit analysis, but banks want comfort that they will have the best guarantee and security coverage that is possible (and practicable).

An additional possibility would be to "make hay while the sun shines" and to put an upstreaming covenant in a financing such that subsidiaries' net profits are required to be upstreamed in full, whether by loan or final distribution, such that they pool outside the subsidiary (there could be arrangements to downstream funds back for capex or working capital needs in future periods to avoid difficulties) so that finance parties can have access to the pooled cash on an enforcement. Whether this is a workable proposition may of course depend on circumstances, both from the perspective of the subsidiary and of the finance parties.

What does not work is re-characterisation. In the context of a financing, for example, making all subsidiaries co-borrowers and relying on joint and severability provisions to simulate the effect of a guarantee would not work as the Saudi courts look to substance over form.

What are the limits of Article 8, if the Restrictive View is correct?

This briefing has focussed on upstream loans and guarantees as these are the proposed benefits most frequently encountered in practice. However, it should be noted that the analysis would apply equally to other valuable upstream benefits, such as where a subsidiary purports to provide security (such as an asset pledge) to secure shareholder debt to third parties.

Though it could apply to direct and indirect shareholders, Article 8 is not thought, even on the Restrictive View, to prohibit cross-stream guarantees (i.e. from one sister company to another), though would generally be necessary to show corporate benefit for these. Downstream loans and guarantees are not affected by Article 8 and are frequently encountered (though may be subject to rules outside the scope of this briefing).

Our view

Based in part on the conversations we have had with MOCI, we would tend towards the Restrictive View and would generally advise against the granting of upstream loans of guarantees unless out of net profits or otherwise subject to limitations as indicated in this briefing.

That said, we are aware of examples in the market where an interpretative risk on the law has been taken, so parties will need to form their own assessments as to the best course of action that is applicable is in their particular circumstances.

Other factors to bear in mind

As participants in the Saudi market will be aware, Shari'ah as applied by the Saudi courts prohibits interest-bearing loans (and though the SAMA committee for the resolution of disputes of a banking nature may impose settlements based on international banking practice when considering disputes between banks and their customers, the loan examples cited in this briefing may fall outside that category).

Guarantees under Saudi law, as in other jurisdictions, may not endure in all circumstances and the indemnity concept, though often seen in "guarantee and indemnity" style language, is not recognised.

Is should therefore be remembered that Article 8 may well not be the only issue to bear in mind when considering intra-group loans or group companies guaranteeing each other's liabilities in a financing context, even if it is one of the more contentious ones.

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