

SAUDI ARABIA'S NEW COMMERCIAL PLEDGE LAW

JUNE 2018

In the last week of April 2018, Saudi Arabia's new Commercial Pledge Law and its Implementing Regulations (together the New CPL) were issued and published, and they came into force immediately upon their publication.¹ In replacing the old Commercial Pledge Law and its Implementing Regulations (the Old CPL)², the New CPL provides an entirely new framework for the grant, perfection and enforcement of pledges over movable assets to secure debts that are considered, pursuant to the provisions of the New CPL, to be "economic debts" as opposed to personal debts.

CONTEXT

The absence of a satisfactory legal regime for the taking and enforcement of valid security interests over the vast majority of the classes of assets which borrowers are able to put forward as collateral, has long been one of the most vexing elements of Saudi Arabian financings. This lack has, over time, proved to be a serious hinderance to businesses in accessing financing in Saudi Arabia and thereby a drag on economic development.

The Saudi government, in its Vision 2030 Programme, expressly recognised the importance of improving access to finance for various sectors of the Saudi economy. Particular emphasis was placed on the ability of small and medium enterprises to obtain the financing that they need, but there has been no lack of focus on the needs of various other sectors, from individuals looking to purchase their own homes to large enterprises looking to invest in capital-intensive industrial projects. To that end, a sea of regulatory change has swept over Saudi Arabia over the past few years, with much more expected to follow.

One particular stream of regulatory change has been the creation of a more business-friendly environment for the taking and enforcing of security interests. Major reforms have recently been made to the framework for taking

Key issues:

- The New CPL introduces an entirely new legal framework for taking pledges in Saudi Arabia
- For the first time, detailed rules for taking pledges over assets such as bank accounts, receivables and business undertakings in Saudi Arabia are set out in law
- Pledging of future property is permitted
- Specific documentary requirements for the creation of a pledge must be satisfied
- Perfection of a pledge is either by registration or transfer of possession
- Detailed rules on priority are established
- Enforcement may be carried out either through the courts or on a self-help basis
- New supporting infrastructure is to be established, including a new comprehensive register of security interests
- Pledge agreements in existence as of 24 April 2018 must be amended to comply with the New CPL within six months of that date, and so creditors are advised to immediately begin considering what amendments to their pledge agreements will be required.

¹ The new Commercial Pledge Law was issued by Royal Decree No. M/86 on 8/8/1439H (corresponding to 24 April 2018). It was published in the Official Gazette and came into force on that same day. The Implementing Regulations were issued by the Minister of Commerce and Investment on 11/8/1439H (corresponding to 27 April 2018). They were published in the Official Gazette and came into force on that same day.

² The old Commercial Pledge Law was issued by Royal Decree No. M/75 dated 21/11/1424H (corresponding to 14 January 2004), and its revised implementing regulations were issued by the Minister of Commerce and Industry on 19/2/1431H (corresponding to 3 February 2010).

security interests over immovable assets, ie real estate.³ The New CPL, which has been in preparation for several years, introduces major reforms in its wholesale re-conception of the framework for taking security interests over movable assets.

SCOPE

The New CPL regulates pledges over movable assets as a broad class of assets.

Certain special categories of movable assets which are subject to specific regimes under separate laws and regulations are excluded, to some extent, from the scope of the New CPL. These assets include listed securities⁴, vessels⁵, aircraft⁶, and intellectual property⁷. Interestingly, however, the New CPL provides that, wherever a legal issue is not specifically regulated by the separate laws and regulations, the New CPL will apply to that legal issue as it applies to the relevant special category of movable asset.

Working out whether a particular legal issue is regulated by the applicable separate laws and regulations may prove to be more challenging than might initially appear to be the case. For example, the Security Depository Centre Rules as amended (the SDC Rules) issued by the Capital Market Authority (the CMA)⁸, and which are applicable to the enforcement of a pledge over listed securities, provide that such a pledge is to be enforced in accordance with the terms of the pledge contract and the applicable regulations and instructions. The SDC Rules do not specifically require that any particular notice of enforcement be served on the pledgor before enforcement takes place whereas the New CPL does. It is not immediately apparent on the face of the New CPL whether or not the silence in the SDC Rules on this issue should be understood to mean that the issue is not regulated by the SDC Rules and that the requirements of the New CPL should therefore apply.

We suspect that the relationship between the New CPL and the separate laws and regulations applicable to the special categories of movable assets that are partially excluded from its scope may be one of the areas of the New CPL in which extended legal analysis will be required.

³ Please see our client briefing “Changes in the practice of taking real estate security” https://www.cliffordchance.com/briefings/2018/05/changes_in_the_practiceoftakingrealestat.html, in which we provided a brief update on some of those reforms.

⁴ These are subject, inter alia, to various regulations issued by Capital Market Authority pursuant to the power granted to it under the Capital Market Law including the Regulatory Rules and Procedures issued pursuant to the Companies Law relating to Listed Joint Stock Companies pursuant to Resolution No. 8-127-2016 dated 16/1/1438H (corresponding to 17 October 2016) and the Securities Depository Centre Rules pursuant to Resolution No. 2-17-2012 dated 08/06/1433H (corresponding to 29 April 2012) (as amended).

⁵ These are subject to various laws and regulations including the Vessel Mortgage Law issued by Royal Decree No. 9/3/8469 dated 01/09/1374H (corresponding to 23 April 1955).

⁶ These are subject to various laws and regulations, including the Civil Aviation Law issued by Royal Decree No. M/44 dated 18/07/1426H (corresponding to 23 August 2005) and the GACA Safety Regulations which came into effect on 1 March 2016.

⁷ This is subject to various laws and regulations, including the Intellectual Property Law issued by Royal Decree M/41 dated 02/07/1424H (corresponding to 30 August 2003).

⁸ These were issued by the CMA pursuant to the CMA Board Resolution No. 2-17-2012 dated 8/6/1433H and have subsequently been amended.

ECONOMIC DEBTS

The New CPL regulates pledges that are granted as security for debts that are incurred in the course of an activity entered into for commercial, professional or other profit-making purposes.

It permits the grant of valid and enforceable security in respect of liabilities that are unproven and debts that are contingent.

PARTIES' CHOICE

A notable feature of the New CPL is the emphasis that it places on honouring the agreement between the relevant parties. While setting out a detailed regime for the grant of pledges, considerable latitude is afforded to the relevant contracting parties to contract out of the positions set out in the New CPL.

PLEDGEABLE ASSETS

The New CPL expressly provides for the grant of valid pledges over the following types of movable asset, tangible and intangible:

- **The entirety of an economic enterprise.** This concept is known elsewhere in the Gulf Cooperation Council region, eg in the United Arab Emirates, but is a novelty in Saudi law. It involves an economic enterprise granting a pledge over its business assets, tangible and intangible, and should be distinguished from the grant by a shareholder of a pledge over its shares in a company
- **Receivables.** For the first time, the grant of a security interest over receivables is clearly recognised in law. Receivables form a significant collateral base in Saudi Arabia, particularly in the construction financing sector, and this development provides useful support to a part of the Saudi economy which is already important and is expected to become even more so with the anticipated upswing in the development of the Kingdom's infrastructure
- **Current accounts, investment accounts and term deposits.** The New CPL expressly addresses the key limitations that have bedevilled the taking of security over accounts and cash balances for many years. It, for example, makes it clear that a pledge of a current account will cover deposits made after the pledge was first granted, and that granting the pledgor the ability to make withdrawals from the pledged current account prior to the occurrence of an enforcement event does not prejudice the validity of the pledge
- **Inventory.** Inventory financing has raised tricky issues for lenders over the years, issues which have led to the development of complicated structures to mitigate the inability to take satisfactory security over inventory. The New CPL engages with these issues and expressly provides for the grant of a pledge over inventory. The newly-introduced floating pledge, which can be used to create a security interest over an undifferentiated mass of inventory, is one tool which is likely to prove particularly useful
- **Unlisted securities.** The Old CPL provided a reasonably certain framework for pledges over unlisted securities on which the New CPL builds. For the first time, a framework for pledging shares in a Saudi limited liability company has been established

- **Special categories.** As mentioned above, assets such as listed securities, vessels, aircraft and intellectual property are excluded from the scope of the New CPL save to the extent that the specific regimes applicable to such assets do not regulate an issue which the New CPL does regulate. In such circumstances, the New CPL will fill in the relevant gap.

DOCUMENTATION

The New CPL, sets out detailed documentary requirements for the creation of a valid pledge. These include a written pledge agreement which contains certain prescribed details.

The value of the pledged assets will need to be determined or estimated at the outset and included in the pledge agreement. The parties will be able to agree on the valuation method but, in the absence of an agreement, it may be necessary for a professional valuation by an accredited valuer acting in accordance with the guidelines issued by the Saudi Authority for Accredited Valuers (Taqeem).

CREATION AND PERFECTION

Perhaps the most fundamental innovation introduced by the New CPL is that it removes the key limitation of the previously existing law which was that the only type of clearly-recognised pledge was possessory in nature. Many of the other key changes introduced by the New CPL flow from this fundamental change.

Perfection (ie making a pledge effective against third parties) is primarily by registration of the pledge in a new Unified Register for Commercial Pledges (the Register), the creation of which is envisaged in the New CPL.

Various provisions of the New CPL address the interaction between the Register and other specialist registers of security interests (or of title) that may exist in the Kingdom.

Note, however, that actual transfer of possession to the pledgee or security agent is required in certain cases. For example, a pledge of a bearer instrument requires transfer of possession of the bearer instrument, a pledge of goods covered by a bill of lading requires transfer of possession of the bill of lading and a pledge of specific items of inventory (as opposed to a floating pledge over a mass of inventory) requires transfer of possession of the relevant items of inventory.

Following a similar step taken with respect to immovable property several years ago,⁹ multiple pledges of different levels of priority may be granted over the same pledged movable asset.

THE REGISTER

The New CPL requires that the Minister of Commerce and Investment issue a new set of regulations governing the operation of the Register (the Register Regulations) within 180 days of the date on which the New CPL came into effect, ie by no later than approximately 20 October 2018.

⁹ We refer here to the Registered Real Estate Mortgage Law issued by Royal Decree No. M/49 dated 13/08/1433H (corresponding to 3 July 2012).

The Register Regulations, when issued, are expected to deal with, among other things:

- Registration procedures
- Procedures for the search of the Register by the public
- Procedures for obtaining extracts of information from the Register.

The timeframe for actual establishment of the Register and the infrastructure required for its effective functioning is yet to be disclosed. The Ministry of Commerce and Investment (MOCI) will primarily be responsible for the establishment and, once it is set up, the management of the Register.

The New CPL provides that the Register will operate as a comprehensive record of all registered pledges.

Creditors and debtors will be aware of the existence of the Unified Centre for Lien Registration (the UCLR) at the Saudi Arabian General Investment Authority, which was established in 2011 with the intention that it would be the first comprehensive register of pledges over movable assets in Saudi Arabia.

The robustness of the registration regime that is prescribed in the New CPL, and of the registration infrastructure that it contemplates, raises the hope that the new Register will prove to be an invaluable resource to creditors in ascertaining whether any particular asset is already subject to an encumbrance.

PRIORITY

The provisions of the New CPL regulating priority of competing pledges over an asset are complex and require careful examination. Speaking broadly (very broadly indeed), registration in the Register confers priority, determined by reference to the date of registration.

Failure to register therefore risks being significantly prejudicial to the value of the pledge but there is no specified deadline following the signing of the pledge agreement by which registration must be effected.

A pledge agreement which is not perfected may, however, still be effective as a contract between the pledgor and pledgee.

ADDITIONAL ASSET-SPECIFIC PERFECTION REQUIREMENTS

Additional perfection requirements depending on the type of pledged asset include:

- **The entirety of an economic enterprise.** The pledge must be registered in the Commercial Registration held at MOCI
- **Receivables.** The pledge must be notified to the receivables debtor
- **Current accounts and term deposits.** The account bank must issue a pledge confirmation letter
- **Unlisted bearer securities.** The pledge must be noted on the security certificate.

ENFORCEMENT

In another major departure from the previously existing state of affairs, the long-established prohibition on self-help remedies has been removed.

The New CPL provides for two mechanisms for enforcement of a pledge, ie enforcement by an enforcement judge in accordance with the Enforcement Law¹⁰, and self-help enforcement by the pledgee or security agent.

The Register plays a key role.

Where enforcement is to be carried out by an enforcement judge, the Register will be required to issue a Pledge Execution Extract, which serves as an Execution Deed under the Enforcement Law.

Alternatively, the pledgor and pledgee may agree that the pledgee will be entitled to carry out the enforcement procedure itself, in which case the Register will issue a Direct Pledge Execution Extract, which serves as an authorisation to the pledgee to carry out the relevant enforcement actions.

Where multiple pledgees benefit from security over the relevant asset, an execution agent must be appointed. The execution agent may need a licence from MOCI to carry out that business activity.

DISPOSAL OF PLEDGED ASSETS

Rights in relation to the disposal of pledged assets include the following:

- Right of the pledgor to substitute the pledged property for similar assets where the pledged property is fungible
- Right of the pledgor to sell non-fungible pledged property with the consent of the pledgee
- The pledgee's right to trace non-fungible pledged assets where such assets are sold without its consent.

DUTIES OF CARE

Pledgees or security agents in possession of pledged assets are placed under an explicit duty of care with respect to, inter alia, the maintenance of such assets, the keeping of records and enforcement of the pledge.

Breaches of duty will leave them open to compensation claims.

Pledgees and security agents have long been cognisant of the need for caution in the possession of, and enforcement against, pledged assets. Nevertheless, the codification of specific duties of care in the New CPL is an important development and a reminder of the need to pay due accord to, among other things, the "boilerplate" provisions (typically at the back end of a facility agreement) regulating the indemnities and protection of the security agent.

¹⁰ The Enforcement Law was issued by Royal Decree No. M/53 dated 13/08/433H (corresponding to 3 July 2012).

MISCELLANEOUS ISSUES

Of the multiple other points of interest arising from the New CPL, a few points to note include the following:

- The New CPL clearly provides for the grant of a pledge over future property, ie assets not owned or in existence at the time of the grant of the pledge
- The ability of lenders to accelerate their debt upon the occurrence of an event of default other than a payment default has long been doubtful. The New CPL clearly provides for acceleration in specified circumstances where the value or effectiveness of the pledge securing the debt is in some way compromised
- Pledging of an undivided part of an asset is permissible
- Importantly, proceeds of an asset are covered by the pledge over such asset unless agreed otherwise.

INITIAL ASSESSMENT

Having for so long been regarded as perhaps the most challenging of the GCC jurisdictions in which to advance credit, Saudi Arabia has, with the New CPL and an accompanying suite of laws and regulations, the ambition to create possibly the most modern and creditor-friendly security regime in the GCC, while remaining balanced and cognisant of the rights and interests of debtors.

The New CPL is revolutionary but also intricate. There can be no reasonable doubt that it will have a very positive impact as it is digested and applied. However, particularly important to its overall effectiveness will be (i) the way its provisions are fleshed out and applied in practice, (ii) its interaction with other laws and regulations, for example the CMA regulations with respect to listed securities, and (iii) the proper establishment and operation of the infrastructure required to make the New CPL work properly, such as the establishment of the new Register and the licensing of execution agents.

IMMEDIATE NEXT STEPS FOR DEBTORS AND (ESPECIALLY) CREDITORS INCLUDE THE FOLLOWING:

- The New CPL requires that all commercial pledge agreements in existence as of the date the New CPL came into effect be amended to comply with the provisions of the New CPL within six months of that date, ie by no later than approximately 24 October 2018.
- Creditors, in particular, are recommended to immediately seek legal advice on what changes to their security documents are required in order to ensure that their pledges remain or become effective.
- Lenders who have hesitated to enter into certain financing transactions or structured them in a less than optimal way as a result of concerns regarding the ability to take valid and enforceable security may wish to re-examine and reassess such transactions.

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