

Client Alert

[Latham & Watkins Restructuring & Special Situations Practice](#)

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Addressing COVID-19-Related Financial Challenges in Saudi Arabia

Debtors and creditors can use several options under the Insolvency Law in Saudi Arabia to address COVID-19-related difficulties.

The government of the Kingdom of Saudi Arabia (the Kingdom) has taken immediate measures to address the unprecedented financial consequences of the COVID-19 pandemic, including exemptions and postponement of some government dues. These measures are intended to provide liquidity to the private sector, thereby enabling businesses to continue their activities despite major economic setbacks. Some businesses, however, are likely to encounter difficult financial challenges and may need to consider some form of restructuring of their debt. This *Client Alert* outlines the Kingdom's Insolvency Law¹, and discusses the options available for a company (either a creditor or a debtor) under the Insolvency Law, such options include filing for a preventative composition, financial reorganization, liquidation, or an administrative liquidation.

Key Features of the Insolvency Regime

- The Insolvency Law applies to both natural and legal entities undergoing financial setbacks (including "small debtors" as defined therein).
- Four options are available under the Insolvency Law, varying to the degree in which they are debtor- or creditor-friendly.

Prior to the introduction of the Insolvency Law, the Companies Law (promulgated by Royal Decree No. M/3 dated 10 November 2015, amended by Royal Decree No. M/79 dated 11 April 2018), addressed situations of financial distress by imposing certain obligations on the managers and (as applicable) directors, as stipulated in Article 150 for JSCs and Article 181 for LLCs. These Articles provide, for example, that if a company's accumulated losses exceed 50% of its share capital, shareholders' approval is required for either increasing or decreasing its share capital within a certain timeframe or otherwise voluntarily dissolving the company in accordance with Chapter 10 of the Companies Law. Failing to comply with such obligations potentially exposes managers and (as applicable) directors to both civil and criminal liabilities.

The Insolvency Law provides entities in financial difficulty with four options: a preventative composition, financial reorganization, liquidation, or administrative liquidation, each described in turn below. In terms of jurisdiction, the Insolvency Law is personally binding over local debtors and is binding in rem over foreign or local debtors with assets within the Kingdom.

Furthermore, the Insolvency Law differentiates between a debtor who is insolvent and a debtor who is bankrupt. This distinction becomes important when choosing an applicable option. An insolvent debtor is a natural or legal entity who is no longer able to pay debts as they fall due, while a bankrupt debtor is a natural or legal entity whose assets have become insufficient to pay off debts.

In application, the Insolvency Law introduces a number of key stakeholders who play major roles in each of the four options. These stakeholders include:

- **Bankruptcy Committee:** A committee formed pursuant to a ministerial resolution for a renewable period of three years, consisting of five or more experienced and qualified members recommended by the Ministry of Commerce. Under the Insolvency Law, the Bankruptcy Committee enjoys a legal personality, financial and administrative independence, and operates under the supervision of the Ministry of Commerce.
- **List of Bankruptcy Trustees:** A list of trustees prepared by the Bankruptcy Committee.
- **Bankruptcy Trustee:** A person appointed by the Commercial Court or the applicant, pursuant to the List of Bankruptcy Trustees, who performs duties as required by the specific option adopted under the Insolvency Law.
- **Bankruptcy Registrar:** A registrar established by the Bankruptcy Committee that records — for public notification purposes — the names of debtors who have successfully implemented an option under the Insolvency Law.

Options Under the Insolvency Law

Under the Insolvency Law, the following options are available to insolvent or bankrupt debtors and (as applicable) to creditors:

- Preventative composition
- Financial reorganization
- Liquidation
- Administrative liquidation

Preventative Composition

What is it?

A debtor applying for a preventative composition is allowed to reach agreement with its creditors to settle its debt while maintaining its operations. Therefore, this option preserves the autonomy of the insolvent/bankrupt debtor through the debt-settlement process.

Who may apply?

Under a preventative composition only the debtor may apply.

Why choose preventative composition?

Under the Insolvency Law, a preventative composition is made available to a debtor that is insolvent, bankrupt, or likely to suffer from financial distress that will lead to its insolvency, but wishes to maintain control of the company. Debtors falling within any of these categories may apply to the Commercial Court for preventative composition.

How can a debtor apply for preventative composition?

A debtor applying for a preventative composition is required to submit a proposal that includes a description of the debtor's financial situation, the effects of the financial situation on the debtor, and a list of its creditors at the time of application.

Once submitted, the Commercial Court reviews the proposal within 40 days and decides whether to accept, dismiss, or postpone (under certain circumstances detailed in the Insolvency Law) the debtor's application. If the application is accepted, the Commercial Court must notify the debtor within five days of its decision to accept the application.

Within seven days of the court's approval of a debtor's application, the debtor must notify its creditors of the commencement of procedures under this option, and must provide the creditors with a debt settlement proposal. Creditors must vote on the proposal within 40 days. If the proposal is approved by each category of creditors, the proposal shall be ratified by the Commercial Court and will be binding on all creditors. A category of creditors is deemed to have approved the proposal if creditors whose claims represent two-thirds (2/3) of the total value of the claims of creditors voting in all categories, including creditors whose claims represent more than half of the non-related party's debt (if any).

A debtor may submit a request to the Commercial Court asking to suspend creditors' claims. If accepted, the suspension will prohibit creditors from taking any action or lawsuit against the debtor or its assets, or otherwise taking any action with respect to enforcing any security. The Commercial Court may grant a suspension for a period not exceeding 180 days.

Financial Reorganization**What is it?**

Under a financial reorganization a debtor can agree with its creditors to reorganize its finances under the Bankruptcy Trustee's supervision.

Who may apply?

A financial reorganization allows the debtor, creditors, or governmental authorities to apply.

Why choose financial reorganization?

Under the Insolvency Law, a Financial Reorganization is made available to debtors, creditors, and governmental authorities on behalf of debtors who are insolvent, bankrupt, or are likely to suffer from financial distress that will lead to its insolvency. As such, unlike a preventative composition, this option is less debtor-friendly and provides greater protection for creditor rights.

How can a debtor, creditor, or governmental authority apply for financial reorganization?

Under a Financial Reorganization, the requirements for filing an application differ based on the identity of the applicant, with those requirements as follows:

- In the event that the debtor is the applicant:
 - A brief of the debtor's activities and copies of its licenses
 - Proof of the debtor's insolvency or potential insolvency
 - Financial information related to the debtor
 - A list of creditors and amounts due thereto
 - A list of any pending judicial action related to the debtor
- In the event that a creditor is the applicant:
 - A detailed account of the debt owed
 - Proof of the debtor's insolvency or potential insolvency
- In the event that a governmental authority is the applicant:
 - Proof of that authority's jurisdiction over the debtor
 - Proof of the debtor's insolvency or potential insolvency

Once such requirements are satisfied, the Commercial Court reviews the documents submitted within 40 days and decides whether to accept, dismiss, or postpone (under certain circumstances detailed in the Insolvency Law) the application. If the application is accepted, the Commercial Court must notify the debtor within five days of its decision.

Within seven days of the court's approval of the application, the Bankruptcy Trustee must notify the creditors of the commencement of the option. Furthermore, the Bankruptcy Trustee must invite all creditors to submit their claims within 90 days of the commencement of the financial reorganization. Failure to submit a claim excludes the creditor from voting on a debt settlement proposal. Following the lapse of that 90 day period, the debtor, with the assistance of the Bankruptcy Trustee, must deposit a debt settlement proposal with the Commercial Court. Creditors must vote on the proposal by the date set by the Commercial Court. The Bankruptcy Trustee has the right to propose to the Commercial Court a date which it deems appropriate.

The debt settlement proposal is ratified by the Commercial Court and binds all creditors, if:

- All categories of creditors accept the proposal.

Or all of the following:

- At least one category of creditors accepts the proposal.
- Creditors whose claims represent at least 50% of the total value of the claims of creditors voting in all categories, including creditors whose claims represent more than half of the non-related party's debt (if any) vote to accept the proposal.
- The Commercial Court deems that the ratification of the proposal is in the interest of the majority of creditors.

Unlike a preventative composition, creditors' claims are mandatorily suspended in a financial reorganization. This suspension prohibits creditors from taking any legal action against the debtor or its assets, or otherwise taking any action with respect to enforcing any security. The Commercial Court may grant a suspension for a period not exceeding 180 days.

If a creditor or governmental authority commences proceedings against the debtor before the Commercial Court in respect of a financial reorganization, the Commercial Court must notify the debtor within a period not exceeding five days of the proceedings. In such event, the debtor may submit an application to the Commercial Court to dismiss the financial reorganization on the basis of any of the following:

- The conditions set out in the Insolvency Law for opening such proceeding are not satisfied.
- The debt is disputed.
- The creditor is seeking to abuse the proceeding.

Liquidation

What is it?

Under a liquidation, the assets of a bankrupt debtor are sold, and the proceeds of the sale are paid to the debtor's creditors. Following the sale of assets, the debtor ceases all its operations and activities, and the Bankruptcy Trustee manages the liquidation process.

Who may apply?

A liquidation allows the debtor, creditors, or governmental authorities to apply.

Why choose liquidation?

Under the Insolvency Law, a liquidation is available to debtors, creditors, and governmental authorities on behalf of debtors who are insolvent or bankrupt, if the conditions set out in the Insolvency Law for opening such a proceeding are satisfied, or if a financial organization has been terminated.

All of the following pre-conditions must also be met:

- The debt is of a fixed amount, and is due and payable.
- The amount of the debt is not less than the minimum amount set by the Bankruptcy Committee.
- The creditor has made a demand to the debtor to pay such debt at least 28 days before the commencement of the liquidation.

How can a debtor, creditor, or governmental authority apply for liquidation?

Under a liquidation, a debtor, creditor or governmental authority may submit an application for liquidation to the Commercial Court. Once the submission is made, the Commercial Court must review the proposed liquidation of the debtor within 40 days, and decide whether to accept, dismiss, or postpone (under certain circumstances detailed in the Insolvency Law) the application. If the application is accepted, the Commercial Court must notify the debtor within five days of its decision.

Similar to a financial reorganization, claims by creditors are mandatorily suspended. Such suspension prohibits creditors from taking any legal action against the debtor or its assets, or otherwise taking any action with respect to enforcing any security. The Commercial Court may grant a suspension for a period not exceeding 180 days.

However, if a creditor or governmental authority commences proceedings against the debtor before the Commercial Court in respect of a liquidation, the Commercial Court will notify the debtor within a period not exceeding five days. In such event, the debtor may submit an application to the Commercial Court to dismiss the liquidation on the basis of any of the following:

- The conditions set out in the Insolvency Law for opening such proceeding are not satisfied.
- The debt is disputed.
- The creditor is seeking to abuse the proceeding.

Administrative Liquidation**What is it?**

Similar to a liquidation, an administrative liquidation involves the selling of the bankrupt debtor's assets, using the proceeds of the sale to pay the debtor's creditors. However, this option can only be adopted in the event that the proceeds from the disposal of the assets of the bankrupt debtor are insufficient to satisfy the expenses of a liquidation.

Who may apply?

The debtor, creditors, or governmental authorities may apply on behalf of a debtor for an administrative liquidation.

Why choose administrative liquidation?

Under the Insolvency Law, an administrative liquidation is made available to the debtor, creditors, or governmental authorities, so long as the following conditions are met:

- The debtor is either insolvent or bankrupt.
- The assets of the bankrupt debtor are insufficient to satisfy the expenses of a liquidation.

Unlike a liquidation, the Commercial Court appoints the Bankruptcy Committee to carry out the management of the debtor throughout this process.

Creditors' Distribution

The Insolvency Law organizes the hierarchy of creditors with the Bankruptcy Trustee generally responsible to issue a decision and distribute the proceeds to the creditors in accordance with the following order of priority:

- The Bankruptcy Trustee and experts' fees and expenses (if applicable); and the expenses relating to the sale of the debtor's assets
- Debt secured by real property
- Secured financing
- Wages in an amount equal to 30 days' work for the debtor's employees
- Family expenses determined by a statutory provision or a court order
- Expenses necessary for the continuity of the debtor's activity during the proceeding, as determined by the Implementing Regulations
- Wages for former workers of the debtor
- Unsecured debt
- Fees, subscriptions, taxes, and unsecured government entitlements as determined by the Implementing Regulations

The Bankruptcy Trustee is obliged to issue its decision and distribute the proceeds of any restructuring or sale based on the order of priority described above. Following the decision, the Bankruptcy Trustee must notify each creditor of its share of the distribution, and deliver a copy of such notice at least 30 days prior to the date of such distribution. Once notified of the distribution allotted to a creditor, the creditor may object before the Commercial Court within a period of 21 days. In such a case, the Bankruptcy Trustee must discontinue the distribution process until the objection is adjudicated, with such adjudication to be finalized within 20 days from the date of the creditor's objection.

During the distribution process, if more than one distribution occurs and any creditor makes a successful claim before the final distribution has been completed, the creditor shall receive a distribution such that their level of recovery is pro rata to the distributions paid to other creditors.

Practical Application

Since the introduction of the Insolvency Law, a number of issues have arisen with respect to its interpretation by the Bankruptcy Trustees and the Commercial Court, principally with respect to the following:

- **Claims:** Whether claims should be evidenced by a final non-appealable judgement issued by an adjudicatory body in the Kingdom is still unclear. In the authors' experience, in certain circumstances, the Bankruptcy Trustee and the Commercial Court have only accepted claims evidenced by final non-appealable judgements.

Another challenge has been with respect to the status of creditors' claims that may not have been accepted. In the authors' experience, in certain circumstances, the Commercial Court has held that while such creditors are not able to vote on the settlement proposal, such creditor's claim will not, however, be extinguished. This, in turn, raises the critical question as to how such claims are to be treated by the Bankruptcy Trustee and the Commercial Court in view of the Insolvency Law's policy objective, which is to provide a conclusion to the financial distress of the debtor.

- **Claimed Amount:** Whether claims should consist of funded and non-funded credit lines remains uncertain. In the authors' experience, in certain circumstances, only funded credit lines have been accepted in the claimed amount
- **Suspension of Claims:** This term is defined under the Insolvency Law as "suspending the right to initiate or continue any action, process or claim against the debtor, its assets, or its guarantees, within the specified period of time pursuant to the provisions of the Law." The term was recently amended for a Financial Reorganization so as to mirror the same principle under a Preventative Composition and a Liquidation.

This has led to different interpretations by the Bankruptcy Trustee and the Commercial Court as to whether the principle extends to letters of credit (LCs) / letters of guarantee (LGs) issued by banks. In the authors' experience, the current prevailing view amongst the Bankruptcy Trustees and the Commercial Court is that the suspension of claims extends to LCs / LGs and banks are not obliged to pay out under LCs / LGs. To this end, the Saudi Arabian Monetary Agency (SAMA) has issued a circular No. 41039914 dated 2 February 2020 requesting that banks cooperate with the Bankruptcy Trustees in connection with suspension of claims.

Another challenge has been with respect to whether creditors can initiate or continue any action after the lapse of the period of the suspension of claims. This is a critical issue which Bankruptcy Trustees and the Commercial Court will need to address when the procedures currently before them reach that crucial stage during which the suspended claims period has lapsed.

- **Secured Creditors:** There have been different views on what constitutes a secured financing. In the authors' experience, some of the Bankruptcy Trustees have interpreted a secured financing to mean those creditors who are secured by real property. The authors understand, however, that the Commercial Court has yet to provide a view on its interpretation of what constitutes a secured financing under the Insolvency Law.

Future Outlook

The Insolvency Law is among the many reforms to arise from Vision 2030, with the aim of providing a legal framework for a modernized insolvency regime in the Kingdom. The introduction of the regime has heralded that the traditional multi-creditor out-of-court settlements are no longer a viable route for settling distressed debt in the Kingdom. However, as with any new law, the practical application of the Insolvency Law is still being tested and refined so that it can be applied in the interests of all stakeholders. Given the difficult financial challenges brought on by COVID-19, the application of the Insolvency Law will be increasingly prevalent. Thus, leaders of organizations (*i.e.* managers and directors) should seek legal advice when using options under the Insolvency Law to address difficult financial challenges

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Endnotes

¹ The Insolvency regulations were promulgated by Royal Decree No. M/50 (the Insolvency Regulations), dated 14 February 2018 and amended pursuant to the Royal Decree No. M/89 dated 4 March 2020 and its implementing regulations which were issued pursuant to Ministerial Resolution No. 622 (the Implementing Regulations, and together with the Insolvency Regulations, the Insolvency Law), dated 4 September 2018. The Insolvency Law replaces the existing provisions in the Law of Settlement Against Bankruptcy, promulgated by Royal Decree No. M/16, dated 24 January 1996 and Chapter 10 of the Companies Law, promulgated by the Royal Decree No. 32, dated 1 June 1931.