

Personal and Corporate Guarantees under KSA Law

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Additionally, the Shari'ah principles relating to contracts are not codified in KSA in the manner known in most modern jurisdictions. Accordingly, the broad and general nature of the Shari'ah means that KSA courts can be expected to apply a combination of discretionary powers and established legal principles in the review and interpretation of contracts generally, including guarantees. Given this flexibility, KSA law generally provides parties the freedom to negotiate the terms of their dealings, unless such dealings relate to activities prohibited under the Shari'ah.

Guarantees are generally recognized under KSA law and are commonly provided by corporations and individuals for third party debts as an undertaking to make payment where the primary obligor has failed to make the payment. While both corporate and personal guarantees justifiably provide lenders with some comfort and recourse to the guarantor there are various aspects a cautious lender must be aware of in respect of guarantees in the KSA. This article seeks to highlight certain nuances and enforceability issues in relation to guarantees in the KSA.

Primary Obligations

The obligations of a guarantor under a guarantee are secondary to those of the primary obligor. Furthermore, if the creditor releases the principal obligor from any guaranteed obligation, the guarantor will also be released from such obligation. In the same vein, if the primary obligations are found to be void, the guarantee will also be void as a result. Lenders should also be aware that if the primary obligor's obligations relate to a transaction that does not satisfy the primary objective of Islamic finance there is a risk that the guarantee may not be enforceable. For instance, derivative contracts are generally not recognised as enforceable from a Shari'ah perspective. Therefore if a guarantee was provided to secure such transactions, it is unclear whether it would be deemed enforceable if the underlying obligations are seen as too uncertain or speculative in nature.

Demands

Any demands under the guarantee contract should be in writing. Furthermore, in certain instances, KSA courts and other judicial authorities of KSA have acted in a manner which suggests that no reliance may be placed on any notice given by facsimile, telex, bank wire or electronically. Accordingly, from an evidentiary perspective lenders should ensure that all communications to guarantors, including demands, are delivered by way of hard copies.

Enforceability

Lenders should note that the KSA courts and judicial committees are likely to interpret guarantees in favour of the guarantor, for the reason that guarantees under KSA law, are considered "voluntary" obligations. By way of example, while KSA law does not stipulate a time period or limitation period during which a demand must be made, the Banking Disputes Settlement Committee has in the past found that any delays on the part of a lender to exercise its rights against a guarantor can be construed as a waiver of the lender's rights against the guarantor.

All monies guarantees

The distinction between specific guarantees and all monies guarantees is an important one. Under an all monies guarantee, a guarantor guarantees any and all obligations from the principal debtor to the lender, whether existing at the time of the guarantee or arising in the future. Lenders should be aware that guarantees for 'all monies' may face issues upon enforcement in the KSA. A fundamental rule of Shari'ah is that contracts must be free from uncertainty. In applying this principle, KSA courts generally require that guarantees are issued with respect to a specified debt or a thing certain in amount. Additionally, KSA courts have shown a preference for guarantees to include a maximum amount recoverable and to also have a fixed validity.

Promissory notes

Lenders should also note the importance of promissory notes, a form of quasi-security in the KSA. Promissory Notes fall within the definition of commercial papers as provided for in the Law of Commercial Papers 1964 and are commonly used in KSA as they are generally one of the quickest documents to enforce. Any claims under a promissory note can be filed directly with the Execution Court, which should generally not examine the underlying transaction that the promissory note relates to as promissory notes are treated as independent of their underlying agreements.

A promissory note can be enforced in six months as opposed to a guarantee which can take up to two years or longer for enforcement. For this reason, a market practice has developed wherein promissory notes are taken for financings from both borrowers and guarantors. Provisions for the granting and reissuance of promissory notes can be built into the guarantee providing the lender a more efficient avenue for enforcement. Promissory notes may also be enforced by a foreign lender that is not licensed in KSA although successful enforcement would be limited by the liquidity of the borrower.

Upstream guarantees

With regard to upstream guarantees (i.e. guarantees provided by subsidiaries for the benefit of their shareholders), and the extent to which these are permitted, this is a somewhat controversial issue under KSA law. In particular, there are differing views as to whether Article 10 of the KSA Law No. 999 of 2015 (the "Companies Law"), which states that only profits from distributable profits may be distributed to the shareholders, applies to guarantees. Lenders should be aware that there are two views on this. The more restrictive view considers that where payments under guarantees are not made out of net profits, this would constitute a prohibited distribution of dividends. The alternative view is that payments under guarantees do not constitute a prohibited distribution where made for a proper purpose and there is demonstrable corporate benefit for the guaranteeing subsidiary. As this is a grey area, lenders should consider the impact of including an upstream guarantee in a security package.

Additionally, Article 10 of the Companies Law is not thought to prohibit cross-stream guarantees (i.e. guarantees provided to affiliated companies), although it is generally necessary to demonstrate corporate benefit for this. Similarly, downstream guarantees (i.e. guarantees from parents to their subsidiaries) are not affected by this provision.

Governing Law & Jurisdiction

The KSA courts and other adjudicatory authorities do not traditionally recognise the choice of foreign law irrespective of any agreement between the parties in respect of jurisdiction and applicable laws. Accordingly, lenders should be aware that the KSA courts would not be bound by the choice of a foreign law as the law governing a guarantee, or the consent by the parties to the jurisdiction of foreign courts and may in their own discretion apply KSA law which does not recognise the doctrine of conflict of laws.

Lenders interested in enforcing a foreign law judgment in the KSA should also note that the KSA courts have to date rarely enforced judgments rendered by courts in jurisdictions other than, in some instances,

countries which are members of the League of Arab States. For this reason, lenders should be prepared to enforce a guarantee provided by a KSA entity in the KSA.

Conclusion

While there are various factors for lenders to consider before relying on a guarantee, appropriately drafted guarantees can be an important aspect of a security package. Although there are certain grey areas and a lender should ensure that any uncertainty is avoided, the KSA courts approach to guarantees is generally quite clear. That said, a prudent lender should always consult with legal counsel on the efficacy and suitability of any security package to avoid any pitfalls.

Al Tamimi & Company's Banking & Finance team regularly advises on taking security in the KSA, including on the requirements for and the enforceability of guarantees. For further information please contact Arina Gidwani (a.gidwani@tamimi.com) or Agathi Trakkidi (a.trakiddi@tamimi.com).