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# Bankruptcy Reform in Saudi Arabia

***Bridging Islamic Law and Modern Bankruptcy?***

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In 2012, U.S. bankruptcy proceedings were for the first time used to restructure a shari'ah-compliant Middle Eastern business. *See* James H.M. Sprayregen, et al., Arcapita and the Need for Mideast Restructuring Regimes, *Insol Int'l Group Thirty-Six*, Q4 2014, at 18, 18. Emerging from bankruptcy in 2013, Arcapita, a Bahranian private equity and investment firm, was referred to by some analysts as the first true post–financial-crisis Arabian company to undergo debt restructuring. Because Arcapita was based in Bahrain, a nation without an effective insolvency system, restructuring under Bahranian law was not a feasible option. Therefore, United States court approval of shari'ah financing arrangements was required to confirm Arcapita's restructuring in the United States. Fortunately for Arcapita and its stakeholders, the company held a Delaware incorporated subsidiary, and was given access to the bankruptcy court for the Southern District of New York.

Post-Arcapita, the risk remains that future shari'ah-compliant companies will not find similar court approval, or will not have the U.S.-based assets needed to pave an avenue into U.S. bankruptcy courts. Additionally, debtors seeking access to U.S. bankruptcy courts will be required to categorize their Islamic financing arrangements as traditional western debt. This acknowledgment is at odds with long-standing notions of Islamic financing, which prohibit profit-based receipt of interest. Arcapita was willing to categorize its Islamic financing arrangements as debt under Chapter 11, but other Islamic business and government leaders may be hesitant to do so. In other words, practitioner reliance on the American bankruptcy system to reorganize shari'ah-compliant entities is tenuous.

These risks are particularly relevant in Saudi Arabia, a nation that adheres to sharia'ah law and is also one of the Middle East's largest economies. Recent reform proposals, however, suggest that there may be potential for Saudi Arabia to be on the vanguard of developing sophisticated Middle Eastern insolvency laws. This development could provide an effective forum for restructuring Middle Eastern businesses and catalyze government efforts to diversify an oil-dependent economy.

## What Has Spurred the Saudi Development?

The story of the global economy in the past 18 months has been

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depressed oil prices. Predictably, the shocks of this downturn have been felt acutely in Saudi Arabia, a nation where the sale of oil created 70% of government revenue in 2015. The IMF estimates that Saudi Arabia's fiscal break-even point for crude oil is $66.70 a barrel. As of Nov. 1, 2016, crude oil prices have remained below $50 for all of 2016. Recently, the Saudi Deputy Economic Minister voiced his concerns in a public appearance that "our reliance on oil is a pure dependence … economic diversification is basically non-existent."

In an effort to distance itself from this state of oil dependence and to drive diversified growth, the Saudi government has taken steps to attract foreign capital. In June 2015, Saudi Arabia opened its stock market to foreign investors for the first time. Immediately, investors expressed hesitancy regarding clarity of the nation's financial regulations. As a result, today foreign investors currently own less than one percent of listed Saudi companies. Recently, as part of its "Vision 2030" plan to modernize the economy, Saudi Arabia announced an easing of restrictions on foreign investment, which included plans to sell up to 5% of state-owned oil giant, Aramco.

In today's global environment, clear and comprehensive insolvency laws are necessary to attract foreign investment interest. These investments have evolved from bilateral agreements often based on treaties between two nations to complex arrangements, which now routinely involve international credit markets and systemic risk analysis. Transparent commercial law systems allow easier access to credit, operate as a safety valve for investors and facilitate sound corporate governance.

## Features of the Current Saudi Bankruptcy System

At the core of the American bankruptcy system is the concept of a fresh start. Originating in the Bankruptcy Act of 1898, this concept was elicited in American jurisprudence as early as 1904, by the U.S. Supreme Court in *Wetmore v. Markoe*, 196 U.S. 68 (1904). In Saudi Arabia, Islamic shari'ah tradition guides the development of all laws. In contrast to the American view of debt forgiveness, cancellation of debt is strongly forbidden in shari'ah tradition. Benaeouda Bensai, et al., Enduring Financial Debt: An Islamic Perspective, 13 *Middle East J. Sci. Research* 162, 163 (2013). This sentiment has been strongly upheld throughout the development of shari'ah law over the centuries and along with the traditional prohibition on lending for interest (see below), represents a core challenge for modern applications of shari'ah law.

Islamic tradition also includes the forbiddance of interest as a profit mechanism. Abed Awad & Robert E. Michael, Iflas and Chapter 11: Classical Islamic Law and Modern Bankruptcy, 44 *Int'l L.* 975, 981 (2010). Instead of interest-based loans, Islamic financing is often based on a structure known as a murabaha, wherein a lender purchases an asset, sells it to the borrower at a profit, and the borrower sells the asset to gain cash infusion. These lender-borrower relationships are defined by devotion to reputation, relationships and Islamic tradition. This is in stark contrast to the modern American bankruptcy system, which has become increasingly dominated by sophisticated creditor groups operating on a short-term profit basis.

As a result of these principles, the Saudi system focuses on liquidation of companies, and does not offer restructuring options similar to those of the United States and other developed economies that are grounded in debt forgiveness and adjusted interest payments. Specifically, there are no legal provisions for a restructuring arrangement, or debtor financing during reorganization. There is neither a clear test nor consistency of practice in determining insolvency. Additionally, there is no automatic stay on debt collection — the only procedure for liquidation avoidance allows a committee of three bureaucrats to negotiate a settlement with the debtor. The head of this committee is responsible for determining that the restructuring complies with shari'ah law. Hawkamah/World Bank/Oecd/Insol, International Survey on Insolvency Systems in the Middle East and North Africa 51 (2010).

The Saudi Commercial Court Law (CCL) is the nation's primary legal framework to address insolvencies. The CCL, which offers limited options to both debtors and creditors, includes a priority system of "privileged debts." Unlike priorities in the American System, the CCL limits priority debts to employee wages, rent, and a wife's dowry. Non-privileged debts receive equal distribution, a concept that is aligned with the American principle of equally placed creditors sharing in equanimity. Saudi Arabia's commercial contracts are subject to a two-tier court system: the shari'a courts and the Diwan al Mazalim. Commercial contracts may be adjudicated under the Diwan's commercial circuit, but remain subject to shari'a law, which can lead to revisions of contract terms on an otherwise approved agreement. In effect, shari'a courts maintain the ability to disrupt any reorganization arrangement.

Due to the lack of an effective insolvency structure, Saudi Arabia has reported very little use of its bankruptcy system. Mahesh Uttamchandani, World Bank, "No Way Out": The Lack of Efficient Insolvency Regimes in the Mena Region 4 (2010). Informal out-of-court restructurings are common, and exist primarily in the form of arbitration conducted by the Chamber of Commerce. These restructurings are often categorized by "extend and pretend" plans that create an unrealistic and ineffective long-term solution to liquidity disruptions.

## Proposed Reform

Recently, the Saudi Arabian Ministry of Commerce and Investment held a series of workshops to seek public opinion on proposed changes to the country's bankruptcy laws. Discussion focused on overhauling the bankruptcy system in an effort to attract foreign investors. These workshops followed an internal analysis of Saudi Arabia's financial issues and a benchmarking study of the best international practices in bankruptcy.

The project manager of the Saudi bankruptcy overhaul described a comprehensive, debtor-friendly system akin to those in developed nations. Specifically, he stated that the proposed new system contains 320 articles, and is designed to encourage reorganization over liquidation. The new system would allow for debtors to choose between a financial reorganization at going concern value or a liquidation. These reforms are rooted in a theory of rehabilitation. *See* Alex Gross & Christopher J. Smith, Saudi Arabia to Introduce Revolutionary New Insolvency Law in 2016, *Nat'l L. Rev.*, Dec. 10, 2015. Specifically, this proposed system will allow for the disposal of assets and rescheduling of debts. Additionally, the proposed system would give priority incentives to creditors who lend to companies in bankruptcy, mimicking debtor-in-possession laws of the United States system.

Importantly, the reform proposal also allows for the forgiveness of debt in the advent of a confirmed restructuring. While this has long been a core tenet of modern western bankruptcy systems, this one important facet of the reformed system seems to conflict with a core principle of Islamic finance: the forbiddance of debt cancellation. This is a striking modernization in a country that upholds Islamic law as its highest source of law.

## Implications for Saudi Arabia's Future

The Saudi government has taken a strong step in the right direction with these proposals. The presence of solidified insolvency laws can spur foreign investment, but predictable enforcement of law is equally important. The development of China's insolvency framework presents a cautionary example. In 2007, in an effort to spur foreign investment, the Chinese government adopted a reformed insolvency law largely modeled after the United States' Chapter 11 process. Optimistic observers praised the system as allaying concerns over investment risks, citing the new law as a springboard for successful foreign investment. *See* Ann Vom Eigen, China's New Bankruptcy Law Encourages Investment, *ABI*, Oct. 2006. Years later, enforcement of China's insolvency laws has been labeled a "bankruptcy riddle," wherein wide-ranging judicial discretion eliminates investment predictability. Umesh Dashi & Michelle Price, Amid China Slowdown, Foreign Investors Face Bankruptcy Riddle, *Reuters*, Nov. 30, 2015.

The role of judicial discretion in bankruptcy administration is particularly interesting in the case of Saudi Arabia due to the fundamental conflict between a forgiveness-based reorganization structure and traditional shari'ah principles. This conflict is exacerbated by the element of discretion inherent in the Saudi bankruptcy system. For example, judicial bankruptcy decisions are not reported, leaving an absence of precedent. Additionally, judges also do not hold the security of tenure, making them more prone to extrajudicial influence.

Because shari'ah courts in Saudi Arabia are courts of general jurisdiction, any restructuring is subject to shari'ah analysis. However, shari'ah principles, such as a ban on the payment or receipt of interest, are not actually codified but are instead moral and religious guidelines. *See* Chris Johnson, A Bank, a Bankruptcy, and the World of Shariah Law, *Am. Law.*, Oct. 2014. Will the judiciary find modern Saudi insolvency systems at odds with shari'ah principles? Or, similar to the management team of Arcapita, will these courts distance themselves from shari'ah financial traditions to realize bankruptcy reformation? What consistency, if any, will pervade these decisions? It remains to be seen how debt forgiveness and interest restructuring inherent to modern bankruptcy comport with the practices and beliefs of a shari'ah system.

## Conclusion

The Saudi government should be applauded for taking steps to formalize a reliable insolvency process in a region that has struggled to create effective solutions to business liquidity problems. This goal is complicated, as demonstrated by the restructuring of Arcapita, by traditional Islamic laws that are often at odds with modern restructuring platforms.

In order to effectuate reliable administration of these laws, the Saudi government will be required to reconcile long-standing shari'ah principles with the design of a modern bankruptcy system. Without an effective reconciliation of these diverging forces, bankruptcy administration could be subject to the whims of the judiciary and will undercut the predictability necessary for both effective bankruptcy administration and modern foreign investment.

If Saudi Arabia is able to bridge shari'ah tradition with modern restructuring principles, Saudi Arabia's bankruptcy system could serve as a model to its Middle Eastern neighbors. An effective system would drive foreign investment and offer a restructuring haven in an area that sorely lacks bankruptcy infrastructure. But, without clarification of these administrative issues, practitioners and investors alike should be wary of reliable insolvency proceedings, even in the presence of impressive legislation.

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