

The Commercial Pledge Law: Ushering in a New Era in Saudi Arabian Banking and Security Enforcement

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The Commercial Pledge Law was issued in April 2018. This step was taken in response to the long-awaited and highly pressing need to support the growth of financing options for Saudi Arabia's business sector. The newly issued Commercial Pledge Law will be a catalyst for greater and sustained credit growth in the years ahead.

The Commercial Pledge Law has changed the landscape of creating security over 'movables' in Saudi Arabia. These changes will have an impact on the law and practice of banking in the Kingdom and will provide a wider variety of options when structuring lending transactions. Significantly, pledge agreements are required to comply with the Commercial Pledge Law within a six-month period from the effective date of the law. The law also specifies a comprehensive and complete procedure for expedited enforcement of security over movable assets. These procedures would reduce risks associated with debt collection and thereby encourage banks, financial institutions, and other lenders to participate with confidence in the credit markets.

This article will cover the key features of the Commercial Pledge Law and will explain the law and its Implementation Regulation. The article will also discuss how the Commercial Pledge Law will help in tackling various issues associated with enforcement relating to pledged properties.

Movables: Current and Future Property and Future Rights

Under earlier laws, it was possible to create security over movables that were in existence but it was largely the case that security could not be created over future movables. Therefore, where a movable asset was not in existence (e.g. machinery that was under-construction or future deposits in a bank account) it was not possible to create security.

The Commercial Pledge Law covers the creation of security over movable property, which includes present as well as assets that will come into existence in the future. For movables that will come into existence (e.g. machinery that is under-construction) the pledgor would have a contract for purchase or construction and should be able to describe the asset, its value and date of completion.

Future rights include debts that can be pledged or assigned by way of security. This would cover receivables under contracts or invoices.



Security for a Commercial Debt

Significantly, the Commercial Pledge Law applies to pledge contracts that secure 'Commercial Debts'. A Commercial Debt is a debt that arises from business or professional activities. A loan to finance the purchase of a computer server by a company for storage of its files would be a Commercial Debt. A loan to finance the purchase of a computer server by an individual for storage of personal data would not be a Commercial Debt. The provisions of the Commercial Pledge Law would apply to the former scenario but not the latter scenario.

Registered Pledges, Possessory Pledges and Priority

Registration of pledges (where applicable) under the Commercial Pledge Law are required to be registered at the Unified Register of Commercial Pledges or if there is a special register for a type of asset (e.g. vehicles, ships, aircraft) registration on the relevant special register would suffice. A pledge contract relating to movable property is valid as against third parties if it is registered or possession of the movable property is transferred to the pledgee or to a trustee. For inventory and raw material, a floating charge is required to be created (discussed below).

It is possible to create more than one pledge on the same pledged property. A registered pledgee will have priority over an unregistered pledgee in respect of the same pledged property. If there is more than one registered pledgee, the pledgee having the earlier date of registration will have priority. Unless otherwise agreed between the pledgees, a pledgee under a pledge contract shall have priority over a pledgee under a floating charge or a Pledge over Economic Enterprise.

The Ministry of Commerce and Investment has published the draft bill of the Commercial Pledges Unified Register Regulation, which aims to make the registration of pledges electronically, for the public to express opinion and feedback. The regulation is expected to be issued shortly.

Pledge over Bank Accounts

The significant development under the Commercial Pledge Law when it comes to pledging deposits is that it is now possible to pledge both present and future deposits in the bank account. This is especially important where security is to be taken over deposits in current and operating accounts where deposits and withdrawals occur on a regular and on-going basis. Unless the pledgor and pledgee agree otherwise, the pledgor is not permitted to operate the bank account.

Floating Charge

The Commercial Pledge Law defines a floating pledge or charge as a pledge created over movable property without determining the elements of the movable property. Effectively, the pledgor and the pledgee are not required to identify the specific assets that are subject to the pledge. Inventory and raw materials are covered under the scope of a floating charge. A floating charge must be registered in the Unified Register of Commercial Pledges in order for the security to be effective against third parties. The pledgor is required to provide monthly reports of the stock available and if the quantity is not permitted to fall below 50% of the required pledged property unless the parties have agreed otherwise.

Pledge over Economic Enterprise

The pledge over economic enterprise or pledge over commercial business enables the secured party to obtain security over an entity that carries out commercial or professional activities. The pledge over economic enterprise creates security over all elements of the commercial or professional business including its intangible elements (goodwill and customer database) and its tangible elements including its movable assets, rights (receivables and book debts) as well as the location where commercial activities are carried out. Inventory of products sold by the business would be excluded.

Pledge over Securities

The Commercial Pledge Law excludes from its application shares of companies that are listed as well as shares of unlisted companies (being shares of Joint Stock Companies Closed). However, portions in entities (e.g. a portion or shares in a limited liability company) may fall under this Commercial Pledge Law and require registration at the Unified Register of Commercial Pledges. Other unlisted securities may also require registration unless they are governed by a special law governing perfection requirements.



Pledge Contract

The Commercial Pledge Law sets out the constituent elements of a pledge contract. The key elements include (a) where the pledged property is not in existence, the expected description, approximate date of existence and approximate value of the pledged property should be specified; (b) the general description, amount or maximum limit of the secured debt should be specified; and (c) the due date or expected due date of the secured debt should be specified.

The Execution Agent

The designation of an “Execution Agent” (he/she cannot be one of the parties involved in the pledge) is given to an individual licensed by the Ministry of Commerce and Investment (“MOCI”) for practicing the act of enforcing pledged properties if the pledgor defaults and there are multiple pledgees.

The Commercial Pledge Law, however, allows any individual (even if he or she does not have the license of the MOCI) to play the role of an Execution Agent if all the pledgees agree to allow him/her to be their representative when the enforcement procedures are underway.

Whatever might be the case, appointing an Execution Agent is a must whenever there are multiple pledgees. This is because the writ of execution (we have discussed it later in this article) is always issued under name of the concerned Execution Agent.

Self-help Enforcement

Under the Commercial Pledge Law, where the pledgee and pledgor agree, the pledgee may enforce the pledge directly without the requirement of a court order. The procedures that can be adopted for self-help enforcements are as follows:

1. Self-help enforcement can be carried out using a Direct Execution Extract. A Direct Execution Extract authorizes the concerned party (i.e. the party to whom the extract is issued) to carry out the steps for enforcing the pledge which finally culminates in the sale of the pledged assets.
2. When there are multiple pledgees for a single property and any one of them along with the pledgor believe that there should be a direct execution, an Execution Agent will have to be appointed. Such a situation would also make it mandatory for the Execution Agent to obtain a Direct Execution Extract.
3. In cases where the pledgor and the debtor are not same, a notice is served to the pledgor and debtor requiring them to satisfy the secured debt in just 10 business days. The Commercial Pledge Law makes it mandatory to obtain the written notice annexed to copy of the Direct Execution Extract.
4. Once the notice period (10 days) ends, the Execution Agent/ pledgee will have to submit the extract to the authorities.
5. The above step would be followed by thorough evaluation of the pledged property in question in order to put the property up for sale.
6. Next, the property would be sold following the procedures explained in the notice received by the pledgor and debtor.
7. If the Execution Agent would need to supervise the execution procedures discussed above (this happens if there are multiple pledgees), he or she would deduct the entire execution cost from the amount obtained by selling the property. The Execution Agent is also required to set aside the amount the pledgees deserve to get from the proceeds.
8. Once the rights of all the pledgees are fulfilled (rights are fulfilled based on the priority of each pledgee), the pledgor would need to submit an application to the execution agent or registrar (whichever is applicable) to return the balance amount.

It is important to mention that the self-help clause does not permit the inclusion of a provision in the agreement, which allows the pledgee to take direct ownership of the pledged property against secured debt in the event that the debtor fails to make payment of the debt. Such a provision would be void but would not impact the rest of the agreement.

The Commercial Pledge Law, however, has provided the pledgee (when an event demanding the execution of pledged property takes place) with the right of enjoying preference over other involved parties when it comes to buying the concerned pledged property. The price the pledgee would be required to pay for making the purchase would be same as that determined during the evaluation of the property unless another buyer offers a larger amount than the property’s assessment price.

Execution Carried out by the Enforcement Court

When a financing contract is breached by the debtor in a manner that makes execution mandatory and the pledge agreement does not contain a self-help enforcement clause, the execution agent or pledgee would carry out the following steps for enforcement:

1. Obtain a Writ of Execution (being an extract of the recorded pledge) from the Unified Register of Commercial Pledges. The extract, however, will be issued to the Execution Agent when there are multiple pledgees. In such situations, the Unified Register of Commercial Pledges will have to record the event of making the extract available.
2. When the pledgor and debtor are not the same, but a third party security, a notice is served to the pledgor and debtor for satisfying the secured debt in just (6) six business days, unless mentioned otherwise in the pledge agreement.
3. The pledge would automatically be fulfilled the moment the secured debt is paid by the debtor. However, once the notice period is over and the debt is still not paid back, the Execution Agent or pledgee will have to submit the extracted Writ of Execution and request the Enforcement Court to commence the process of execution of the pledged property.
4. In such situation, the execution will be carried out abiding by the Law of Enforcement and the Implementation Regulation. The process might involve selling of the property at a public auction, where the pledgee would enjoy precedence and preference in buying the property over others by paying the assessment price unless someone else is ready to pay a higher sum for buying the property.
5. If an Execution Agent has been appointed to supervise the execution procedures, he or she would be allowed to deduct the entire execution cost from the amount obtained by selling the property. The Execution Agent, however, would first set the pledgees' right from the sale proceeds aside. Then, the pledge would satisfy the balance due to the person in whose favor the execution has been carried out. The remaining amount would be kept in the bank in an account owned by the registrar. This leftover amount will be assigned for other pledgees.
6. After getting all the dues cleared, the pledgor might request the Execution Agent or registrar (whichever is applicable) to return the remaining amount.

Pledged Property Assessment upon Enforcement

The pledged property's value is determined by following the procedures and regulations agreed upon by the parties involved in the pledge agreement. In case there is no agreement between the pledgee and the pledgor, the assessment will be carried out by a professional (certified) assessor. Each party would have his/her own assessor; the final assessment price would be the average of the assessment prices put forward by the two assessors.

If any one of the two parties does not appoint their assessor within 10 business days from the date the other party appointed an assessor and notified his/her counterpart about the appointment, the appointed assessor's assessment would automatically be approved.

Conclusion

The issuance of the new Commercial Pledge Law in April of this year, responded to a most pressing and long awaited requirement for supporting credit in the business sector in the Kingdom of Saudi Arabia. This Law sets out a complete and comprehensive mechanism for quick collection of debts secured by pledges and lessening risks implied therein; and thus encouraging banks, finance companies and others to engage in credit business with confidence. All existing pledge agreements should be brought in line with the Commercial Pledge Law within six months of the issuance of the law, that is, by the 3rd week of October 2018.