

Structuring joint ventures in Saudi Arabia: what every foreign investor should know...

Saudi Arabia is a complex jurisdiction for non-GCC investors, with high transaction execution risks but yet is also brimming with business opportunities.

It is imperative that investors choose the right professional advisors to guide them through the legal framework and requirements that apply in this market.

Here are some of the considerations for non-GCC investors wishing to set up a joint venture in the Kingdom of Saudi Arabia (KSA).

Professional legal advice

There is no doctrine of precedent in KSA and at times it may appear as if laws and regulations are potentially inconsistent with each other. The Saudi Arabian legal framework is complex and constantly evolving which means that legal advice and practice often feels to be in a state of flux compared with some western jurisdictions. Foreign investors should seek proper guidance from local professional advisors with regard to legal as well as corporate, financial, immigration, tax and zakat matters.

Foreign investment approval

The Saudi Arabian General Investment Authority (SAGIA) needs to approve any foreign investor before it can invest and conduct business in Saudi Arabia. Its website is www.sagia.gov.sa. (which is also in

English) and is a useful source of basic information. It is preferable that the foreign investor, or the entity actually investing, has a demonstrable track record in the activity to be undertaken in KSA. That track record as well as audited financial statements showing profits may be requested by SAGIA, depending on the type of license sought by the foreign investor. Many people describe the SAGIA approval process as part of the incorporation process, when in fact it is not and should be considered as a separate pre-cursor to incorporation. Incorporation occurs afterwards and once the shareholders have executed the articles of association before a notary public and the commercial registration certificate has been obtained from the Ministry of Commerce and Industry (MOCI), amongst other things.

We can help you answer the following questions

- What is the best route to market and appropriate structure?
- How do I find a good partner?
- Are there any restrictions on carrying out this business?
- Are there any restrictions and/or requirements on the actual investing company?
- How long is the incorporation process and how can you assist us in the SAGIA and incorporation process?
- As a shareholder in an LLC, is my exposure always limited?
- What are the statutory reserved matters?
- Is there any statutory pre-emption right - does it apply to and intra-group transfer?
- Can we put in place and enforce drag and tag/put and call rights?
- What are the possible management structures that we can put in place?
- What are our Saudization requirements? How does it work? Why does the SAGIA application form say that Saudization has to be 75%?
- Can the legal shareholding and profits split be different?
- What are the most common approaches to "deadlock"?
- As a minority shareholder, what protections can we put in place?
- Is there anything we can do to give us greater protection and control over the other shareholder(s)?
- Can we insert protections within the articles of association that we would typically see in a private equity transaction?
- If you would like help answering these questions then contact us.

There are different types of foreign investment licenses that can be applied for and issued by SAGIA – the most commonly applied for are "industrial", "trading (wholesale and retail)", "contracting" and "services".

SAGIA has different requirements and restrictions depending on the type of license applied for. These include prescribing the minimum amount of capital contributions, relevant demonstrable experience, the shareholding percentages, the provision of audited financial statements and various undertakings, to name but a few.

The appointment of a new Governor of SAGIA within the last year and the introduction of new internal rules and classifications, together with uncertainty regarding the foreign investment licensing process may give some foreign investors cause for concern.

The investor should begin preparing the relevant documentation well in advance of the SAGIA application. The documents need to be translated by an official translating office into Arabic and these documents also need to be notarised, legalised and consularised in the jurisdiction of incorporation of the foreign investor before obtaining a Ministry of Foreign Affairs stamp in Saudi Arabia. In certain circumstances, a stamp from the Ministry of Justice will also be required. The collation of these supporting documents may take up to two months.

The SAGIA process from start to finish can take up to one to three months but we have heard of applications from other advisors taking more than 12 months before being approved. However, SAGIA does also have a "fast track"

procedure which is available to certain categories of applicant.

What is the best route to market and how should the investment be made?

The question is whether the business needs to establish a legal presence or whether the investor can carry out business in Saudi Arabia through another structure.

- **Commercial Agency:** Under the Saudi Commercial Agencies Law, non-GCC manufacturers of goods and principals can only appoint local Saudi agents as their representatives to sell their products and/or services in KSA. These agents must be Saudi nationals and need to be registered as commercial agents with MOCI. With innovative structuring we have assisted many foreign investors and non-GCC shareholders in JVs to also participate in the distribution of products in KSA.
- **Government Tenders:** If the investor's plan is to participate in government tenders only, it should be noted that depending on the tender rules of the relevant government entity, a joint venture company with a foreign shareholder may be ineligible from participating in the tender process. As time may be of the essence, the investor rather than setting up a separate legal entity, may seek to establish a branch or obtain a temporary commercial registration from the KSA authorities with the assistance of the relevant government entity. This is more likely where the contract with the government entity is of limited duration.

- **Incorporation of a company:**

However, most foreign investors will want to set up a joint venture entity in KSA, in which they have an ownership stake and in which they can participate in the management and growth of the company whilst having the benefit of a limited liability protection.

Choosing the right corporate vehicle

The two most common investment vehicles in KSA that limit shareholders' liability to their capital contributions (save as set out below) are (i) the limited liability company (LLC) and (ii) the joint stock company (JSC). The LLC is the entity of choice for most foreign investors, especially for start-up joint ventures. LLCs are more flexible and require only two founding shareholders, unlike the JSC that requires at least five founding shareholders. Further, it is recognized that a JSC is more administratively burdensome to operate and would normally take longer to incorporate.

Liability of shareholders

Under Saudi law there are circumstances in which the shareholders of an LLC (not a JSC) may lose their limited liability protection. Under Article 180 of the Saudi Companies Law, where the losses of the joint venture company are equivalent to 50% or more of its paid-in share capital, the managers should convene a meeting of the shareholders to determine whether or not to continue trading and financially support the company. If they fail to meet within the prescribed time, or at all, and the company continues to trade, the shareholders become personally liable for the payment of the debts of the company on a joint

basis. Therefore, we would recommend that: (i) a foreign investor ensures that the LLC is not thinly capitalised, (ii) that the management put in place appropriately checks to monitor losses on an ongoing basis – especially at the outset of the joint venture company's life when there is little or no revenue and there are fixed monthly costs and overheads, and (iii) if the investor does not have management control, it considers whether it needs any protections as a minority shareholder.

Saudization/Nitaqat

An LLC must employ the requisite percentage of KSA nationals. The Ministry of Labor has set out the percentage of KSA employees required depending on the category of business activity and the number of employees. Depending on the level of compliance or non-compliance, the LLC will have more or less possibility of obtaining visas, blocking transfers of employees to third parties etc. It should also be noted that certain jobs are restricted to Saudi nationals as a matter of law, such as the receptionist, HR manager etc.

Management

The shareholders of an LLC are free to put in place whatever management structure they feel appropriate. They can agree that the company will be managed by a board of managers or by a sole general manager appointed by the shareholders or by both. The powers of the board or the general manager (or executive manager as he is known when reporting to a board) will typically be set out in the articles of association (Articles) and can also be detailed in the shareholders' agreement. The Articles and/or the shareholders' agreement may also contain clauses stipulating how the Board members or the general

manager can be appointed, removed and replaced. If the powers are set out in the Articles it should be remembered that only an affirmative resolution of 75% of the votes of the shareholders can amend the Articles and therefore the powers set out within them.

Statutory reserved matters

The Saudi Companies Law sets out a number of matters that require a certain threshold percentage of shareholders voting yes, to be validly passed. For example, shares representing 75% of the LLC's share capital must vote yes in order to amend the Articles, 100% must vote yes to increase the financial burden of all of the shareholders and a simple majority to remove or replace the auditors.

Dividends

The shareholders must set aside 10% of the net profits of the joint venture company annually before distributing the remainder of the profits. A statutory reserve must be built up equal to at least 50% of the share capital.

Pre-emption right

The Saudi Companies Law provides existing shareholders in LLCs with pre-emption rights on a sale of existing shares to any third party (this also applies to any intra-group transfer of shares).

Transfer of shares/exit

An LLC's shareholders will need to consent to any transfer of shares to a third party. As the names of the shareholders are set out in the Articles, when the shareholders change, this requires an amendment to the Articles, (and a prior amendment to the SAGIA license to the extent there is any foreign

membership). Any such amendment resolution must be signed by the shareholders or their representatives before a public notary. This can be done with 75% of the votes voting yes, however, in practice, the notary public will insist that all the shareholders or their attorneys attend before a notary public to sign. Although, relatively untested there are various ways to mitigate this approach.

Shareholders' Agreement/Articles

The relationship between the shareholders and third parties would be governed by these documents and they will contain similar provisions. If there is a conflict, the Articles will prevail vis-à-vis the rest of the world. In order to keep the costs down when negotiating the shareholders' agreement, we would recommend agreeing a term sheet up-front.

Find the right partner

Finding the right Saudi partner for your joint venture is perhaps the most critical factor for a successful investment in KSA. The Saudi partner should be active, have the adequate experience in the field of activity for the joint venture, should be co-operative or at least be able to facilitate the investment and help with practical issues on the ground. We know of certain financial advisors, accountants and investigative firms who can assist with "partner" searches. Having the right partner can provide the investor with precious insights and on the ground knowledge needed to launch and to run the business smoothly and profitably.

Most international investors will typically consider having a local partner for their first investment in KSA whether or not the foreign investment licensing regime requires them to do so.

The proposed activities

The foreign investor should review the proposed activities with its legal advisors in KSA as early as possible in order to ensure that such activities may be performed by foreigners; and to determine which type of foreign investment license will be required as well as any other legal requirements and restrictions imposed by SAGIA and MOCI.

In essence, foreign investment is permitted in all business activities in KSA, except those areas expressly excluded by the list issued by the Supreme Economic Council or otherwise by Saudi laws or regulations. This "negative list" is updated regularly and should be checked initially to ensure that the proposed activities are not prohibited.

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This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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107074-4-5834-v0.7

ME-8000-BD-PR