

Saudi Arabia: Officers and Directors Liability under the New Companies Law

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Under Saudi Arabia Royal Decree No. M3/1437 dated 28/01/1437 H, corresponding to 10/11/2015, Saudi Arabia has adopted a new companies law regime (the New Companies Law) completely replacing the existing Regulations for Companies enacted by Saudi Arabia Royal Decree No. M6/1385 dated 22/03/1385 H, corresponding to 22/07/1965G (the 1965 Companies Law).

The New Companies Law will come into effect on 2 May 2016. Until then, the 1965 Companies Law remains in effect. The New Companies Law makes several important changes to the 1965 Companies Law.

Officers and Directors Liability under the New Companies Law

However, this Article is limited to changes made to the potential liabilities of Directors and Officers of Saudi Arabian incorporated companies effected by the adoption of the New Companies Law. Since the adoption of the decades old 1965 Companies Law, the business and investment landscape in Saudi Arabia has changed drastically. For example, there has been a significant increase in the number of large family-owned conglomerates in Saudi Arabia, as well as publicly listed companies on Tadawul, Saudi Arabia's stock exchange. In addition, recent corporate financial scandals - such as Enron, Lehman Brothers and most notably in the Middle East, the Algosaiibi-Saad affair, have received worldwide attention and Governments have become increasingly wary of the severe economic damage that may result from corporate fraud and abuse. It is natural that the Kingdom's decision to open its stock market to foreign investors would be followed by building confidence for the investors in the market, such as the implementation of new regulations that are designed to protect shareholders and mitigate issues regarding related party transactions and conflicts of interest. For these reasons, the business and investment community in Saudi Arabia, as well as the public sector community, have felt for some time that a revamp of the 1965 Companies Law was necessary.

What are the most significant changes?

While there have been several changes to the potential civil liabilities of officers and directors of Saudi Arabian companies under the New Companies Law, most practitioners on the ground in Saudi Arabia agree that the most significant changes affecting officers and directors relate to the new potential criminal liabilities.

Criminal Liabilities under the 1965 Companies Law

The 1965 Companies Law provided for criminal sanctions with penalties ranging from fines of 1,000-5,000 Riyals for

certain low-level offences to fines of SAR 5,000 - 20,000 and/or imprisonment for a period of 3-12 months for certain high-level offences (which generally required some degree of malicious intent or purpose to defraud).

Some examples of criminal acts that gave rise only to fines ranging from 1,000-5,000 Riyals under the 1965 Companies Law include:

- a. failing to list the company name, form, paid up capital amount, and head office location on all contracts, receipts, notices and other documents issued by the company; and
- b. obstructing the work of an auditor generally.

On the other hand, some examples of criminal acts that gave rise to fines ranging from 5,000-20,000 Riyals and/or imprisonment for a period of 3-12 months under the 1965 Companies Law include:

- a. receiving or distributing among the shareholders or third parties fictitious (unearned) profits; and
- b. maliciously overestimating the value of in-kind contributions by founders to the share capital.

Criminal Liabilities under the New Companies Law

Under the New Companies Law, acts designated as criminal may now carry penalties of imprisonment for up to 5 years and fines up to 5,000,000 Riyals, thus dramatically increasing the historic criminal sanctions under the old 1965 Companies Law. In addition, low-level offences are now subject to a much higher fine of up to 500,000 Riyals, as compared to the previous ceiling of just 5,000 Riyals. In addition, under the old 1965 Companies Act, penalties involving imprisonment generally required some level of malicious intent and/or purpose to defraud. However, under the New Companies Law, mere negligence without any intent can be grounds for imprisonment.

Some examples of criminal acts that give rise to fines of up to 500,000 Riyals under the New Companies Law include:

- a. deciding, distributing or collecting, with bad intention, profits or revenues in breach of the provisions of the New Companies Law or the company's articles of association;
- b. intentionally causing the delay of the invitation or meeting of the general assembly;
- c. obtaining a benefit or a guarantee or a promise of a benefit or guarantee for voting in a certain way; and
- d. failing to prepare meeting minutes as per the New Companies Law.

Some examples of criminal acts that give rise to fines of up to SAR 1,000,000 and/or imprisonment of up to one year under the New Companies Law include:

- a. (a) declaring, publishing, or announcing the incorporation of a company before completion of its incorporation procedures;
- b. intentionally making false statements against the provisions of the law or the company's articles of association in any documents of the company, in the application for licensing, or in the documents attached with the incorporation application;
- c. exaggerating or attributing to shareholders or third parties false acknowledgments regarding the evaluation of in-kind shares, distribution of dividends among shareholders, or payment of their values; and
- d. using the company for a purpose other than the purpose for which the company is licensed.

Some examples of criminal acts that give rise to fines of up to SAR 5,000,000 and/or imprisonment of up to five years under the New Companies Law include:

- a. Registering false or misleading information in the financial statements or in the reports prepared for the shareholders or the general assembly.
- b. Using company funds, or using one's powers or votes in a way that one knows would affect the company's interests in order to achieve a personal gain for oneself or any other person or company.
- c. Failing to hold the general assembly of the company or shareholders meeting when one becomes aware that the

losses of the company have reached the limits established in the New Companies law, or failing to publish the occurrence thereof (note: knowledge is required only of becoming aware of the losses; the actor does not need to know that failure to hold the meeting is a breach of the law in order to become liable).

What are the most significant omissions?

Lack of Typical Protections

Sharia (Islamic law) is the paramount source of law in Saudi Arabia. While codifications - such as the New Companies Law, as well as circulars, regulations and decrees have the effect of binding law in Saudi Arabia, these codifications are nevertheless subordinate to Sharia. Saudi Arabian courts apply both codified law, as well as Sharia, to disputes brought before them. However, courts do not implement the principle of *stare decisis* (or precedent) and, thus, past judicial decisions are neither binding nor persuasive precedent for subsequent disputes. Even so, courts are generally closed to the public and judges do not typically allow the publication of their decisions or otherwise make them available to the public. In that regard, Saudi Arabia has not been able to develop some of the common law "judge-made" principles that are typical in other, more advanced jurisdictions. For example, in most US jurisdictions, directors are protected by the business judgment rule, which is a rebuttable presumption that the decisions of directors that are alleged to cause harm are presumed to be made in good faith and in the best interests of the company. To overcome the presumption, a claimant must make an allegation of fraud, illegality or conflict of interest. However, there is no case law or statute reflective of the business judgment rule to which an individual can look for protection from the risk of liability for the decisions he makes in his capacity as a member of the board of directors of a Saudi Arabian company. That being said, directors making business decisions based on sound and reasonable principles are in a more superior position to defend their actions than directors who are negligent in carrying out their duties or engaging in questionable behaviour.

Lack of Mens Rea for Jailable Offences

The theory of retributive justice provides mainly that "the punishment must fit the crime." In this regard, in most advanced jurisdictions, criminal culpability generally requires proof of both *actus reus* (a guilty act) and *mens rea* (a guilty mind). That is, an individual should not generally be held criminally liable for committing a harmful act without a corresponding intention to do so, and vice versa. Further, various degrees of *mens rea* - from mere negligence to premeditated and purposeful - give rise to various degrees of punishment. Typically, constraining an individual's physical liberty and freedom via imprisonment is seen as one of the most severe forms of punishment and, thus, proof of an exceptionally malicious *mens rea* would be required to impose such a punishment. However, certain criminal offences in the New Companies Law that carry potential imprisonment do not clearly state that proof of knowledge or intention (*mens rea*) is required in order to determine guilt. Thus, on a strict reading, an individual could be imprisoned under certain provisions of the New Companies Law with proof of merely an *actus reus*. For example, as mentioned in Part 3.2.2(d), directors and officers could be imprisoned for up to one year for engaging in commercial acts on behalf of the company that are not within its authorised commercial activities. At times, it can be difficult to determine whether or not a company's authorised commercial activities carry implied authorisations. For example, if a technology manufacturer is authorised to supply and install electronic equipment, does that also permit the contractor to import its equipment without the express authorisation to do so as per its commercial license? Nevertheless, based on our significant and incomparable experience on the ground in Saudi Arabia and the wider Middle East region, we have found that the Saudi Arabian authorities tend to draft the laws broadly as a deterrent mechanism, while enforcement of the law tends to be lax and followed by sufficient and numerous warnings. It should be noted that there is an emerging trend for Saudi authorities to strictly enforce regulations and issue stiff penalties to violators. This trend is evident in the capital market where the Capital Market Authority regularly penalises companies and announces the fines on *Tadawul*.

What does it mean for corporate governance regulation in other GCC countries?

While Saudi Arabia is the dominant economic force in the GCC region, it tends to lag behind its peers in the realm of legal reform. Developments in corporate governance regulations have been rolled out in certain industries, such as banking and insurance, but have yet to be fully developed with respect to limited liability companies. For example, the UAE's Commercial Companies Law was last updated on 1 July 2015, the Qatari Commercial Companies Law was last updated on 7 July 2015 and the Omani Commercial Companies Law was last updated on 20 July 2014. In contrast, the Saudi Arabian companies law regime has remained largely unchanged. For that reason, the adoption of the New Companies Law likely will not have any significant impact on corporate governance regulation in other GCC countries.

What's next?

Given the increased personal risk to individuals who serve as officers and directors for Saudi Arabian companies, the likely result is that these individuals will demand higher compensation to reflect the higher degree of risk. Alternatively, individuals who serve as officers and directors for Saudi Arabian companies may simply determine that the personal risks outweigh the economic benefits of their roles. Directors will be under pressure to ensure compliance with regulations not only in publicly listed companies, but also closed joint stock companies and limited liability companies. This will result in the board putting a greater emphasis on the compliance function and elevating the role of compliance officers.

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