

# Saudi Arabia

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## Taking Security in the Kingdom of Saudi Arabia

### Introduction

The Kingdom of Saudi Arabia is a nation with significant requirements for soft and hard infrastructure. Historically, the responsibility for procuring this infrastructure has been borne by the Government. However, in conjunction with the development of the Kingdom's vision for social reform and economic diversification (Saudi Vision 2030), the Kingdom is rethinking how it will meet its infrastructure requirements in the future.

As well as calling for a greater focus on the development of non-oil and gas related industries (which creates additional infrastructure demand in and of itself), Saudi Vision 2030 envisions greater participation by the private sector (i.e., through the use of "public private partnerships" and other models where private sector participants bear funding responsibility) in developing the Kingdom's infrastructure. This increased participation by the private sector can be expected to result in a spike in the use of limited recourse debt finance.<sup>1</sup> Although many limited recourse debt financings have been successfully closed in the Kingdom,<sup>2</sup> the laws of the Kingdom have historically presented some challenges for lenders seeking a robust security package in connection with limited recourse debt financings that is comparable to security packages seen in other jurisdictions.

<sup>1</sup>Limited recourse debt finance is seen by private infrastructure developers as the optimal financing model because recourse to developers is restricted to their ownership interest in the applicable infrastructure project (although, in exceptional circumstances, developers may be required to provide additional support) and it enables developers to borrow a large percentage of the development cost of the applicable infrastructure project (thereby maximizing a developer's return on equity). Under a limited recourse debt financing, the borrower is a special purpose vehicle (the "**Project SPV**") that is established to develop the applicable infrastructure project. As a condition to making the debt financing available to the Project SPV, the lenders will typically obtain a 'security package' comprising each developer's shares in the Project SPV (typically effected through a 'pledge of shares') and the assets of the Project SPV (which will include security over the Project SPV's (a) fixed assets, plants and machinery; (b) local and offshore bank accounts; (c) rights under contracts; and (d) rights to receivables under insurance and reinsurance policies).

<sup>2</sup> Lawyers from Shearman & Sterling LLP have worked on many of the most high-profile limited recourse debt financings in the Kingdom, including the financings of the Sadara Integrated Chemicals Project, Shuaba S3, the Ma'aden/Alcoa Aluminium Joint Venture, the Fadhili IPP, the Rabigh IPP, the Marafiq Jubail IWPP and the \$5 billion green hydrogen / ammonia megaproject being conducted by NEOM, ACWA Power and Air Products.

*This article examines some of the key issues that are typically faced when taking security over assets in the Kingdom. It begins with a quick overview of the Saudi legal system<sup>3</sup> and then sets out the key issues with respect to movable tangible assets, real estate, intangible assets and shares. This article also discusses the role of powers of attorney in taking security.*

## Laws of the Kingdom

Granting and taking security in the Kingdom is governed by statutory provisions and general Islamic law (Shari'ah) principles, upon which the laws of the Kingdom are based. The two main sources of Shari'ah are the Qur'an and the writings detailing the Prophet Mohammed's sayings and actions (known as the Sunnah). Shari'ah is the basis of the Kingdom's constitution. In Shari'ah, there are four main schools of jurisprudence, namely: Hanbali, Hanafi, Shafai and Maliki. The Kingdom's courts and judicial committees generally follow the Hanbali school.

The Kingdom's government, from time to time, issues rules and regulations with the objective of supplementing (but not contravening) the provisions of Shari'ah when the need arises. As a result, in addition to provisions of Shari'ah, several laws and regulations have been enacted addressing pledging movable property, shares in companies, taking security over registered trademarks and mortgages over real estate.

## Taking Security Over Movable Tangible Assets

### General

Under the Hanbali school, it is permissible to create a security interest known as a '*rahn*' (a term which means 'pledge' as well as 'mortgage') in respect of collateral, from which it is possible to obtain payment or satisfaction of a debt. This is supplemented by the Moveable Assets Security Law<sup>4</sup> (the **MASL**) and the Implementing Regulation of the MASL (both recently enacted),<sup>5</sup> as well as the Commercial Pledge Law<sup>6</sup> (the **CPL**) and the Implementing Regulations of the Commercial Pledge Law,<sup>7</sup> which address the creation, perfection and enforcement of security interests over movable property. It is worth noting that the CPL has been substantially amended pursuant to Royal Decree No. M/94 (implementing Cabinet of Ministers Resolution No. 512 dated 14/08/1441H (corresponding to 7 April

<sup>3</sup> For a more detailed analysis, you may wish to refer to our separate article entitled 'Introduction to the Legal System of the Kingdom of Saudi Arabia.'

<sup>4</sup> Enacted by Royal Decree No. M/94 dated 15/08/1441H (corresponding to 8 April 2020).

<sup>5</sup> Issued by Ministerial Resolution No. 00312 dated 19/08/1441H (corresponding to 12 April 2020).

<sup>6</sup> Enacted by Royal Decree No. M/86 dated 08/08/1439H (corresponding to 24 April 2018), as amended by Royal Decrees No. M/19 dated 09/02/1441H (corresponding to 8 October 2019) and No. M/94 dated 15/08/1441H (corresponding to 8 April 2020).

<sup>7</sup> Issued by Ministerial Resolution No. 43902 dated 10/08/1439H (corresponding to 26 April 2018).

2020)) and matters such as perfection, self-help remedies and enforcement of pledges are now dealt with under the MASL and not the CPL. For example, prior to the 2020 amendments, the CPL required the pledge agreement to state the condition and value of the pledged assets. This is no longer required. Another notable change is that assignments are now registrable security interests under the MASL, whereas it was not possible to register assignments under the CPL.

### **Scope of the MASL**

The MASL applies to any contract or transaction that includes the creation of a security interest over movable property, and in particular the following:

- commercial pledge (see below);
- sale of movable property with stipulation for its recovery or repurchase;
- transfer of ownership of movable property for the purpose of security;
- sale of the movable property on the condition that the transfer of its ownership is deferred until the price is paid;<sup>8</sup>
- assignment of right by way of security;<sup>9</sup> and
- sale of rights in receivables.

The MASL does not apply to security interests in respect of: (i) ships and aircraft; (ii) securities listed in the financial market; (iii) goods deposited in public warehouses unless the security interest has been granted before the deposit; (iv) trademarks; (v) investment accounts; (vi) assets with ownership registers wherein the security interests are recorded.<sup>10</sup>

The MASL does not otherwise define what constitutes movable property for the purposes of the MASL. Article 3 of the MASL states that collateral can be any movable property, whether tangible or intangible, existing or future, or existing or future rights and whether owned by the guarantor (i.e.,

<sup>8</sup> I.e., the retention of title clause (a.k.a. Romalpa clause).

<sup>9</sup> Assignment of right by way of security is defined in the MASL as an agreement between a creditor and another person under which the latter offers its rights held with third parties to secure payment of his debt towards the creditor. As a result, the assignor needs to be the debtor to be able to grant a valid assignment of right by way of security. It is a general Shari'ah principle that assignments of rights under a contract are not effective against the counterparty to the contract unless the consent of the counterparty to such an assignment is explicitly obtained. This principle is subject to statutory exceptions set out in the Real Estate Finance Law, the Finance Leases Law and the Registered Mortgage Law.

<sup>10</sup> Article 5, MASL. Taking security interests in these categories of assets are subject to various laws and regulations specific to those assets. For example, pledges of listed shares are regulated by the Regulatory Rules and Procedures issued pursuant to the Companies Law relating to Listed Joint Stock Companies (see below).

the provider of security interest) or third parties.<sup>11</sup> A security interest can be created to secure all kinds of obligations: monetary or non-monetary, present or future, conditional or unconditional.

### **Creation of Security Interest**

To create a valid security interest over movable property and to ensure its enforceability against its parties, the security interest must satisfy the requirements of Article 6 of the MASL:

- The security interest must be in a written contract. The contract can be a standalone contract (e.g. a pledge or an assignment agreement) or form part of another contract (e.g. a pledge or assignment clause is incorporated into a shareholders' agreement).
- The guarantor must have the right to grant the security interest in question.
- The secured obligation must be described in a general or specific manner, with the statement of maximum amount for which the security interest may be enforced. This means that it is not possible to use an 'all monies' formulation when describing the secured obligation.
- The collateral must be described in a general or specific manner that reasonably allows its identification (this includes a description indicating that they form all the guarantor's property, or a specific or generic category or type of the guarantor's property).
- The secured creditor must pay or commit to pay consideration for the secured obligation.
- The security interest may secure one or more obligations, whether the obligation is prior to the date of creating the security interest or coinciding therewith or subsequent thereto.

### **Effectiveness of Security Interest**

The MASL sets out two methods of ensuring the effectiveness (i.e. perfection) of a security interest against third parties: by registration in the Unified Register of Rights on Moveable Assets (the "**Unified Register**") or through a direct or indirect transfer of possession of the collateral (whether

<sup>11</sup> Article 3 of the MASL contains a non-exhaustive list of movable property that may be given as collateral: (i) rights held by third parties, whether due or deferred, including receivables; (ii) accounts with banks and other financial institutions, including deposit accounts and current accounts; (iii) negotiable instruments that can be transferred by delivery or endorsement and evidencing the entitlement to an amount or ownership of goods, including commercial papers, bank certificates of deposit and bills of lading; (iv) vehicles and the like; (v) equipment and work tools; (vi) inventory (i.e., tangible assets held for sale or lease, including raw materials and materials under manufacturing and process); (vii) animals and products thereof; (viii) agricultural crops; (ix) fixtures (i.e., a movable asset that is permanently attached to a property, for the purpose of its service and use); and (x) trees (even before cutting them) and minerals (even before extracting them).

de facto or de jure) to the secured creditor (but see discussion on priority of security interests below).

According to Article 3 of the Implementing Regulations of the MASL, possession is the only way to ensure effectiveness of the security interest against third parties if the collateral is any of the following:

- written bonds transferable through endorsement or delivery, of which the possession will be by endorsement to the secured creditor, delivery thereto or to trustee (*adl*);
- credit accounts at banks and other financial institutions, including a deposit account, a current account and a savings account;<sup>12</sup> and
- cash amounts unless they are proceeds of collateral over which a security interest has been granted that is enforceable against third parties.

If the collateral is a right in the hands of a third party, then notwithstanding the above two methods the security interest will only be effective against that third party from the date of informing the third party of the creation of the security interest over the right.

If the secured creditor assigns a security interest that is effective against third parties pursuant to the MASL (for example, in connection with an assignment or transfer of the underlying debt), the assignment is not required to be registered in the Unified Register and the security interest will remain effective against third parties.

The registration by the secured creditor of a security interest in the Unified Register requires the guarantor's written consent. The registration is done online on the website of the Unified Register. Any person may search the Unified Register and for a fee obtain a certified extract therefrom.

### **Priority of Security Interests**

The guarantor may create one or more security interests over the same collateral. Article 19 of the MASL sets out the following priority rules as between secured creditors:

- A security interest effective against third parties in the manner stipulated in the MASL will have priority over other security interests which have not been effective against third parties in the manner stipulated in the MASL. This would presumably cover a situation where, for example, a registered pledge over

<sup>12</sup> Despite possession being the only method of ensuring the effectiveness of certain security interests, for example a pledge, over a bank account, we understand from our informal discussions with the Unified Register that it is possible to register such pledge with the Unified Register. Arguably, the benefit of registration is that it would give notice of the pledge to third parties.

equipment will have priority over another unregistered pledge over the same equipment.

- A security interest effective against third parties by registration will have priority over other effective security interests. This would presumably cover a situation where, for example, a registered pledge over equipment will have priority over another pledge over the same equipment which is effective by possession.<sup>13</sup>
- If there are several security interests that were made effective against third parties by registration, then priority will be given to the secured creditor whose registration was first in time.
- If there are several security interests that were made effective against third parties by transfer of possession, then priority will be given to the secured creditor whose possession was first in time.
- As between security interests that were not made effective against third parties, then priority will be given to the secured creditor whose security interest was created first in time.

The payment of an obligation secured by a security interest effective against third parties will, to the extent that such obligation can be discharged by the proceeds from such security, have priority over other debts of the debtor, including employee and government dues (e.g. taxes, social contributions etc.). Any remaining debt not satisfied from the proceeds of such security will become an unsecured debt.<sup>14</sup>

#### **Enforcement of Security Interest**

In addition to enforcement through the Execution Court,<sup>15</sup> the guarantor and the secured creditor may agree to authorize the latter to carry out non-judicial execution (i.e., self-help remedies) against the collateral in case of the debtor's default in discharging the secured obligations provided that this is agreed in writing prior to the default. The secured creditor's self-help remedies may include selling the collateral by auction, direct sale or purchase by the secured creditor to satisfy its claims. It is worth noting that if the guarantor becomes subject to a bankruptcy

<sup>13</sup> However, it is assumed that security interests that are effective by possession only (e.g. a pledge over a bank account) will not lose priority to a prior or subsequent pledge over the same bank account in favour of a different pledgee which has been registered (if permitted by the Unified Register). The bank is typically a party to a pledge over bank accounts where the pledgee is not the bank itself.

<sup>14</sup> MASL, Art. 20 and 26(3).

<sup>15</sup> The Execution Court is the competent court for the enforcement of judgments, arbitral awards, contracts and other execution documents set out in the Execution Law (enacted by Royal Decree No. M/53 dated 13/08/1433H (corresponding to 3 July 2012)) and its Implementing Regulations (issued by Minister of Justice Circular No. 13/T/4892 dated 17/04/1434H (corresponding to 28 February 2013)).

procedure under the Bankruptcy Law,<sup>16</sup> the enforcement of security interests against the guarantor could be affected by restrictions (e.g., a moratorium on creditor claims) imposed on secured claims or open to challenges (e.g., security interests granted during the “look-back” or “hardening” period).<sup>17</sup>

### Commercial Pledge

The CPL and the its Implementing Regulations deal with taking commercial pledges over movable property to secure a debt which can be all kinds of obligations, present or future, conditional or unconditional, monetary or non-monetary.<sup>18</sup> Unlike the MASL, the CPL contains a definition of movable property, namely any existing or future movable property<sup>19</sup> or any future right.<sup>20</sup> Assets such as ships, aircraft, commercial papers, securities traded on the capital market, shares of unlisted joint stock companies, goods deposited in public warehouses, trademarks and other properties, the pledge of which is subject to the provisions of separate laws and regulations, are excluded from the scope of the CPL. However, if those laws and regulations do not regulate an issue which is covered by the CPL, then such assets will be subject to the provisions of the CPL in respect of such matter. As noted above, the MASL covers commercial pledges. Therefore, commercial pledges are subject to the CPL and the MASL.

The pledged property must be saleable or its worth must be capable of being valued. The pledgee must be the owner of the pledged property at the time of conclusion of the pledge contract and have legal capacity to dispose of the same. It is permissible to pledge a future property provided that it is probable that the pledgor will become the owner of such property. In such a case, the pledge will be valid from the date of the pledge contract and not from the date of availability of the future property or its acquisition by the pledgor or its conversion into movable property. The

<sup>16</sup> Enacted by Royal Decree No. M/50 dated 28/05/1439H (corresponding to 15 January 2018).

<sup>17</sup> For a detailed analysis of bankruptcy procedures under the Bankruptcy Law, see our article entitled “How debtors in Saudi Arabia can manage insolvency risk post-Covid 19.”

<sup>18</sup> Article 2(a) of the CPL requires a pledge contract to include the following information: (i) the names of the pledgor, pledgee and debtor (if the pledgor is an in-kind guarantor) and trustee (*adl*), if appointed, and the identity of the possessor of the pledged property from among them, their addresses and contact details; (ii) a description of the pledged property; (iii) a general description of the secured debt or its amount, or its maximum amount, as the case may be (therefore, it is not possible to use an ‘all monies’ formulation when describing the secured debt); (iv) the date of the pledge contract; and (v) the date or expected date of maturity of the secured debt.

<sup>19</sup> Future property is defined in the CPL as “contingent or existing assets which the pledgor does not have full ownership at the time the pledge contract is concluded, such as contracted assets, movable assets under construction or assets which are not considered to be movable property at the time the pledge contract is concluded.”

<sup>20</sup> Future right is defined in the CPL as “debt which a person commits to pay to the pledgor within a time limit, or a debt which becomes due but not collected, including conditional debts constituting the liability of a third party for the benefit of the pledgor, or contingent third-party liabilities.” Future rights are essentially receivables.

CPL also allows taking a pledge over a business entity (economic enterprise), distinct from taking a pledge over the shares of a company. In such a case, the pledgor (business entity) will grant a pledge over its movable property (tangible and intangible).

A pledge contract will be effective against third parties by registration in the Unified Register or by transfer of possession of the pledged property to the pledgee or a third-party trustee (*adl*) in accordance with the MASL.

### Taking Security Over Real Estate

The Registered Mortgage Law<sup>21</sup> (the **RML**) governs the grant of mortgages over real estate in the Kingdom. The RML provides that, to be effective and enforceable against third parties, the mortgage agreement must be in writing and be duly registered by notation on the deed of ownership as held by a court or notary public.<sup>22</sup> The real estate must be in existence, owned and capable of sale by the mortgagor or its duly authorised agent. The mortgage must be in respect of a specified debt amount or up to a specified maximum amount of debt to be incurred in the future. As such, it is not possible to use the ‘all monies’ formulation as a reference to the underlying debt obligation. The mortgagor may not dispose of the mortgaged property, unless agreed otherwise, and such agreement is documented in the deed and register of such mortgaged property.

Where the mortgagor is not able to meet its debt obligations secured by the mortgage as they fall due, the mortgagee obtains the right to request the sale of the property<sup>23</sup> and the right to appropriate proceeds from any such sale in order to satisfy the mortgagor’s debt obligations. Any unpaid balance of the debt obligation will become an unsecured debt.

Importantly, notaries public in the Kingdom have historically refused to notarise mortgages over real property in favour of banks and financial institutions on the grounds that such lenders charge interest which is a violation of Shari’ah principles. It has therefore been the practice in the Kingdom to utilise an alternative *Ifragh* structure for securing debt obligations over real estate. The *Ifragh* structure requires the borrower to transfer legal title in favour of the lender’s special purpose vehicle until the debt is repaid, with an agreement to retransfer title once the amounts outstanding have been repaid. It should be noted that on 22 May 2017, the Saudi Arabian Monetary Authority (which is the Central Bank of the Kingdom) issued a circular stating that the *Ifragh* structure would no longer

<sup>21</sup>Enacted by Royal Decree No. M/49 dated 13/08/1433H (corresponding to 3 July 2012).

<sup>22</sup>The RML provides for alternative provisions for properties registered on the Real Estate Register. However, as of the date of this article, the Real Estate Register has yet to be formally implemented and, currently, real estate property records are kept and administered by notaries public in each locality.

<sup>23</sup>The sale of the secured property will be carried out by way of public auction. The mortgagor and the mortgagee may agree to sell the secured property directly to a specific purchaser and thereby avoid the auction process and expenses.



be permissible and that all security over real estate would have to be registered as a mortgage under the RML. We understand that some local banks have been successful in registering mortgages over real property.

## Taking Security Over Intangible Assets

### Intangibles Assets Incapable of Registration

Security over intangible assets incapable of registration cannot be effected by a pledge since, given the fact that such an asset is intangible and therefore not capable of giving possession of and delivered to the pledgee, the legal requirement of possession or deemed possession for an effective pledge cannot be satisfied. For example, it is not possible to take an effective pledge over intellectual property rights (other than trademarks) such as goodwill and customer lists.

### Trademarks

Trademarks are intangible assets capable of registration. The pledging of trademarks in the Kingdom is governed by the Gulf Cooperation Council Trademark Law<sup>24</sup> (the **GCCTL**) and its Implementing Regulations.

The pledge becomes effective vis-à-vis third parties once it has been recorded in the Trademarks Register maintained by the Saudi Authority for Intellectual Property (**SAIP**), which is the competent authority in charge of intellectual property matters in the Kingdom,<sup>25</sup> and the notice of the pledge has been published in the bulletin issued or determined by SAIP.

## Taking Security Over Shares

### Participation Interests of a Limited Liability Company

Until the recent amendments to the CPL (effective as of 17 April 2020<sup>26</sup>), the granting of a pledge over the participation interests of a limited liability company was expressly permitted under the CPL.<sup>27</sup> Participation interests in limited liability companies are not specifically listed in Article 3 of the MASL as movable assets capable of being used as collateral to create a security interest.<sup>28</sup> We understand from our informal discussions with the

<sup>24</sup> Enacted by Royal Decree No. M/51 dated 26/07/1435H (corresponding to 25 May 2014). The GCCTL and its Implementing Regulations were published on 1 July 2016 and became effective on 29 September 2016.

<sup>25</sup> Council of Ministers No. 410/1438 Approving the Regulatory Arrangements of the Saudi Intellectual Property Authority.

<sup>26</sup> Amended version of the CPL became effective on the date of its publication in the Official Gazette Issue No. 4827 dated 17 April 2020.

<sup>27</sup> Old Article 37 of the CPL.

<sup>28</sup> See footnote 11 above.

Ministry of Commerce that pledges over participation interests in limited liability companies fall within the broad definition of movable assets in Article 3 of the MASL and that such pledges are registrable in the Unified Register.

### **Shares in Unlisted Joint Stock Companies**

Taking a pledge over shares in a non-listed joint stock company (**NJSC**) is governed by the Regulations of Non-Listed Joint Stock Companies<sup>29</sup> (the **RNJSC**) and, more generally, the Companies Law.<sup>30</sup>

A registered shareholder of an NJSC is permitted to pledge its shares, provided that:

- where the shareholder is a corporate entity, all required regulatory approvals from the authorities which exercise regulatory supervision over the corporate entity and internal corporate authorisations for such pledge have been obtained; and
- the pledge contract meets the statutory requirements set out in Article 36 of the RNJSC.<sup>31</sup>

To be effective vis-à-vis third parties, the pledge must be registered. Registration consists of registering the pledge in the company's share register and including a note on the relevant share certificates to reflect their pledged status.

Upon perfection of the pledge over NJSC shares, the pledgee may receive the dividends due from the pledged shares and enjoy all rights attached to such shares, unless agreed otherwise in the pledge agreement. Such rights are subject to not being able to attend or vote at the general assembly or special assembly meetings of the company.

### **Shares in Listed Joint Stock Companies**

Taking a pledge over shares in a listed joint stock company is governed by the Regulatory Rules and Procedures issued pursuant to the Companies Law relating to Listed Joint Stock Companies.<sup>32</sup> The perfection of the pledge is carried out by registration of the pledge in the company's share

<sup>29</sup> Enacted by Decision of the Minister of Commerce and Investment dated 25/02/1438H (corresponding to 25 November 2016), as amended.

<sup>30</sup> Enacted by Royal Decree No. M/3 dated 28/01/1437H (corresponding to 10 November 2015).

<sup>31</sup> A pledge contract must: (i) be in written form, setting out the names of the pledging shareholder, pledgee and beneficiary creditor (if different than the pledgee), their identification numbers (i.e., ID number for individuals and commercial registration number for legal entities) and their addresses; (ii) set out the number of pledged shares and their nominal value, the name of the issuing company and its commercial registration number; (iii) set out the amount of the debt secured by the pledge or the maximum debt amount permitted by the pledge (as such, it is not possible to use the 'all monies' formulation as a reference to the underlying debt obligation); (iv) set out the name of the debtor (if the debtor is different from the pledging shareholder), his/her identification number and his/her address; (v) state the date of the pledge agreement; (vi) state the conditions and terms of releasing the pledge; and (vii) set out any other conditions agreed upon by both parties.

<sup>32</sup> Issued by the Board of the Capital Market Authority pursuant to Resolution No. 8-127-2016 dated 16/01/1438H (corresponding to 17 October 2016), as amended.

register held at the Securities Depository Centre and delivery of a certified copy of the pledge agreement to the Securities Depository Centre.

### **Power of Attorney by Way of Security**

It is not uncommon to see provisions in loan or mortgage agreements where a borrower/mortgagor purports to grant the lender/mortgagee the authority to take an action on its behalf which might be deemed to amount to an agreement creating a relationship similar to that of a power of attorney or agency. In practice, powers of attorney granted by Saudi Arabian persons or entities for use in the Kingdom are made before a competent notary public using the standard form power of attorney. Under the laws of the Kingdom, it is not possible to grant an irrevocable power of attorney. Therefore, even if expressed to be irrevocable, the grantor of a power of attorney may revoke it at any time. A power of attorney may not be enforceable under the laws of the Kingdom if it is construed as a security mechanism or as a self-help remedy in the absence of legal proceedings authorising the same.

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