COMPANY & COMMERCIAL - SAUDI ARABIA

Liability of managers and directors under Saudi Arabian law

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Introduction

Management liability is a central concern for investors. It provides a means of control over persons with wide authority to dispose of investors' assets by establishing accountability of managerial staff. Further, understanding the relevant management liability regime in the country in which a manager or director is employed is relevant to all parties. Directors and managers must understand what duties a specific legal system imposes on them and the consequences of failing to comply. A review of Saudi Arabia's management liability regime is of particular interest, not only because foreign investors continue to extend their investment in the country, but also because Saudi Arabia recently passed a new commercial company law.

The liability of the person(s) charged with the management of a corporation is relevant not only for the manager, but also for the company and its shareholders. The principal purpose of management liability provisions is to influence management conduct and induce desired behaviour. By virtue of their position and the authority bestowed on them by law and agreement, persons entrusted with the management of a corporation assume far-reaching competences with respect to the administration of assets of third parties (ie, the shareholders of the relevant corporation and other investors). Further, where the liability of the relevant entity is limited and thus its creditors have no recourse against its shareholders creditors and the market in general have an interest in these corporations being managed soundly and diligently. To serve these interests, management liability regulations seek to encourage behaviour that will minimise risks through establishing responsibility for managerial conduct.(1)

However, this deterrent effect poses a risk for the company and its sound operation. Where management liability is too restrictive, managers may become overly cautious and avoid transactions or business opportunities with even moderate risk. This might considerably harm the business of a corporation. Consequently, a balance must be struck between encouraging management not to take unnecessarily high risks and allowing it to conduct the normal business of the company without constant concern of being held liable for acceptable risks.

Understanding the management liability regime in the jurisdiction in which a company is incorporated is not only relevant for local managerial staff in order for them to appreciate their liability exposure, but also for the corporation and its shareholders. Where the existing management liability regime is unsatisfactory for investors, they may choose to amend it by agreement. This may be of particular importance where a local subsidiary will be subjected the control of its parent company.

As the management and administration of different forms of corporation pose different challenges and requirements for their management, the liability of the persons vested with the management of a particular form of corporation may vary noticeably. This update focuses on the regulation of the liability of managers of the two most frequently used corporations in Saudi Arabia:

- limited liability companies (LLCs);(2) and
- joint stock companies (JSCs).(3)

Overview

Unlike the legal systems of its neighbours, Saudi Arabian law is based nearly entirely on Islamic law, as interpreted by the Hanbali school of law. Consequently, Saudi Arabian law is governed much less by codifications and instead by *Sharia* law in other words, the Islamic law principles derived from an interpretation of the three sources of law accepted by the Hanbali school of Islamic law:

- the *Quran*;
- the *Sunnah* (ie, the verbally transmitted record of the teachings and deeds of the prophet Muhammad); and
- the *Ijma*' (ie, the consensus of Islamic scholars).(4)

Apart from *Sharia* law,(5) codifications have been implemented in certain areas of law. Due to the primacy of *Sharia* law, as established by Article 48 of the Basic Law of the Kingdom of Saudi Arabia (Royal Decree A/90, dated August 27 1412 Hijri),(6) these codifications are subordinate to *Sharia* law. This means that they must be interpreted in line with *Sharia* principles. Where it is impossible to conform a codified provision with *Sharia* principles, *Sharia* law will prevail.(7) That said, Saudi Arabian corporate law is largely codified. However, since these codifications must be interpreted in line with *Sharia* principles and gaps therein will be filled by *Sharia* law, Islamic law remains highly relevant in Saudi Arabian corporate law.

Liability under Companies Law

The issue of management liability is regulated for both JSCs and LLCs in individual sections of the Companies Law(8) (Regulation of 1437 Hijri),(9) which was published in the Saudi Arabian *Official Gazette* on December 4 2015 and entered into force in May 2016. JSC directors' liability is governed by Article 165(2) of the Companies Law. The responsibilities of LLC managers is regulated by Article 78(1) of the Companies Law. Both provisions stipulate that persons engaged in the management of a company will be individually and jointly liable towards the company, its shareholders and third parties for:

- violations of their duties under the Companies Law;
- breaches of the company's articles; and
- errors of management.

Liability for fraudulent acts is not expressly mentioned in Articles 78(1) and 165(2) of the Companies Law. Nonetheless, since both articles stipulated extended statutes of limitation for fraudulent acts (Articles 78(3) and 165(4) of the Companies Law), it is clear that they both establish management liability for fraudulent acts.(10)

Where misconduct that would prompt liability of JSC directors under Article 78(1) of the Companies Law is based on a unanimous decision of the board of directors, all board members will be held liable. As for majority decisions, those directors who opposes a majority decision cannot be held accountable, provided that their objection was recorded in the minutes of the relevant board meeting. A director that was absent from the board meeting during which a decision prompting management liability was made will not be released from liability under Article 78(1) of the Companies Law, unless he or she can establish that he or she was unaware of the decision or unable to object to the decision after becoming aware of it (Article 78(2) of the Companies Law). Similar to Qatari law, the general assembly of a JSC may not release a director from its liability under Article 78 (1) of the Companies Law (Article 78(3)).

Liability claims against a director or manager are time barred three years after the harmful act being discovered. Where the harmful act was conducted fraudulently, the statute of limitations is five years (Articles 78(3) and 165(4) of the Companies Law).

Infringements

The duties of a manager of an LLC are not explicitly regulated by the Companies Law. Unlike as, for example, UAE or Qatari corporate law, the Companies Law does not establish that the provisions governing the duties of JSC directors must apply to the managers of an LLC accordingly. However, it was generally accepted that the old Saudi Arabian Companies Law (Royal Decree M/6 of 1385 Hijri) governing the duties of JSC directors applied to LLC managers analogously.(11) Since the management liability regime was not changed within the new Companies Law, it stands to reason that the same understanding will be applied to the new Companies Law, and the articles of the Companies Law governing the liability of JSC directors will be applied to LLC management. However, this interpretation has not yet been tested in front of the Saudi Arabian courts. However, even if the courts were to change their position with the new Companies Law, the duties imposed on JSC directors by the Companies Law are founded in *Sharia* law. Therefore, the same duties imposed on JSC directors under the Companies Law would apply to LLC managers under *Sharia* law, which remains applicable due to the priority of *Sharia* law over codifications of Saudi Arabian law.

General duty of loyalty

Saudi Arabian law does not explicitly impose a general duty of loyalty on directors to their company. While a general duty of loyalty appears to be founded in the more concrete duties bestowed on directors by the Companies Law (eg, see Articles 71 and 72 of the Companies Law), Article 75(1) of the Companies Law   the principle regulation on the powers of directors   provides only that directors must have the "widest authority"(12) to manage the company and does not limit such powers to the objective of the company. However, a general duty of loyalty derives from *Sharia* law. This duty may be derived from the director's classification as an agent of the company's shareholders or as trustee of the shareholders' assets.(13) Regardless which understanding of the director's position is applied, the doctrine generally accepts that *Sharia* law compels a director to act loyalty towards the company and treat all shareholders fairly.(14)

Non-competition

Pursuant to Article 72 of the Companies Law, a director may not engage in any commercial activity that is in competition with a business activity carried out by the company or conduct business in any branch of the activities carried out by the company, unless with the permission of the company. Permission must be issued by resolution of the general assembly and renewed every year. Notably, Article 72 of the Companies Law does not address the issue of a director competing with the company for third-party accounts. However, such a duty is established by Islamic law.(15) Considering the priority of *Sharia* law over the Companies Law, it is immaterial whether Article 72 of the Companies Law prohibits directors from competing with the company for third-party accounts. Where a director infringes this obligation, the company may choose to seek compensation under Article 78(1) of the Companies Law or consider the relevant transaction to be executed in its name and for its benefit (Article 72 of the Companies Law). Considering that the non-competition obligation is, among other things, founded in *Sharia* law, the manager of an LLC is bound to it regardless of whether Article 72 of the Companies Law will apply to LLC management.

Self-dealing

Article 71 of the Companies Law prohibits directors from having a direct or indirect interest in any transaction or contract concluded for the account of the company. Where a director contravenes this ban, he or she will be liable for any damage or loss caused to the company, its shareholders or third parties in this regard (Articles 71 and 78(1) of the Companies Law). Unlike its equivalent in Qatari law, Article 71 of the Companies Law allows directors to be released from the ban of self-dealing. Directors will typically be released by a resolution of the general assembly, which must be renewed annually. Whether Article 71 of the Companies Law can be applied analogously to managers of an LLC is irrelevant, since the same obligation exists under Islamic law as applied in Saudi Arabia.(16)

Use of insider information

According to Article 73 of the Companies Law, directors may not disclose insider information concerning the company. Where they infringe this obligation, they may be held liable for damages or loss caused by such indiscretion.

Duty to call extraordinary meeting of general assembly

If the losses of an LLC reach 50% of its capital thus, its liabilities amount to the value of its assets, plus 50% of its capital the manager(s) must, within 90 days of becoming aware of such losses, convene an extraordinary meeting of the general assembly to consider whether to continue or dissolve the LLC (Article 181 of the Companies Law). Where the shareholders resolve to continue the company, they must cover the losses of the company so that the company's assets amount to 100% of its capital.(17)

A similar requirement exists for JSCs. Article 150 of the Companies Law requires the directors of a JSC to convene an extraordinary meeting of the company's general assembly within 45 days of discovering that the losses of the company reached 50% of its capital in order to decide whether the company will be dissolved or its capital increased. Where managers or directors fail to comply with this duty, they may not only be held liable under Articles 78(1) and 165(2) of the Companies Law, but also may face punitive penalties pursuant to Article 211(d) of the Companies Law.

Infringement of company's articles

The Companies Law does not explicitly state that the duties of a director may be expended in the company's articles. However, this follows indirectly from the fact that the articles of association of a company may deviate from the Companies Law, insofar as the articles do not conflict with any binding provisions therein.(18) Thus, the company's articles may not relieve the director from any duties imposed by the Companies Law. That said, they may introduce additional duties. Considering the existing ambiguity regarding the analogous application of the provisions governing the duties of JSC directors to LLC managers , it is, for the sake of clarity, advisable to include these duties in the articles of an LLC incorporated in Saudi Arabia. In addition, foreign investors frequently choose to impose further duties and restriction of authority on directors and managers through the company's articles or other agreements to extend control over local management. As Articles 78(1) and 165(2) of the Companies Law refer only to the company's articles, their wording suggests that a breach of an obligation imposed on a director in an agreement other than the company's articles will not prompt management liability therein. If this were the case, the relevant director(s) may be held responsible under contractual or possibly tortious liability.(19)

Error of management

Neither Article 78(1) nor Article 165(2) of the Companies Law define what constitutes an 'error of management' that would prompt liability of management under these provisions. Thus, even minor mistakes could produce management liability according to Articles 78(1) and 165(2) of the Companies Law. Since this would significantly hinder the operation of a company, economic considerations suggest that an error of management within the meaning of Articles 78(1) and 165(2) should be interpreted more restrictively. Nonetheless, since no relevant jurisprudence is available from the Saudi Arabian courts, it is unclear whether the courts would follow this interpretation.

Fraudulent act

The liability of JSC directors and LLC managers for damages or loss caused by their fraudulent actions is provided for by Articles 78(1), 78(3), 165(2) and 164(4) of the Companies Law. However, what constitutes a fraudulent act is not defined by the law. Under Islamic law, 'fraud' is generally understood as:

- the suggestion as a fact of something untrue by someone who does not believe his or her statement to be true; or
- the suppression of that which is true by someone with knowledge of that fact.(20)

Whether the Saudi Arabian courts will apply this definition of 'fraud' in respect of management liability is uncertain, since no relevant jurisprudence is available.

Abuse of authority

Directors' liability for abuse of their authority is also not mentioned in Articles 78(1) and 165(2) of the Companies Law. Further, a duty not to exploit managerial powers is not expressly mentioned in the Companies Law.(21) Nevertheless, management liability for abuse of authority is generally considered to be established by the Companies Law.(22)

Liability under Corporate Governance Regulation

Directors of a publicly listed JSC are bound to the Capital Market Regulation, issued by the board of the Capital Market Authority pursuant to Resolution 1/212 of 2006 (October 21 1427 Hijra).(23) It establishes, among other things, corporate governance duties and responsibilities in addition to those deriving from the Companies Law. These include setting out rules of internal control (Article 10(b) of the Capital Market Regulation) and internal codes of conduct (Article 10(c) of the Capital Market Regulation). Further, some of the duties established by the Companies Law are reaffirmed in the Capital Market Regulation (eg, the ban of self-dealing without the permission of the general assembly (Article 18(a) of the Capital Market Regulation and Article 71 of the Companies Law, respectively) or the obligation not to compete with the company without the approval of the general assembly (Article 18(b) of the Capital Market Regulation and Article 72 of the Companies Law, respectively)). However, the Capital Market Regulation contains no clause holding directors liable for breaching their obligations under the regulation.(24) Thus, liability for a violation of a director's duties will unless the violation also constitutes an infringement of the Companies Law likely be available only under tort.

Penalties and punitive measures
Further, directors may be penalised pursuant to Article 212 and following of the Companies Law. The most severe penalties are provided for in Article 211 of the Companies Law, which stipulates that a director may be punished by incarceration for up to five years or a fine of up to Sr5 million for conduct (eg, misuse of funds and forgery of a company's financial records) listed in Articles 211(a) through 211(e) of the Companies Law. Notably, Article 211(d) of the Companies Law penalises directors for failing to call for an extraordinary meeting of the general assembly pursuant to Articles 150 and 181 of the Companies Law. Somewhat less severe punishments for misconducted are provided for in Article 212 of the Companies Law, which penalises making misrepresentations regarding the company to the public with imprisonment of up to one year and/or fines of up to Sr1 million. Finally, certain lesser offenses may be punishable by fines of up to SR500,000 pursuant to Article 213 of the Companies Law. These include, among other things, not calling for the regular annual general assembly or preventing a shareholder from participating in a general assembly.

While penalties under Articles 211 and 212 of the Companies Law will be imposed by public prosecution, fines according to Article 213 of the Companies Law will be imposed by the Ministry of Commerce and Industry or the Capital Market Authority.

Comment

While Saudi Arabian law is chiefly based on Islamic law, its corporate law is largely codified. Therefore, management liability is mostly regulated by codified law. That said, some provisions of Islamic law must be consulted in order to clarify certain ambiguities and gaps in the relevant statues. The management liability regime of Saudi Arabia establishes the liability of managerial staff towards the company, its shareholders and third parties. Managers may be held liable for infringement of the Companies Law, breach of the company's articles of association and errors in management. In principle, Saudi Arabian law comprises a management liability regime that is quite similar to that of European jurisdictions. However, managements' responsibilities with respect to preventing over-indebtedness under Saudi Arabia law are much stricter than in western jurisdictions. However, the Saudi Arabian provision are similar to those of the other Gulf Cooperation Council companies.

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Endnotes

(1) Cf B Frisch, *Haftungserleichterung für GmbH-Geschäftsführer nach dem Vorbild des Arbeitsrechts* (Duncker & Humbolt, 1998), at 234.

(2) LLCs under Qatari, Saudi Arabian law and UAE law are more or less comparable to LLCs under Austrian, German and Swiss law.

(3) JSCs under Qatari, Saudi Arabian law and UAE law are more or less comparable to JSCs under Austrian, German and Swiss law.

(4) For an overview of the sources of Islamic law see H G Ebert, J Heilen, *Islamisches Recht. Ein Lehrbuch* (Edition Hamouda, 2016, at 49 and following; A Nerz, *Das Saudi-arabische Rechtssystem. Eine Darstellung anhand ausgewählter Rechtsgebiete*, 2nd ed (EHV Academicpress, 2014), at 7 and following; W B Hallaq, *An Introduction to Islamic Law* (Cambridge University Press, 2009), at 16 and following. The fourth source of Islamic law, the Qiyas (the deductive analogy by which the other three sources of Islamic law are applied to new circumstance), is not recognised by the Hanbali school and thus not relevant in Saudi Arabian law; cf A R I Doi, *Shari'ah. Islamic Law*, 2nd ed (Ta-Ha Publishers, 2008), at 71; I A Haqq, "Islamic Law. An Overview of its Origins and Elements" in H M Ramadan, *Understanding Islamic Law. From Classical to Contemporary* (AltaMira Press, 2006), at 28; A Nerz, *supra* n 4, at 25.

(5) Since Saudi Arabia applies *Sharia* law as interpreted by the Hanbali school, any reference made to *Sharia* law in this section should be understood as referring to *Sharia* law as interpreted by the Hanbali school.

(6) Arabic original text available at www.wipo.int/wipolex/en/text.jsp?file_id=200020. Unofficial English translation available at www.saudiembassy.net/about/country-information/laws/The_Basic_Law_Of_Governance.aspx.

(7) C H Johnson, R E Pump, "Kingdom of Saudi Arabia" in D Campbell, C Campbell, *Legal Aspects of Doing Business in the Middle East*, 2nd ed (Juris, Release 4, 2015), at KSA-7 and following; A Nerz, *supra* n 4, at 55 and following; I Usa, *Saudi Arabia. Company Laws and Regulations Handbook*, vol 1 (International Business Publications, 2015), at 46.

(8) The Saudi Arabian legislature refers to codifications issued by it not as law, but rather as regulation or decree to emphasise the primacy of *Sharia* law. This publication uses the term 'law' when referring to Saudi Arabian legislation only in order to maintain consistency of language. No statement as to the status of Saudi Arabian codifications in respect of *Sharia* law shall be incurred by such reference.

(9) Arabic original text available at http://mci.gov.sa/cl2015/Documents/01.pdf.

(10) In any case management, liability for fraudulent acts is established by Islamic law; N A Saleh, *The General Principles of Saudi Arabian and Omani Company Laws. Statutes and Shari'a* (Namara Publications, 1981) at 91.

(11) N A Saleh, *supra* n 10, at 81.

(12) Where not indicated otherwise, citations of laws are citations from the Arabic original text translated by the author.

(13) See, for example, M K Hassan, M Mahlknecht, *Islamic Capital Market. Products and Strategies* (Wiley, 2011), at 180; G Bilal, "Business organization under Islamic Law. A Brief Overview", in Centre for Middle Eastern Studies, *Proceedings of the Third Harvard University Forum and Islamic Finance. Local Challengers, Global Opportunities* (Havard University Press, 1999), at 84; T Frankel, *Fiduciary Law* (Oxford University Press, 2011), at 84 and following.

(14) T Frankel, *supra* n 13, at 84 and following.

(15) Islamic law requires a director to act trustworthy and with transparency. This duty is generally considered to comprise a duty not to compete with the company; see, for example, N A Saleh, *supra* n 10, at 118; F S Al Kahtani, *Current Practice of Saudi Corporate Governance. A Case of Reform* (Brunel University, 2013), at 123 and following.

(16) N A Saleh, *supra* n 10, at 109.

(17) Under Article 180 of the old Companies Law, the shareholders of an LLC would lose the limitation of their liability if they refused or failed to decide whether the company should be dissolved or continued. This consequence was abandoned in Article 181 of the Companies Law.

However, companies and shareholders may now face punitive penalties under Article 211(d) of the Companies Law, should they fail or refuse to make such a decision.

(18) See, for example, Articles 52(6) and 62(2) of the Companies Law.

(19) For an overview of contractual liability under Islamic law see, for example, A Nerz, *supra* n 4, at 48 and following; M. Muslehuddin, *Concept of Civil Liability in Islam and Law of Torts* (Islamic Publications, 1982), p 54. For an overview on tortious liability under Islamic law see, for example, A B B Mohamad, "Islamic Tort Law" in M Bussani, A J Sebok, *Comparative Tort Law. Global Perspective* (Edward Elgar Publishing, 2015), at 441 and following; *ibid*. "Strict Liability in Islamic Tort", 39(3) *Islamic Studies* (2000), at 450 and following; S M Al Zarqa, (*On Tort and Compensation*), ((*Knowlege House*), 1988), at 7 6 and following.

(20) For an overview, see S F A Jabbar, A H A Halim, "The Concept of Fraud in Islamic Law", in B Rider (ed): *Research Handbook on International Financial Crime* (Edward Elgar Publishing, 2015), at 356 and following.

(21) While some commentators have suggested that such a ban could be established by Article 75 of the Companies Law (or Article 73 of the old Companies Law), this article states that only the directors will have the "widest authority" to manage the company.

(22) F S Al Kahtani, *supra* n 15, at 123, 135 and following.

(23) Unofficial English translation available at www.cma.org.sa/En/Documents/CORPORATE%20GOVERNANCE%20REGULATIONS-2011.pdf.

(24) Article 11(a) of the Capital Market Regulation stipulates only that the board of directors is "responsible" for the company and Article 11(c) of the Capital Market Regulation requires only the directors to act in "good faith and with due diligence".