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Participation and Registration in the Kingdom of Saudi Arabia

Some foreign businessmen in the Kingdom of Saudi Arabia often ask how they can avoid having a Saudi participate in transactions involving government contracts. The question, with very few situations excepted, is self-defeating in that a search for the non-existent answer is a distraction from the much more pertinent problem of how to insure that such participation is in the best interests of the foreign company, the Saudi government and the Saudi participant.

Participation refers to any of the methods whereby a Saudi national receives a portion of the proceeds from a Saudi government contract to which a foreign company is a party. The requirements for participation, together with registration, are the two fundamental legal requirements encountered by foreign companies in Saudi Arabia. While these two requirements seem to be subjects so different from each other as to preclude joining them in one discussion, they come together in an informed basic decision process for doing business in the Kingdom.

As in most countries, there are two basic areas within the Saudi economy—the private sector and the government. However, because of the nature of its needs and the size of the purchases made, the government looms as the only one of these that holds a strong interest for most foreign companies. Yet the government itself cannot be viewed as one large monolith with an absolutely consistent way of enforcing most rules and regulations. Rather it is a group of potential customers, each having unique characteristics. Therefore while the following discussion will cover the requirements for registration and participation which prevail over dealings with all branches of the Saudi government, each of those branches has its own accent in the details involving those requirements, especially participation.

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Because registration provides fewer choices in how it is implemented by a company, it will be discussed before the more complex subject of participation.

Registration

Any foreign company doing business in the Kingdom of Saudi Arabia must register with the authorities. This registration is in the name of the foreign company unless it has joined with a Saudi partner to form a mixed company, in which case it is the mixed company that registers. Basically, a company, foreign or mixed, must have permission to operate within the Kingdom. Technically, the award of a contract is not the granting of such permission but only a qualifying step. Permission is obtained by registration, either temporary or permanent. Temporary registration is in the form of a temporary license while permanent registration is obtained through a commercial registration.

Temporary Registration

Temporary registration is designed for a foreign company new to Saudi Arabia. If the company does not have a commercial registration when it receives the award of a government contract, the company must apply for a temporary registration within thirty days of contract signing. The process of obtaining a temporary registration is not difficult but it usually takes about a month. Unless a commercial registration is obtained, the temporary registration document must be amended for each new contract and the full registration process must be followed for each amendment. Temporary registration lasts only so long as the period of the contracts covered and lapses with the end of the last contract covered. This is the biggest potential disadvantage of temporary registration when compared to the more permanent commercial registration.

It is because of registration, either temporary or commercial, that a foreign company is allowed to carry out the activities necessary for the execution of a contract. These activities include sponsorship of expatriate employees, rental of property, importing of equipment and other necessary activities. If a company using a temporary registration were to reach a point where its current contracts came to an end and no new ones had taken their place, the temporary registration would lapse and the company could not legally continue to carry out operations in the Kingdom. Until there was a new contract there could be no temporary registration and thus no sponsorship of employees or importation of equipment. This gap could be avoided by obtaining a commercial registration.

Commercial Registration

A commercial registration is simply a permanent form of registration. It provides no benefits beyond those available under temporary registration

except continuity. Once the commercial registration is obtained, the foreign company can continue operating even during gaps between contracts.

Unlike the temporary registration, an application for a commercial registration requires the approval of the Foreign Capital Investment Committee. This entity within the Ministry of Industry is the same entity that must approve the establishment of a mixed company and the process in both situations is very similar. The process usually takes about three months and requires fairly extensive information from the company. The Committee wants to ascertain that the company is substantive and that it is providing a service that is both needed by the Kingdom and not being sufficiently provided by a Saudi firm. It should be noted that it is improbable that a foreign company would be granted a commercial registration when it first enters the Kingdom unless it enters into a joint venture with a Saudi company. Without such a joint venture, a foreign company would first operate under a temporary registration and later apply for the commercial registration.

Commercial registration seems to have the disadvantage over temporary registration of requiring government access to books, the filing of annual statements and the keeping of books in Arabic. Actually, these are required even under a temporary registration but the filing of financial statements is simply not enforced under a temporary registration. The access to books and the keeping of books in Arabic has not, thus far, been strongly enforced under either temporary or commercial registration.

Purpose of Registration

Registration is more than a mere formality in Saudi Arabia. The Saudi government demands that companies doing business in the Kingdom meet certain qualifications. The registration process provides an opportunity to ascertain whether a company meets those qualifications, three of which are the most important.

First, the company must render a service that is needed in the Kingdom. Service here is used in its broadest possible form and includes such activities as construction and maintenance. The second qualification is the company's absence from the Israeli boycott list. The registration process provides an opportunity to assure that the company is not so listed. If on the list, a company would, of course, be disqualified when doing business in the Kingdom.

Finally, if a foreign company is using an agent, the registration process is a way of ascertaining whether the amount of the agency fee is within the legal limit. If the company is not using an agent, there must be stated in the registration application the reason as to why there is no agent. Otherwise, the amount of the agency fee must be stated as a percentage of the total contract value which itself must be stated in Saudi riyals. As will be seen, the circumstances under which a foreign company can operate without an

agent are extremely limited unless the foreign company joins with a Saudi national to form a joint venture.

Participation

Neither temporary nor commercial registration eliminate any requirements that may exist for Saudi participation and some form of participation is mandatory for foreign companies in most Saudi government transactions. Such participation may consist of one of two basic forms—agency or joint venture. When agency is used, the Saudi participation is limited to receiving a percentage of the proceeds from the contract. If a foreign company forms a joint venture with a Saudi national, the Saudi participates as an actual party to the transaction.

Agency

Agency is a relationship whereby a Saudi national receives a percentage of the proceeds from a contract effort but does not have an equity interest in that effort. An agent must be a Saudi national.

There are two types of agents in Saudi Arabia—the commercial agent and the service agent. The commercial agent exists pursuant to Royal Decree M/11 and operates only in the private sector. The service agent exists pursuant to Royal Decree M/2, hereinafter referred to simply as M/2. When a foreign company utilizes an agent in a transaction with the Saudi government, it is a service agent and only this type agency is discussed herein.

The advantage of using a service agent as opposed to other types of Saudi participation is simple. There is a legal maximum of 5 percent of contract value on an agency fee and the agent has no say in the management of the company. It should be noted that the maximum is not also a minimum so the fee can legally be less than 5 percent. Any effort by the agent to increase the fee beyond the limit by entering into side agreements is, as with any sham avoidance of a law, illegal. The agent can, of course, in addition to acting as an agent, render a valid commercial service to the principal through a subcontract arrangement and in this way actually receive a portion of the prime contract in excess of 5 percent.

Agency is not required for companies that act as subcontractors on government contracts. The reason for this is an effort to reduce the downstream costs to the government that would be caused by having subcontractors as well as the prime contractor paying agency fees.

Agency is prohibited in armaments transactions as well as all government to government contracts. The prohibition of agency in these sensitive areas came about after the revelation of extremely large agency payments in military contracts. While agency is still allowed in other areas as an alternative to joint venture, some Saudi quarters believe agency does not ever benefit the Kingdom and is too often a transparent cover for influence peddling. Though some agency arrangements may render truly valuable and ethical

services to a foreign company, there is presently a Saudi government committee that is studying the feasibility of eliminating agency in all government transactions. If agency were eliminated, it is not yet known whether the result would be a government wide espousal of the present Saudi Royal Commission demand that foreign companies do work for the Commission through a joint venture or whether foreign companies would simply be allowed to choose between either joint venture or to work directly with the government without any Saudi participation. The latter course is highly doubtful. Most likely, a requirement for joint ventures will fill any vacuum left by the elimination of agency. There are two reasons for this.

The first reason has to do with trust. The idea that originally underlay the initiation of a requirement for a Saudi agent was to have a trusted party—any Saudi national—responsible for the actions of a literally foreign party. Though this reasoning has been rendered moot by the actual practice of most agents taking little interest in a transaction beyond the fee, it nevertheless existed. A joint venture, with its most substantive Saudi participation goes much further than agency toward meeting this need for trust and assuaging the basic xenophobia that clouds the image of any foreign company in a developing nation. The other reason that joint venture will probably replace agency is the pervasive desire by Saudis, and the commitment by the government, to maximize Saudi participation in economic activity in the Kingdom. Saudi participation enables the government to channel a large portion of government expenditures into the hands of private Saudi citizens. These efforts constitute a strong influence to have joint venture fill any void that would be left by the elimination of service agents.

Joint Venture

In Saudi Arabia the term “joint venture” is often used interchangeably for a variety of business forms. But the essence of any of them is that a foreign company and a Saudi participant form a relationship more substantive than that of agent to principal. As to the types of joint venture, there are basically two. One is the contractual joint venture and the other is a Saudi company formed pursuant to the Saudi Companies Act. When a Saudi company has both Saudi and foreign components, it is often referred to as a “mixed” company.

Contractual Joint Venture

The contractual joint venture—in Saudi Arabia called a joint adventure—is what is thought of as a typical joint venture in the United States. The parties enter a contractual arrangement to bid for and subsequently execute a project. The advantage, at least nominally, is that the Saudi participation is upgraded from that of agency. However, under Saudi law, the joint venture does not have juristic personality (Companies Act, Part IV, Article 10), so the foreign partner must still have an agent unless otherwise prohibited as in the area of armaments. The Saudi partner can, of course,

double as the agent. Also, the foreign partner would still need a temporary or commercial registration.

While it is true that the actual proceeds derived by the Saudi partner may be the same or less than would have been paid to an agent, it is also true that a joint venture can be a subterfuge whereby the Saudi simply receives a larger cut than is allowed by the limitation on agency fees. There may even be an attempt to use a joint venture to camouflage an actual agency relationship in the area of armaments where agency—though not joint venture—is prohibited. The success of such an attempt is highly doubtful as concerns a contractual joint venture—due to the need for an agent. The contractual joint venture lacks the tax holiday, bid preference and some less important benefits accorded to a mixed company. But the primary fault seems to be the lack of substance. It is simply the joining of two parties through the rather tenuous bond of an agreement. Such an arrangement may be suitable for a short range narrow objective. But only the formation of a separate legal entity in which both parties participate can provide sufficient support for a long term coordinated effort between two partners. This, as will be discussed, means a Limited Liability Company. The Royal Commission takes a very interesting approach toward joint venture. They make it clear that a foreign company doing work for it must work through a joint venture unless the service of the foreign company is so unique that it can't be acquired elsewhere. Such an advantage is very rare. Furthermore, the Commission has a device that encourages the formation by the partners of a mixed company rather than use a contractual joint venture. They first demand that the contractual joint venture describe a substantive contribution to be made by the Saudi partner. Then the Royal Commission forces the disclosure of the existence of the joint venture. The impact of this disclosure can be understood in view of Part IV, Article 46 of the Companies Act, which specifically discusses liability of partners to a contractual joint venture. This article provides that a third party can have recourse only against the partner with whom he deals *unless* the existence of the joint venture is disclosed in which case recourse can be had against all partners. Thus it is clear that in transactions with the Royal Commission, liability problems strongly favor the formation of a Saudi company with limited liability for all participants.

Taking a broad view where the question of liability is concerned, a contractual joint venture has little value in any situation since, as a practical matter, its existence will be disclosed whenever it is used. Furthermore even without disclosure of the Saudi participant, the foreign company would bear more liability exposure than as a participant in a mixed company with limited liability.

Limited Liability Company

The alternative to the contractual joint venture is for a foreign company, with a Saudi partner, to form a mixed company. Of the various forms of

entities provided for in the Saudi Companies Act, only one is feasible for consideration by most foreign companies and that is the Limited Liability Company. Except for banks, the Limited Liability Company—the LLC—is the only type of company in which the Saudi Foreign Investment Committee will allow foreign participation.

The LLC is the same as a *Société à Responsabilité Limitée* and is akin to the closed corporation used in the United States. It consists of two or more participants—referred to in the Saudi Companies Act as partners—each of whom have their liability limited to their respective shares in the capital of the company. Formation of the company, and thus the necessary issuance to it of a foreign investment license, is subject to approval by the Foreign Capital Investment Committee of the Ministry of Industry. Not counting the time necessary for the parties to negotiate the terms of their relationship, the formation process usually requires from three to six months. Once the company is formed, the bid preference and tax holiday, plus other benefits, are available if there is sufficient Saudi participation as discussed below.

Besides the liability of the parties being limited to the amount of capital shares, the LLC shares themselves cannot go out on public subscription and they can't be sold to a third party until right of first refusal is given to other shareholders. Furthermore, Saudi law requires that the LLC use Saudi approved public auditors and that 10 percent of the initial profits be reserved until there exists a reserve fund equal to 50 percent of the stated—not actual—capital. Finally, a standard practice by the Foreign Capital Investment Committee seems to be to demand an initial capitalization of 1,000,000 Saudi riyals though a higher amount might be demanded if the intended projects are particularly large.

Once an LLC is formed and receives a foreign investment license, it automatically qualifies for commercial registration. Furthermore if there is sufficient Saudi participation there is available a tax holiday and bid preferences.

Tax Holiday

The tax holiday available to an LLC could be a very valuable asset. The tax holiday, with some exceptions, lasts for five years and it is applicable only to contracts signed after issuance of the foreign investment license whereby the company is entitled to the holiday. Only the foreign participant receives the holiday. The Saudi participant pays no income tax though his income is subject to the *zakat*, a small religious tax imposed on the capital of citizens of Saudi Arabia.

There is some belief that the tax holiday becomes available to a company for a contract signed before issuance of the license if, before such signing, the parties have taken substantive steps, including execution of the contract of association, toward formation of the company. However, there is no evidence to support this belief. So if a company were to want the tax holiday

for the proceeds of a particular contract, the LCC must be formed before such contract is signed.

Obtaining the tax holiday requires a 25 percent minimum Saudi participation. An example of how to reduce this burden on the foreign partner will be discussed after covering the bid preference available to an LLC.

Bid Preference

Article 1(d) of the Saudi Tenders Regulations states the following:

Saudi individuals and companies licensed to operate in accordance with the existing laws and regulations shall have priority in dealing with the government followed by establishments consisting of Saudis and non-Saudis whenever Saudi interests in the capital amounts to 50% or more.

As clear as that statement may initially seem, it leaves much clarification to be desired to the term "priority." This clarification has emerged in the form of an apparent rule of thumb. The key to that rule is 10 percent. If a wholly Saudi company—all other things being fairly equal—can perform a job at a price no more than 10 percent higher than would a mixed company, the wholly Saudi company will win. The same rule seems to apply to the preference of a mixed company with a least 50 percent Saudi interest when compared to a bidder with a smaller Saudi participation.

Control and Profit Structuring

There are many ways in which the LLC can be structured. Among other things it can be designed for treatment as either a corporation or a partnership under U.S. income tax laws. However, of more immediate concern is control and gross profit. There is always the basic premise that the bid preference is desired; therefore the Saudi participant will have at least 50 percent of the shares. The term "at least" is used because there is always the possibility that Saudi Arabia will some day join other Arabian Gulf states and require at least 51 percent Saudi participation. The figure of 50 percent also, inherently, provides the tax holiday. Furthermore the foreign company usually wants more than 50 percent of the profits plus effective control. However, such a distorted situation could jeopardize the tax holiday. This jeopardy would arise because the share distribution could appear as a sham to the Saudi authorities. For example, there seems to be a basic, though not formalized, rule that if the distribution of profits differs more than 10 percent from share ownership, the Foreign Capital Investment Committee will question the validity of the LLC. If the distortion affects the 25 percent minimum Saudi participation, the tax holiday could be disallowed.

The alternative to structuring the LLC itself to achieve a variance of control and profit distribution from ownership is to use a management agreement. The foreign company would own a 50 percent interest in the LLC and also enter into a management contract with the LLC. The proceeds

flowing to the foreign company through the management contract would not have the benefit of the tax holiday but Saudi law will allow the LLC to reimburse the foreign company for such taxes and take such reimbursements as a deductible expense against its own profit. Thus, the burden of the tax under the management contract, though not benefiting from the tax holiday, could be distributed between the partners.

One last point about the LLC is that there is no legal prohibition under Saudi law against forming one without a Saudi participant. There have not been any formed up to now but the Foreign Capital Investment Committee is presently reviewing an application in which all participants would be foreigners.

Consultant

Before concluding a discussion of the options available to a foreign company the subject of consultancy should be touched on. Can a foreign company retain a Saudi as a consultant, paying an annual fee, and thus have the benefit of such a person where agency is not allowed? Not as a substitute for agency. In Saudi Arabia a consultant must be registered and must be one of the liberal professions such as a lawyer, engineer, accountant or an economist. A businessman or business firm would not fit such a classification. Thus, for example, a Gaith Pharoan could not be retained as a consultant on armaments matters. Furthermore, under Article 4 of the Saudi Bribery Law, "mediation" is illegal even if no payment is promised, offered or received.

Conclusion

A foreign company operating in Saudi Arabia has options available in two basic areas—registration and participation—and one can affect the other. If a foreign company were to enter into a contractual joint venture with a Saudi national, the foreign company could choose between a temporary registration and commercial registration. If an LLC were formed, the LLC must have a commercial registration but the foreign company participant would need neither temporary nor commercial registration. Should a foreign company restrict its activity in Saudi Arabia to armaments, subcontracting, or government-to-government transactions, the temporary registration would be sufficient unless there were to arise a point in time that the company incurred a gap in its contractual relationship with the government. If the company were to foresee such a gap, the best course would probably be to apply for a commercial registration or form a joint venture.

Participation is usually an inevitable aspect of doing business in the Kingdom and the choice is simply the form it will take unless the company restricts itself to the armaments business, government-to-government transactions or acts purely as a subcontractor. Putting such a restriction to the side, the formation of an LLC seems the most attractive for participation. Agency, like the contractual joint venture, has none of the official benefits

of an LLC such as the tax holiday or bid preference. Furthermore, there is the apparent emergence of the LLC as the approach desired by the government, both because of the negative implications of agency and the positive goals of maximizing the extent of Saudi participation in the economy. A company need not use one approach for all situations but rather can develop a strategy based on a spectrum of approaches. There could be four components of the spectrum consisting of non-participation, joint venture, agency and subcontract with each one used according to the needs of a particular government entity and the capacities of various potential Saudi participants.

The non-participatory approach could be used in the armaments area unless marketing or finance factors indicated the need for a joint venture. Subcontracting may be appropriate where a company has neither the opportunity nor capacity to act as a prime contractor. There would possibly be a need for agency where participation is required if there is not enough time to form a joint venture and as long as agency is permitted by the authorities. As concerns joint venture, the contractual joint venture seems to have little value when compared to the LLC. Furthermore, there is no restriction against having more than one agent.

The term strategy was used and that is exactly what is needed in a long range plan considering the factors of marketing, finance, and law that influence a company's future in Saudi Arabia. Allowing the question of participation to be decided purely on the basis of an immediate contract is but a narrow tactic. A full strategy is needed with all the options considered and resolved into long range planning.