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**SOME LEGAL ASPECTS OF DOING BUSINESS
IN THE CURRENT SAUDI ARABIAN MARKET**

Predictions of the collapse of the Saudi Arabian economy appear to have been greatly exaggerated. It is true that many of Saudi Arabia's large infrastructure projects have been completed, and new "mega-deals" will be less frequent. However, Saudi Arabia will need to maintain (and in many cases up-grade) its existing infrastructure. Moreover, the Saudi private sector continues to expand and strengthen. Thus, good opportunities remain available for U.S. companies having products, technology and expertise needed in the current Saudi market.

This memorandum describes some common forms of business which a U.S. company might use in the Saudi market, and then summarizes some legal issues which often are relevant to U.S. companies approaching that market.

Doing business in Saudi Arabia sometimes differs from doing business in the United States -- after all, the culture differs, the language differs, even the dress differs. In addition, there are some significant differences between the Saudi and U.S. legal systems. For example, Saudi Arabian "law" is based on Islamic law (shari'a); supplemental Saudi government regulations are designed to remain consistent with the principles of Islam while addressing certain aspects of modern commercial activity.

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I. COMMON FORMS OF BUSINESS

Four of the more common business methods or forms used by U.S. companies for the Saudi market are: (1) offshore sales; (2) commercial agencies (including distributorships and franchises); (3) branch offices; and (4) joint ventures. Each form of business has some comparative advantages over the other forms, depending on the U.S. company's overall strategy or approach to the Saudi market.

1. Offshore Sales

In general, Saudi law does not prevent a U.S. company from making offshore sales directly to customers in Saudi Arabia, and a Saudi-based customer can directly import the goods. Moreover, the offshore seller's profits from such sales generally should not be subject to Saudi income tax.

Nevertheless, many U.S. companies selling into the Kingdom decide to appoint a Saudi commercial agent or distributor. Given the increased competition in the Saudi market, for example, U.S. suppliers often need a local party's marketing and sales support. In addition, Saudi government procurement rules favor products for which a Saudi commercial agent or distributor has been appointed.

2. Commercial Agency

Under Saudi regulations, the term "commercial agent" generally refers to commission agents (who promote a foreign company's sale of goods), distributors (who buy and resell goods), and franchisees. The Commercial Agency Regulations state that only Saudi nationals (or Saudi companies that are wholly owned and managed by Saudi nationals) may act as commercial agents within the Kingdom. The Commercial Agency Regulations require commercial agents to register their commercial agency agreements at the Ministry of Commerce.

Unlike the other Gulf Cooperation Council countries (Bahrain, Kuwait, Oman, Qatar and the United Arab Emirates), Saudi Arabia has not enacted any special "dealer protection" law. Many Saudi courts generally take the view that the rules applicable to a foreign company's termination (or non-renewal) of its Saudi commercial agent is primarily a contractual matter to be agreed upon between the parties. In addition, Saudi courts generally have been

unwilling to award compensation to a terminated Saudi commercial agent for lost profits or other indirect, consequential or speculative kinds of loss. Of course, in the event a foreign company breaches the terms of its commercial agency agreement, or acts in bad faith when terminating or refusing to renew the commercial agency, the Saudi courts may award compensation to the commercial agent.

3. Branch Offices

The Saudi government's policies regarding branch offices vary from time to time. Therefore, in any given case, a U.S. or other foreign company might face administrative difficulties when seeking to establish a branch in the Kingdom.

(a) Temporary License.

Some U.S. companies concentrating on public sector work might establish a presence in Saudi Arabia through a so-called temporary license (also called a temporary branch, temporary commercial registration or "TCR"). However, under present Saudi practice, such a temporary license is generally only available to a foreign company acting as prime contractor under certain Saudi government contracts, and the foreign company may only engage in activities directly related to its performance under that specific government contract. The temporary license lapses upon completion of the relevant Saudi government contract.

A foreign company operating under a temporary license retains complete and direct control of its work, e.g., the company can sponsor its own employees and import necessary equipment. However, a foreign company operating under a temporary license will be subject to Saudi income tax, and may be at a competitive disadvantage due to the incentives and preferences offered to Saudi nationals and Saudi/foreign joint venture companies.

(b) Permanent Branch.

The "permanent" branch, in contrast to the temporary license, is not limited in scope or duration to a foreign company's performance of a particular Saudi government contract. A permanent branch can perform private and public sector contracts, and can continue to exist during periods between contracts. In other

aspects, the permanent branch has generally the same advantages and disadvantages as those of the temporary license.

The Saudi government carefully vets any foreign company applying to establish a permanent branch, because of the broad range of activities permitted for this form of business. In fact, the Saudi government's review and approval process of a permanent branch is somewhat similar to its review/approval process of a joint venture company (discussed below).

4. Joint Ventures

A joint venture, like Beauty, is sometimes in the eye of the beholder. Over the years, businessmen have used the term "joint venture" to describe a wide range of different commercial arrangements (including buy-sell agreements and employment contracts!). In the Saudi legal context, however, there are two primary types of joint venture: the unincorporated joint venture and the joint venture company.

(a) Unincorporated Joint Venture.

Under Saudi Arabian law and practice, an "unincorporated joint venture" is recognized as a contractual arrangement whereby two or more parties (they could be corporate entities or individuals) join together, usually to pursue a particular project. In creating this type of joint venture, the parties have not established a separate and independent legal entity.

The unincorporated joint venture is created contractually, and the joint venture partners generally have broad discretion to agree on appropriate terms and conditions of the venture -- subject to the regulations governing business conduct in Saudi Arabia. For example, as a matter of Saudi law, an unincorporated joint venture is treated as a general partnership in some circumstances. As a result, the joint venture partners would be jointly and severally liable to third parties for debts of the joint venture.

In most instances, an unincorporated joint venture is only suitable for short-range and/or narrow purposes. If partners contemplate a long-term coordinated effort, then they probably should consider establishing a joint venture company.

(b) Joint Venture Company.

Some U.S. companies decide that a local joint venture company, with Saudi participation, may be the preferable form of business for the Saudi market. While encouraging U.S. and other foreign investors in local development projects, the Saudi government carefully scrutinizes all proposals for foreign shareholding in a local company. The Saudi government's review and approval process, consisting of somewhat lengthy documentary and administrative requirements, seeks to ensure that foreign investors possess the requisite experience, financial strength and technical expertise needed in the Kingdom.

Thus, the Foreign Capital Investment Committee ("FCIC"), at the Ministry of Industry & Electricity, will issue an investment license to a foreign applicant only if the objectives of the proposed joint venture company will enhance the economic development of the Kingdom. (In practice, the FCIC will not generally grant an investment license for a joint venture company with capital of less than Saudi Riyals 1,000,000; depending on the joint venture's objectives, the FCIC may require substantially greater capital.) If the FCIC grants the necessary investment license, the joint venture parties then must obtain approval from the Ministry of Commerce of the proposed company's constituent documentation.

Saudi regulations offer a variety of incentives for joint venture companies with the requisite Saudi equity participation (at least 25% of share capital). Such a joint venture company generally is eligible for a Saudi income tax holiday, of 5 or 10 years (depending on the company's purposes, e.g., contracting, manufacturing, agriculture). A joint venture company with industrial or manufacturing objectives might also qualify for other incentives, such as favorable financing from the Saudi Industrial Development Fund. A foreign company operating under a temporary license or a permanent branch would be ineligible for such incentives.

II. SELECTED LEGAL ISSUES

Saudi Arabia, like any other market, has its share of opportunities and challenges. The following discussion is intended to illustrate the types of legal issues which may arise in the Saudi market.

1. Getting Paid

In the words of a colleague, "getting paid and staying paid" is among the primary concerns of a successful businessman, whether in Middle Eastern or other markets. In that context, payment delays, especially by Saudi government ministries, have been a sporadic problem for foreign (and Saudi) contractors in recent years. In 1992, the Foreign Affairs Committee of the House of Representatives held two hearings on particular commercial disputes between U.S. contractors and Saudi customers. Of course, given the significant amount of trade between the U.S. and Saudi Arabia, occasional commercial disputes are inevitable.

In recent years, contractors have worked increasingly closer with Saudi government customers to build financing packages into projects, thus easing the burden of delayed payments. Moreover, the Saudi government has expressed its desire to resolve any legitimate claims from foreign contractors. For example, in recent years, the Saudi government has issued special government bonds to "securitize" government late payments to contractors.

2. Government Tenders

(a) Contracting Rules

The Saudi government continues to be an important customer for U.S. businesses. The Saudi Tender Regulations contain many of the most important rules relevant to a foreign company's contracting with the Saudi government, including submission and evaluation of bids, rules on bid/performance bonds (bank guarantees), advance payments, changes to the scope of work, and fines/penalties for delayed work. In 1988, Saudi Arabia adopted a standard government public works contract, which in some aspects resembles (but also contains differences from) well-known FIDIC contract conditions.

Saudi regulations governing public sector procurement also include various "preferences" for Saudi contractors and suppliers, some of which favor Saudi-manufactured items over similar foreign products. Further, Saudi government contracts are awarded with first preference given to wholly Saudi-owned companies, then a second preference to joint venture companies with requisite Saudi ownership. Such "buy Saudi" preferences are strengthened by the "30% Rule", requiring certain foreign

contractors to subcontract that percentage of the works to wholly Saudi-owned contractors.

(b) Service Agency

The Saudi Service Agents Regulations require, inter alia, that if a foreign company is pursuing a Saudi government contract by means of a branch office, then in most cases that foreign company must appoint a Saudi service agent. Such a service agent usually will provide advisory and support services to the foreign contractor. The foreign contractor may limit the service agent's responsibilities to a particular Saudi government contract. Only Saudi nationals, or companies formed in Saudi Arabia and owned entirely by Saudi nationals, may act as service agents.

The Saudi Service Agents Regulations limits the service agent's commission to no more than five percent (5%) of the government contract price. In armament and related contracts, and/or "government-to-government" contracts (such as the U.S. government's Foreign Military Sales program), Saudi regulations broadly prohibit the use of all agents, brokers, middlemen and other intermediaries. Moreover, even if a foreign company must use a Saudi service agent in a particular government project, the service agent may not be appointed to exercise "undue influence or mediation".

3. Labor Law

The Saudi Labor Regulations generally apply to most employees in Saudi Arabia (including expatriate employees). The Labor Regulations contain detailed provisions on various aspects of employment, including wages, working hours, sick pay and vacation, rules on termination of employment and severance pay. Although an employer may grant an employee greater rights than those specified in the Labor Regulations, an employee's attempted waiver of rights granted under those regulations will generally be void.

4. Income Tax

First, the good news: expatriate wages and salaries have not been subject to Saudi income tax since 1975.

Now, the bad news: the Saudi income tax regulations applicable to foreign companies are often obscure and subject to a significant

degree of administrative interpretation. (Saudi nationals are not subject to the Saudi income tax but rather zakah, an Islamic levy or tithe.) Moreover, Saudi Arabia has not established anything that resembles a comprehensive set of multi-lateral treaties for the prevention of double taxation. Therefore, interpretations and changes to Saudi tax rules would not necessarily need to be based on OECD and similar principles that normally provide significant comfort to Western tax practitioners.

As a basic rule of Saudi income taxation, only "Saudi-source" income is subject to tax, but there is some ambiguity as to what constitutes income derived from Saudi Arabian sources, particularly if a foreign company is working on a project which involves work both inside and outside the Kingdom. U.S. companies should obtain advice from competent tax practitioners in Saudi Arabia, in order to develop appropriate tax planning.

There are two alternate ways in which Saudi Arabian income tax might be imposed: the taxpayer files an income tax return on the basis of net taxable income; or the Saudi tax authorities assess tax, under the so-called "deemed profit" basis, on the gross payment(s) received by the taxpayer.

A taxpayer filing a Saudi Arabian net income tax return is required to maintain books and financial records (relating to taxable income) in Saudi Arabia, in the Arabic language, and audited by a local accountant. Such taxpayers are taxed on their net income at progressive rates, up to 45%.

The Saudi "deemed profit" tax method is often used if a foreign company with Saudi source income has no presence in the Kingdom. Under this tax method, the Saudi tax authorities impute the profit of a foreign company to be not less than fifteen percent (15%) of its gross Saudi source income, and the deemed profit is then taxed at the regular progressive income tax rates. The Saudi Arabian tax authorities have discretion to increase the deemed profit percentage used in any particular case, and have employed higher percentages, up to one hundred percent (100%), on such payments as royalties and certain other licensing fees.

5. Intellectual Property

In recent years, Saudi Arabia has taken significant steps to increase the protection available to owners of intellectual property. In particular, Saudi Arabia has enacted regulations for trademarks, patents and copyrights. Unfortunately, these

regulations are still relatively new and untested. For example, the patent office has been slow to take action on the hundreds of patent applications received.

The Saudi Copyright Regulations had contained a different shortcoming, whereby a foreign work would be protected only if it was "first published, performed or presented in the Kingdom of Saudi Arabia." This significant limitation was ameliorated by Saudi Arabia's subsequent accession to the Universal Copyright Convention. The Saudi Ministry of Information has initiated a campaign to improve compliance with the Copyright Regulations, and the local market has begun to feel these recent enforcement efforts. Last spring, the U.S. Trade Representative placed Saudi Arabia and 25 other trading partners on the watch list [under Section 301 of the U.S. Trade Act], and scheduled an "out-of-cycle" review for Saudi Arabia, in order to assess the ongoing effectiveness of Saudi efforts in reducing the availability of pirated software, videos and sound recordings.

In any event, a foreign company should insist upon a thorough and well-drafted licensing agreement (including confidentiality and non-disclosure provisions) with any parties using its intellectual property in the Kingdom.

6. Boycott/Anti-Boycott

In 1962, Saudi Arabia enacted domestic regulations in accordance with the "unified law" for the Arab Boycott of Israel, joining fellow members of the Arab League. The United States eventually enacted its own legislation in response to the Arab Boycott, by establishing two separate sets of "anti-boycott" regulations, under the Export Administration Act (administered by the Department of Commerce) and the Internal Revenue Code (administered by the Department of Treasury). The U.S. anti-boycott regulations are complicated, and the two sets of regulations (i.e., Treasury and Commerce) are not always consistent with each other.

Although this maze of U.S. regulations appears daunting, U.S. companies doing business in Saudi Arabia should not be overly discouraged, but should remain diligent and careful. For example, when U.S. companies are presented with contract language causing serious concern under the anti-boycott rules, the parties are usually able to agree upon acceptable alternative language.

A few years ago, Saudi Arabian and other GCC government officials announced that their countries would end the secondary and tertiary boycott of Israel (leaving intact the domestic ban on trading directly with Israel). It remains unclear how quickly Saudi Arabia and the other GCC states will act to formally eliminate blacklists and other aspects of the secondary and tertiary boycott.

7. Commercial Disputes

In general, Saudi businessmen are far less litigious than their U.S. counterparts. In almost all cases, Saudi parties have a strong preference for amicable settlement of disputes. In those instances where amicable settlement is not possible, some special rules and practice are relevant in the Saudi context.

For example, since 1963 the Saudi government has prohibited ministries and other government departments/agencies from entering into agreements which specify non-Saudi arbitration or governing law, subject to some narrow exceptions and special approvals. In Saudi private sector contracts, however, there are fewer constraints on the ability of contractual parties to choose Saudi or foreign governing law, and Saudi or foreign arbitration to resolve disputes. Ministry of Commerce officials now generally accept commercial agency agreements for registration which contain foreign arbitration and foreign governing law provisions. Moreover, in December 1993, Saudi Arabia signed the U.N. Convention on the Recognition and Enforcement of Foreign Arbitral Awards. (There remain some uncertainties as to the practical effect of this treaty within the Saudi courts.)

A U.S. company should carefully consider all the circumstances relevant during negotiation of each particular contract, rather than assume that the U.S. company's interests are always best served by non-Saudi governing law and/or non-Saudi dispute resolution. For example, a judgement or arbitral award issued by a non-Saudi tribunal pursuant to foreign law will be difficult to enforce in Saudi Arabia. Moreover, in many cases, the damages which can be recovered by a Saudi party against a foreign party under a foreign law may exceed the damages available under Saudi law.

At a Middle East business conference a few years ago, one of the participants began his presentation by announcing "Welcome to Saudi Arabia -- the Land of Milk and Honey!" No country, not even Saudi Arabia, is likely to live up to such hyperbole. Nonetheless, the Kingdom continues to offer opportunities to U.S. businessmen who accept the commercial challenges, respect the country's special cultural and religious values, and carefully plan for the legal issues which may arise in the current Saudi market.

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