

Client Alert

Finance & Restructuring

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Different Paths to a Just Result: The Saudi Bankruptcy Law's Fairness Standard

A pillar of modern insolvency restructuring regimes is the so-called “cramdown” plan. In a cramdown plan, a sufficiently high number of creditors can vote to approve a plan that binds dissenting creditors. The Fifth Circuit Court of Appeal in Riyadh (the “**Appeals Court**”) addressed an important limitation on cramdown plans last year in the financial restructuring case *Arkad Engineering and Construction Company*.

PLAN CONFIRMATION IN SAUDI FINANCIAL RESTRUCTURING PROCEEDINGS

Chapter Four of the Saudi Arabian Bankruptcy Law (the “**Bankruptcy Law**”) lays out rules for a Financial Restructuring Proceeding (an “**FRP**”) in Saudi bankruptcy cases. The Bankruptcy Law, by design, gives a debtor wide latitude in crafting a business reorganization plan and capital structure to fit its particular industry and creditor mix. But flexibility has a potential downside: A majority-rule system, if unchecked, could lead to gamesmanship, tactical buying and selling of claims and oppression of minority creditors.

In Saudi Arabian cases, a guardrail for cramdown plans is found in Bankruptcy Law Article 80(4), which provides that a creditor prejudiced by the plan may, subject to certain conditions, object to court confirmation on the grounds that “it does not meet the standards of fairness.” “Standards of fairness” is codified in Bankruptcy Law Article 35, which requires proper voting, sufficient information to creditors, and, most importantly for these purposes, that “the creditors’ existing rights are observed, especially in relation to sharing losses, and the distribution of new rights and benefits and security.”

Precisely what that means is not spelled out in the Bankruptcy Law or its Implementing Regulations. In some countries, such as the United States, an approximation is found in the “absolute priority rule,” which requires full payment of senior claims before junior claims receive anything.

Other rules prohibit unfair discrimination among similarly-situated classes of creditors, or plans that would result in creditors receiving less than they would recover in a liquidation.

THE ARKAD PROBLEM

The interpretation of the Bankruptcy Law's "standards of fairness" was the central issue in the FRP case of *Arkad Engineering & Construction Company*, filed with the Commercial Court in Dammam (the "**Commercial Court**"). In *Arkad*, the debtor had approximately SAR 3 billion of total debts, including bank debt (SAR 562 MM), leasing company debt (255 MM), trade debt (811 MM), customer debts (820 MM), employee dues (148 MM) and government debt to the General Organization for Social Insurance ("**GOSI**") (29 MM). The plan proposed by *Arkad* provided most unsecured creditors with payouts through a sukuk and Murabaha facility lasting as long as twelve years (with no payment during the first two years). However, repayments for two classes of creditors were accelerated: GOSI would be repaid in four years, employees in seven years. It also estimated a 100% recovery for GOSI and employee creditors, but only a 50-60% repayment to other creditors through the sukuk and Murabaha facilities during the 12-year repayment period. The plan contemplated refinancing and/or equity raise to extinguish the remaining debts at the end of the designated FRP period. The plan's documents explained that accelerated repayment of GOSI was a market practice in an FRP - reflecting the reality that, without access to GOSI services (which would be lost if GOSI were not paid on an accelerated basis), *Arkad* would go out of business, leaving everyone unpaid.

The plan was approved by a vote of 85.13% of the value of claims. The only class to reject the plan was that of financial leasing companies. At the confirmation hearing, creditors objecting to the plan argued, *inter alia*, that the plan violated the standards of fairness because it conflicted with regulatory provisions relating to the priority of debts. The Commercial Court agreed, finding that the plan violated the standards of fairness in Article 35. It entered an order on September 13, 2023 rejecting the request to ratify the plan and terminating the FRP.

THE APPEAL

On appeal, *Arkad* argued that standards of fairness were not violated because all creditors would be repaid in full. While GOSI and employees would be paid on an accelerated timetable, other creditors would be paid 50-60 percent through the sukuk and Murabaha over twelve years (at most) - and the balance would be paid through refinancing or an equity infusion. *Arkad* argued that the different repayment periods were necessary: Without accelerated payment to GOSI, the company would shut down and all creditors would be harmed. (*Arkad* noted that the plan paid GOSI only principal due and fines accumulated through the date the FRP was initiated, 21 June 2021). *Arkad* also argued that the Commercial Court had improperly grafted the priority of debts for liquidation cases - Bankruptcy Law Article 196 - onto FRP cases.

The Appeals Court held that the Commercial Court erred in concluding that creditors other than GOSI and employees would take a 40-50 percent reduction. On examination, the Appeals Court concluded that trade, leasing and other creditors would not suffer a discount, because those creditors would receive the balance due through an equity raise or refinance.

As for differences in the repayment periods for different classes of unsecured creditors, the Appeals Court concluded that differing time periods do not violate the fairness standard: "The standards of justice outlined in Article (35) of the Bankruptcy Law referred to in the financial restructuring procedure do not prevent variation in the payment period or the percentage of the discount if what justifies the variation is achieved, such as the difference in the nature, amount or order of priority of the debts. Furthermore, equality in the [payment] periods or percentage of discount does not necessarily mean achieving justice in all cases." The court further held, "[T]he proposal serves the interests of the

majority of creditors according to the details outlined in the proposal,” and reversed the Commercial Court’s judgment.

ANALYSIS

The *Arkad* case signals flexibility in interpreting the standards of fairness where a debtor needs to pay favored creditors early in order to survive. But the Appeals Court did not stop with repayment terms; although all creditors in *Arkad* should ultimately be repaid in full under the plan, the Court referred to “the payment period or the percentage of the discount” may be varied among similarly-situated creditors. Because all creditors had the prospect of being paid in full, this reference to “percentage of the discount” did not matter in the *Arkad* case. Whether courts will accept different discounts among different classes remains to be seen.

The Appeals Court’s decision avoids strict rules that inhibit flexibility within FRP plans (for example, it avoids grafting the Article 196 liquidation waterfall onto FRP plans). Plans necessarily need to address each debtor’s unique situation, especially where a small number of creditors hold key relationships that can spell success or failure for a reorganised company. The *Arkad* decision will help future debtors as courts examine FRP plans to ensure they comply with the standard.

In *Arkad Engineering and Construction Company*, the debtor was represented by King & Spalding LLP (Michael Rainey, Zaid Al-Farisi, Jonathan Jordan and Asal Saghari).

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