1. Introduction

The 1989 creation by Texaco, Inc. and Saudi Refining Inc., of a refining and marketing joint venture—Star Enterprise—is yet another example of the continued interest in United States/Saudi Arabian business combinations. However, it may signal a change in Saudi foreign investment from ventures located in Saudi Arabia to ventures, like Star Enterprise, located outside the country. Since the passage of the Foreign Capital Investment Code in 1979, joint ventures between Saudi companies and United States companies have increased due to incentives presented by the Saudi government. However, the rise in the number of joint ventures has not been a result of the ease of structuring such operations or simple legal considerations.

The structure and operation of Saudi Arabian law poses many challenges for United States companies or individuals interested in joint venture combinations with Saudi companies or, as is common in Saudi Arabia, with the Saudi government. These challenges stem from the peculiarities of Islamic Law as well as from the inconsistencies of governmental legislation relating to corporate, contract and foreign investment law. While investment in Saudi Arabia can be advantageous to a United States investor, these challenges create a labyrinth of legal obstacles that must be overcome before structuring a joint venture in the Kingdom.

This comment will examine the major legal challenges faced by companies wishing to establish a United States/Saudi joint venture.

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3 This paper does not address the social, cultural, and political challenges foreign investors face. However, these factors can be significant and must be taken into consideration by the foreign investor. The political volatility of the region, for example, can have serious repercussions on any investment in Saudi Arabia as the 1990 Middle East Crisis illustrates.
The scope of the comment will be limited to joint venture formation within the Kingdom of Saudi Arabia. It will begin with a discussion of Islamic Law principles which influence all areas of commercial and contract law. The comment will then examine the aspects of the Saudi Limited Liability Company, the Foreign Capital Investment Code, the Tenders Regulations and the Arbitration Regulations which act as impediments to the formation of United States/Saudi joint ventures.

2. ISLAMIC LAW

When contemplating formation of a joint venture between a United States investor and a Saudi partner, one of the first considerations for the United States investor and its counsel must be of general principles of Saudi law. Ignorance of Saudi law has led to delays, obstacles and even premature termination of projects for foreign investors. Saudi Arabia does have specific regulations governing the formation, licensing and operation of companies jointly owned by Saudi nationals or entities and foreign nationals or entities. However, consultation of Saudi law should not be limited to these regulations only:

[I]f [an investor's] contacts with [Saudi Arabia] are to be anything more than superficial, [the investor] should be familiar with the general principles of Islamic law in areas such as contracts, property, and torts. Not only are these principles fundamental in themselves, but they may help to provide a better understanding of the reasons a business transaction is conducted in a particular manner.

Compliance with the specific regulations will be easier if one has an understanding of the premises upon which Islamic Law is based. Such an understanding will also help protect the United States company from legal complications that can develop as the joint venture begins to take shape and eventually becomes operational.

The Kingdom of Saudi Arabia is an absolute monarchy and is governed by Islamic Law, a law deeply set in religion. The executive

7 See generally Brand, Aspects of Saudi Arabian Law and Practice, 9 B.C. INT'L & COMP. L. REV. 1, 3 (1986) ("Islamic belief does not separate faith from law."); Comment, The Influence of Islamic Law on Contemporary Middle Eastern Legal Sys-
and legislative powers of regulations and legislation in the Kingdom are “concentrated in the Council of Ministries subject to the absolute authority of the King.” The constitution of the Kingdom is the holy book, the Qur'an. Although the Qur'an serves as the constitution of the country, it contains relatively few verses which are of legal consequence; most of these verses deal with family law and inheritance. As a result, many of the regulations governing legal, commercial and contract areas are promulgated in the form of royal decrees.

The law in Saudi Arabia is called Shari'a which means “the Path to be followed.” Shari'a is considered to be divine law, given from Allah, and “regulates the entirety of human conduct in the moral, ethical, religious, social and legal spheres.” Because the constitution of the Kingdom is the Qur'an, religious, moral and ethical considerations spill over into the legal areas of commercial and contract law: “In Saudi Arabia, as in other Muslim countries, religion and law are inseparable.” Therefore, it is imperative that an attorney counseling a foreign investor examine such aspects of Saudi Law:

It is in the differences of shari’a law, the law’s religious origins, its role as protector of the Islamic faith and guide to daily social life, and its historical aversion to contemporary reinterpretation, and in Western lawyers’ ignorance of these differences, that misunderstandings arise.

Western attorneys can be lulled into a false sense of comprehension of the legal system of Saudi Arabia because legislation and royal decrees in the Kingdom bear a resemblance in form to Western legislation. Although there appears to be such similarity, an attorney must never forget that “[t]he Shari’a is still, however, very much the law in Saudi


Brand, supra note 7, at 3. Many Arabic words have several alternate spellings, each equally correct. For this reason, Arabic words that appear within this comment are reproduced as they appear in the original, rather than conformed to the spelling chosen for this comment. Similarly, where the author of the quoted material chose not to italicize words, they appear in the comment as in the original.

Of 6,237 verses, only approximately three percent or one hundred ninety, can be considered to be of legal consequence. Id.; Badr, supra note 8, at 188.


Comment, supra note 7, at 387.

Note, supra note 5, at 115.

Brand, supra note 7, at 2.
Because the Shari'a is the law of God, even legislation and royal decrees are secondary to it. Furthermore, all legislation and royal decrees must be in keeping with the Shari'a and must not contradict it. As a corollary, a Saudi national or company cannot agree to be bound by any other law besides the Shari'a. Consequently, a company wishing to invest with a Saudi company must be willing to subject itself to the Shari'a. Before doing so, the company must be familiar with the law:

Even Western attorneys who engage exclusively in Saudi corporate law will find themselves at a distinct disadvantage without at least a passing acquaintance with the fundamentals of the Islamic faith and the general principles of Islamic contract law. It is critical, moreover, for Western attorneys to be familiar with Arab social mores and customs if they are to effectively advise or represent United States clients doing business in Saudi Arabia.

An example further underscores the importance of the necessity of being familiar with not only the regulations regarding commercial transactions in the Kingdom, but also with other aspects of the Shari'a and the Saudi Arabian culture as well: Saudi law will render a contract null and void if it contains a provision which is illegal. In doing so, Saudi law does not differ from many other legal systems which will not recognize contracts that are formed with an illegal purpose. However, the United States investor can be in trouble when the Shari'a will not recognize contracts which contain what might be a seemingly innocent subject to the investor but which turns out to be proscribed by the religious law of the Qur'an. For example, the inclusion in a contract of a provision for the trading of alcoholic beverages will render the entire contract null and void because alcoholic beverages are prohibited in the Kingdom. It is advisable to be familiar with Saudi social customs and

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16 Asherman, supra note 11, at 337.
17 Cf. Ministry of Commerce, Memorandum on Arbitration Clauses, 3/3/1756, 24/5/1399, reprinted in 2 A. Keesee, supra note 2 (An arbitration clause "providing for the submission of any disputes arising between contract parties to an arbitration committee outside the kingdom . . . contained in the charter of a Saudi company is considered absolutely void"); Brand, supra note 7, at 29 (There is no reason for conflict of laws doctrine. Only Shari'a law and Shari'a courts may prevail because Shari'a is God's law and all other laws are man's).
18 Note, supra note 5, at 115.
20 Id.
21 Id.; Brand, supra note 7, at 27-28.
 traditions as well: "[T]he Western attorney should not underestimate the active role which tradition, custom, and the Arab viewpoint play in the Saudis' daily business practices, because even an unintended social faux pas can upset a sensitive business negotiation."\textsuperscript{22} Inquiring about a Saudi's family, except as to the family's health, and uninvited conversation regarding religion and politics are examples of cultural taboos.\textsuperscript{23}

As might be obvious, a company wishing to undertake a joint venture with a Saudi company should retain counsel who is familiar with Islamic law and traditions. There has been an increase in the amount of legislation promulgated in the Kingdom due to the increased complexities of the business environment.\textsuperscript{24} Should this trend continue, as is expected, "access to and understanding of the latest Saudi legal developments will be increasingly critical to successful business there."\textsuperscript{25} Restrictions on the ability of foreign attorneys to practice law in the Kingdom affect the possibility of being able to obtain a competent United States attorney with the experience necessary for the complex negotiations of structuring a joint venture. Only Saudi nationals are able to obtain licenses to practice law in the Kingdom,\textsuperscript{26} although non-Saudi attorneys may be employed in the office of a Saudi legal consultant.\textsuperscript{27} The non-Saudi attorney can perform only limited duties: "The work of the employed consultant shall be confined to the preparation of memos in the name of the Saudi consultant and to providing the Saudi consultant with counsel and technical assistance within the scope of office work."\textsuperscript{28} Furthermore, the non-Saudi attorney is "banned from practicing the profession of legal consultation in the Kingdom in any manner, whether independently or in partnership with a Saudi individual or office."\textsuperscript{29} Although legal consultation is not defined by the Minister of Commerce in Ministerial Resolution 1190, it is clear that the resolution was designed to restrict the legal practice to Saudis. This policy forces the United States company to seek Saudi counsel to provide necessary expertise for the company in understanding and interpreting Saudi laws.\textsuperscript{30}

\textsuperscript{22} Note, supra note 5, at 115.
\textsuperscript{23} Id. at 176.
\textsuperscript{24} Id. at 176.
\textsuperscript{25} Homsy, Legal Aspects of Doing Business in Saudi Arabia, 16 INT'L LAW. 51, 66 (1982).
\textsuperscript{26} Id.
\textsuperscript{27} Id. art. IV, reprinted in 5 MID. E. EXEC. REP., Feb. 1982, at 26.
\textsuperscript{28} Id. art. VI.
\textsuperscript{29} Id. art. VI.
\textsuperscript{30} See Note, supra note 5, at 173.
2.1. Contractual Agreements Under Saudi Law

Awareness and understanding of the high value placed on personal honor and on the sanctity of contracts in Saudi Arabia are critical to success for the United States investor. Both factors will influence the approach taken by the Saudi partner in negotiations as well as the expectations the Saudi company will have of the United States partner to fulfill its obligations. The Saudis often consider "each man's word as legally reliable as a contract provision."\(^{31}\) The United States investor must consider the fact that it is a rare occurrence for a Saudi businessman to go back on his word once it is given, "regardless of the legal arrangements."\(^{32}\) The Saudi will, in all likelihood, expect no less from the United States investor.\(^{33}\)

In Saudi Arabia, contracts are considered sacred:

In a Muslim's priority of obligations, adherence to contract ranks below only one's obligations to God and to family. Contracts are the *shari'a* of the parties, and no distinction is made between public agreements such as treaties and private contracts; both are pacts to which God is a witness and both therefore must be observed.\(^{34}\)

Muslim attorneys have commented that "[t]he contract is the *shari'a* or sacred law of the contracting parties."\(^{35}\) Although *Shari'a* is synonymous with traditional Muslim or Islamic law, "[i]t is also, in a narrower meaning, the bargain made between two contracting parties."\(^{36}\) This concept suggests that not only is the *Shari'a* the law of the Kingdom, but that it is also "man's law, the 'law' that private parties to a mutual contract establish for themselves."\(^{37}\) A contract breach becomes more than simply an unfulfilled obligation for which a remedy is available. It is a transgression of the law as well as a serious affront to the Saudi company. Therefore, the United States investor simply cannot afford to underestimate the importance of the agreement to the Saudi partner. Should the investor act "dishonorably" and breach a contract

\(^{31}\) Id. at 175.
\(^{32}\) Id.
\(^{33}\) Such an expectation is not far-fetched to the Saudi because the Saudi will hold that the laws of contract and obligation of Saudi Arabia are applicable to foreigners and non-Muslims. Asherman, *supra* note 11, at 329. A passage from the Qur'an states "O ye who believe! fulfill your undertakings." Brand, *supra* note 7, at 27. "Saudis attach a great deal of weight to confidence and trust in all relationships, whether business or private and will hold a person to his word." Comment, *supra* note 4, at 304.
\(^{34}\) Brand, *supra* note 7, at 27.
\(^{35}\) "Al-'aqd Shariat al-muta'aqqidin." Id. at 7; Asherman, *supra* note 11, at 335.
\(^{36}\) Brand, *supra* note 7, at 7.
\(^{37}\) Id.
or contract provision, the investor will lose face with the Saudi partner and may find it difficult to find other Saudis with whom to do business. Consider, as an example of the sanctity of the contract in Saudi Arabia, the following:

[T]he government [of Saudi Arabia] once renounced its sovereign immunity in an arbitration with the Arabian American Oil Company, adjuring that the company and the government 'have never entertained the thought that they would not be bound by the agreement they have made . . . .'

Because the Qur'an has few legal provisions, Shari'a contract law has tended to evolve through experience, similar to the evolution of common law in the United States. However, unlike common law in the United States, binding precedent is not a concept of Saudi Law. Therefore, a company cannot rely on past experiences or past Saudi court decisions as definitive. Although the situation may be similar, no court is bound by a previous decision.

3. THE JOINT VENTURE

Once a company begins to sort through and understand the premises of Shari'a, it can begin to focus on the particular regulations to be complied with in order to form the joint venture. The penalties for non-compliance with any of the regulations range from fines to expulsion from doing business in the Kingdom. Complying with the regulations is no easy task because many of the regulations are not as straightforward as they appear. The officially promulgated regulations (royal decrees) are not the exclusive vehicle by which the government regulates companies. There are also government officials and committees overseeing the activities of foreign investors in the Kingdom. These officials continually make policy decisions and have the delegated authority to make regulations. These regulations are contained in ministerial or ad-

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38 Id. at 27.
39 Id.; see Badr, supra note 8, at 189 ("The case law . . . was not reflected in court decisions; the cases were rather situations, real or hypothetical, formulated for discussion and resolved according to the teachings of the particular school of law to which the jurist belonged.").
40 Simpson, supra note 6, at 4.
41 See Companies Regulations, Royal Decree M/6, art. 229, 22/3/1385 (1965), as amended by Royal Decrees M/5, 12/2/1387, M/23, 28/6/1402 and M/46, 4/7/1405, reprinted in 2 A. Keesee, supra note 2. See also Cartwright & Hamza, Service Agents Regulation and Related Laws Affecting Foreign Companies in Saudi Arabia, 17 INT'L LAW. 203, 212 (1983) ("One sanction for violation of the Regulation by a foreign company is that it may be prohibited from engaging in any further business in Saudi Arabia.").

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ministrative memoranda and circulars. The problem posed to the United States investor by these regulations is that although they carry the same weight as royal decrees, they are not published in the Official Gazette. Limited knowledge of and access to such regulations may therefore make it extremely difficult for a company to comply with them.

3.1. Registration

Any company wishing to operate in the Kingdom must obtain permission to do so. Permission is granted in the form of temporary or permanent commercial registration with the Saudi government. The only difference between temporary and permanent registration is that permanent registration establishes continuity. Temporary registration is valid only for short contracts and the company must re-apply with each new contract it obtains. Therefore, a United States company establishing a joint venture with a Saudi company will want to obtain permanent registration.

Registration serves three primary government objectives: 1) ensuring that the company renders a service that is needed in Saudi Arabia; 2) ensuring that the company is not on the Israeli Boycott List; and 3) permitting the government an opportunity to determine whether the foreign company has a Saudi agent and if not, the reason why. Although registration primarily serves these purposes, it also provides several benefits for the United States company, such as "[s]ponsorship of expatriate employees, rental of property, exporting of equipment [as well as] other necessary activities for the execution of a contract."

3.2. Participation

Complying with registration requirements alone, however, is not

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42 Asherman, \textit{supra} note 11, at 325.
43 \textit{Id.}
44 All royal decrees become effective upon publication in the \textit{Official Gazette}. \textit{Id.}
46 \textit{Id.}
47 \textit{Id.}
48 Listed companies are those that conduct business with Israel. Several Arab countries, Saudi Arabia included, have joined together to boycott Israeli goods as well as companies that do business with Israel. If a company is on the list, it would be disqualified from doing business in Saudi Arabia. \textit{Id.} at 563. \textit{See} L. \textit{Glick, TRADING WITH SAUDI ARABIA} 565 (1980); Code of Regulations for the Boycott of Israel, Royal Decree 27, 25/6 (Nov. 23, 1962), \textit{reprinted in} L. \textit{Glick, supra}, at 574.
49 Santire, \textit{supra} note 45, at 563.
50 \textit{Id.} at 562.
enough for the company to begin operations. The United States company must obtain the participation of a Saudi national or company in order to operate in the Kingdom. Participation can take two forms, agency or joint venture. There are two types of joint ventures, the contractual joint venture and the mixed company. The mixed company involves equity ownership by both a Saudi national or company and a foreign national or company. It is the more beneficial joint venture form for a United States company to take because, with the Saudi ownership, the mixed company has juristic legal personality in the Kingdom. One form of mixed company, the limited liability company, is the governmentally favored avenue for investment in Saudi Arabia by foreign entities. The government has gone so far as to require that any contractor dealing with the government have a Saudi agent or partner. Although it is possible for a United States company to operate in the Kingdom with only a Saudi agent, Saudi government policy tends to favor increased joint involvement between foreign and Saudi entities. "[T]he Government welcomes foreign capital as well as foreign expertise and their participation in industrial development ventures in cooperation with Saudi businessmen." Indirectly, through such policy, the Saudi government has successfully controlled the choice of business form.

3.3. The Saudi Joint Venture vs. The Limited Liability Company

The Saudi joint venture and the limited liability company are two business forms which allow foreign participation in the Kingdom. The Saudi joint venture however, is the less beneficial of the two for the United States company. The joint venture is often a short term contrac-

81 Id. at 564.
82 Id.
83 Id. at 565.
85 Santire, supra note 45, at 566.
86 Service Agents Regulation, Royal Decree M/2, art. 2, 21/2/1398 (Jan. 20, 1979), reprinted in L. GLICK, supra note 48, at 161; see also Santire, Registration and the Saudi Associate: Choices in the Kingdom, 5 MID. E. EXEC. REP., Apr. 1982, 5, 7.
87 Foreign investors can operate in the Kingdom without an agent in the areas of armaments and related services where agency is prohibited. However, Saudi partnership in a joint venture is permissible in these areas. Service Agents Regulation, supra note 56, art. 3.
tual arrangement, similar to joint ventures as they are known in the United States. 5 9 Article 40 of the Saudi Companies Regulations (hereinafter Companies Regulations), which governs businesses in the Kingdom, defines a joint venture as "an association of which third parties are not aware, which does not have legal personality and which is not subject to publication formalities." 61 Besides lacking the benefits granted to the limited liability company, the chief drawback of the contractual joint venture is that it is a tenuous agreement between two parties for a narrow objective and usually for a short time period. 62 Another shortcoming is that the joint venture is an impractical choice for the United States company to make because the partner who deals with the third party is solely liable for any damages, unless the third party knows of the combination, in which case all partners are liable. 63 The United States company is therefore forced to disclose its participation in order to protect itself from heavy liability. Practically then, the joint venture combination is never hidden from third parties. 64

The limited liability company is the most advantageous and practical 65 form of investment for the United States company to take with a Saudi partner; it is also the most popular form. 66 The Companies Regulations define the limited liability partnership 67 as "a partnership consisting of two or more partners who are responsible for the debts of the partnership to the extent of their respective interests in capital, and in which the number of partners shall not exceed fifty." 68 Further references to joint ventures in this paper shall be to a Saudi limited liability company. The limited liability company can operate in all areas of Saudi business except "insurance, savings or banking operations." 69

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59 Santire, supra note 45, at 565.
60 Companies Regulations, Royal Decree M/6, 22/3/1385 (1965), as amended by Royal Decrees M/5, 12/3/1387, M/23, 28/6/1402 and M/46, 4/7/1405, reprinted in 2 A. Keesee, supra note 2.
61 Id. art. 40.
62 Santire, supra note 45, at 566.
63 Companies Regulations, supra note 60, art. 46.
64 Santire, supra note 45, at 566.
66 Comment, supra note 4, at 301.
67 A footnote in the text of the regulation also defines the partnership as a "'Limited Liability Company,' a form of commercial company similar to the English 'private company' with ownership represented by shares with restricted transferability whose holders are liable for company debts only to the extent of their contributions to the company's capital." Companies Regulations, supra note 60, art. 157. The limited liability partnership has also been likened to a United States closed corporation. Santire, supra note 45, at 567.
68 Companies Regulations, supra note 60, art. 157.
69 Id. art. 159.

https://scholarship.law.upenn.edu/jil/vol11/iss4/3
Articles 157, 158, 159, 161 and 162 of the Companies Regulations are the most pertinent parts to comply with in forming a limited liability company. Article 161 prescribes certain particulars that must be included in the Memorandum of Association, the signed agreement between the parties. Failure to comply with any of these pertinent articles will result in the limited liability company "being considered null and void as regards any interested party," with the exception that the partners cannot use the invalidity against third parties to shield themselves. The company must, within thirty days of formation, file an application with the Companies Registrar at the Department of Companies and have the Memorandum of Association published in the Official Gazette. Publication in the Official Gazette affords the government an excellent opportunity to scrutinize the company and the agreements that have been made between the partners. As a result, many companies have chosen to embody many of the proprietary provisions in agreements, other than the Memorandum of Association, which are not subject to government scrutiny. Publication also provides the government with valuable details about the company enabling it to determine compliance with government regulations.

The Companies Regulations do not specify a minimum capital amount that the Saudi company must contribute nor do they require any specific degree of control that the Saudi partner must have. However, in the future, Saudi Arabia could join other Arab countries and require that foreign investment in the Kingdom be conditioned upon Saudi control of at least fifty-one percent of the company. The Companies Regulations allow the parties to specify, in the Memorandum of Association, the rights conferred in net profits and partners equity.

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70 The Memorandum of Association must contain at least the following provisions:
1) The kind, name, object, and head office of the partnership; 2) The partners' names, residence addresses, occupations, and nationalities; 3) The names of the managers, whether they are partners or nonpartners; 4) The names of the members of the board of controllers, if any; 5) The amount of capital and the amount of contribution in cash and in kind, as well as detailed description of the contributions in kind, their value, and the names of contributors in kind; 6) A statement by the partners that all the capital shares have been allotted and paid up in full; 7) The method of distribution of profits; 8) The dates of commencement and expiration of the partnership; and 9) The form of the notices to be served by the partnership on the partners. Id. art. 161.

71 Id. art. 163.
72 Id.
73 Id. art. 164.
75 Santire, supra note 45, at 568.
should the partners choose not to split them equally. This appears to give the partners considerable latitude in structuring the limited liability company, possibly allowing the United States partner to structure a joint venture in which it shares profits equally but retains majority managerial control. Practically, however, this will not happen because of the minimum ownership and control requirements the government has imposed in order for the company to obtain benefits under the Foreign Capital Investment Code and Tenders Regulations.

3.4. Formation of the Limited Liability Company

Formation of the limited liability company, as with any joint venture, is no easy task. It is also one that is time consuming. There is a considerable time lapse between when negotiations begin and when the company actually comes into being. A newspaper announcement of the formation of the Texaco/Saudi Refining Company joint venture called the twelve month development of that joint venture "speedy, despite its size." The complex negotiations are not only a result of the particulars of the company, but also a result of attempting to reconcile two systems of law. Another reason for the time lapse is Saudi postponements: "It is not at all unusual for Saudis to miss appointments altogether or to postpone them literally for weeks." To the United States investor this type of action is frustrating. However, to complain of the delays to the Saudis could be seriously detrimental to the proposed joint venture, since Saudis "tend to view impatience as a sign of bad manners or a lack of self-confidence." Those who endure the delays and show an understanding of this aspect of Saudi culture are often rewarded with valuable deals.

The documents which structure the joint venture usually provide some indication of the complexity of the negotiations. The newspaper article, referred to above, reported that the "document covering the terms of the agreement is more than three inches thick, with pages

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[76] Companies Regulations, *supra* note 60, art. 171.
[77] In order to receive the tax holiday available under the Foreign Capital Investment Code, at least twenty-five percent of the capital must be Saudi owned. Foreign Capital Investment Code, *supra* note 2, art. 7. In order to receive priority status when bidding for a government contract at least fifty percent of the capital must be Saudi owned. Saudi Arabian Tenders Regulations, Royal Decree M/14, art. I, 7/4/1397 (Mar. 27, 1977), *reprinted in* L. Glick, *supra* note 48, at 171.

[79] *Saudi Texaco Venture, supra* note 1.

[80] Note, *supra* note 5, at 175.

[81] *Id.* at 176 (footnote omitted).

[82] *Id.*; Comment, *supra* note 4, at 300.
The Assistant General Counsel for Mobil Chemical reported that "no single document lays out the guts of the joint venture arrangement. Rather the relationship is detailed in a number of different documents." Eight documents comprise the joint venture arrangement between Mobil Yanbu Petrochemical Company, Inc. and Saudi Basic Industries Corporation.

One particularly troublesome area of joint venture formation is the drafting of the purpose or objective clause of the joint venture. The objective clauses in Articles of Incorporation of United States companies are often open-ended statements which enable the company to pursue almost any line of business. However, the Saudi government frowns on such all-encompassing objective clauses. It is the government's intent to allow foreign investment into Saudi Arabia when it appears that the investment will be beneficial to the Saudi economy, technological development, or to the government itself. Therefore, the government will scrutinize the joint venture agreement to ascertain whether or not it meets these qualifications. Since the objective clause must be contained in the published Memorandum of Association, the government has easy access to the information it desires. The government wants to be sure that the foreign capital is truly devoted to development and wants strict control of foreign companies' activities in the Kingdom. Consequently, it will require specific, clear objective clauses: "Applications [for Foreign Capital Investment Licenses] are returned for having objectives that are too broad and ambiguous."

However, a company complying with this requirement, with a specific, detailed clause, can be in legal tax trouble if it operates outside its stated scope and enjoys profits from the operation. Profits obtained by activities outside the scope of the objective clause can cause the company to lose its tax holiday, as discussed below. As proposed by an accountant specializing in international accounting, one solution to this tax problem is "[w]hen applying for tax holiday. . . to widen the objects of the company as much as possible in order to cover activity in which the company expects to be engaged." However, this course is
not advisable from a legal standpoint since the tax holiday application is a separate document also subject to government scrutiny. Two different objective clauses pertaining to the same company will, in all likelihood, be looked upon unfavorably by the government and could put the United States partner's potential investment in the Kingdom in jeopardy. It appears that the conflict between these two policies can only be resolved by limiting the scope of the business, perhaps at the expense of forgoing future opportunities.

4. FOREIGN CAPITAL INVESTMENT CODE

Through the highly desirable five or ten year tax holiday, the government has an effective means of limiting and exercising control over foreign investment in Saudi Arabia. The government has made the holiday difficult for a company to pass up and so advantageous to the foreign company desiring to invest in the Kingdom that most companies will attempt to obtain it: "The ten year tax holiday. . . is an attractive inducement, particularly since, when coupled with an appropriate investment structure, it is possible for companies to operate in Saudi Arabia free of local as well as home country taxation."

The holiday is contained in the Foreign Capital Investment Code (hereinafter FCIC). The FCIC was implemented in 1979 to help stimulate foreign investment in the country. Through such investment the Saudi government hoped to use foreign technology, experience, and expertise to better Saudi business capabilities:

[The] benefits are being given with the expectation that the foreign firm will conduct itself with its Saudi partners so as to enhance their experience and their capabilities, and with the expectation that ultimately, the joint venture company will create a genuine, independent, self-reliant, economic enterprise. . . . [T]hat is the real result which the existing legal requirements are attempting to achieve. To the extent these results are not achieved, [it can be expected] that further regulations will follow designed to more effectively

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81 The Foreign Capital Investment Code provides a ten year tax holiday for industrial and agricultural enterprises and a five year holiday for all other enterprises, provided certain requirements are met. Foreign Capital Investment Code, supra note 2, art. 7(2).

82 Absent the tax holiday, a non-Saudi partner would be subject to an income tax of up to forty-five percent on profits in excess of $300,000. Homsy, supra note 74, at 23.

83 Taylor, supra note 54, at 89.

84 Foreign Capital Investment Code, supra note 2.

https://scholarship.law.upenn.edu/jil/vol11/iss4/3
Ten years after its promulgation, the FCIC has become the primary vehicle through which the Saudi government exercises control over foreign companies and jointly owned limited liability companies. In order to obtain the coveted benefit of the tax holiday, a company must comply with a complex maze of provisions not limited exclusively to those in the code itself.\(^9\) As a result, the United States investor must check compliance with other Saudi regulations in order to enjoy the tax holiday.

The heart of the code is Article 2, which provides that

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\text{[a]ny investment of foreign capital}^{97}\text{ must be authorized by a license to be issued by the Minister of Industry Committee, and must meet the following two conditions: (1) It must be invested in an economic development project, which term, for purposes hereof, does not include petroleum and mineral projects; and (2) It must be made in connection with the utilization of foreign technical know-how.}^{98}
\]

The code further establishes a committee (the Foreign Capital Investment Committee) to oversee the investment of all foreign capital into Saudi Arabia.\(^99\) This Committee has the powers to recommend projects it deems to be economically developmental, to review applications for foreign capital investment, to consider both complaints made by foreign investors and disputes arising from application of the code, to make recommendations for penalties to be imposed on those who violate the code and to provide for implementation of the FCIC.\(^100\) Through such discretionary authority, the Committee wields immense power over foreign capital investment policy and over the choice of companies permitted to operate in the Kingdom.

The Committee has used its discretionary powers to create several requirements that are not explicitly stated in the code as originally promulgated. In order to qualify as an economic development project, the project must fit into one of the categories specified by the Minister

\(^{95}\text{Zerfas, }\text{Legal and Practical Issues in Forming and Operating Joint Ventures (Part I), 2 MID. É. EXEC. REP., Feb. 1979, at 3, 17.}\)

\(^{96}\text{Enterprises that enjoy benefits under the code are "subject to the Regulations for Workmen and Social Insurance and other laws and regulations in force in the Kingdom." Foreign Capital Investment Code, supra note 2, art. 8.}\)

\(^{97}\text{Foreign capital is defined in the code as "any monies, notes, bonds, instruments, machinery, equipment spare parts, raw materials, products, means of transport, rights, including patents and trade mark, and similar assets. . . ." Id. art. 1.}\)

\(^{98}\text{Id. art. 2.}\)

\(^{99}\text{Id. art. 5.}\)

\(^{100}\text{Id.}\)
of Industry and Electricity. The five types of economic development projects that have been identified are industrial, agricultural, health development, services and contracting projects. The important criteria used to determine the desirability of a project are whether it will employ and train Saudi nationals, what type and how much technology will be imparted to the Kingdom, and what the potential is for the project to expand the manufacturing capabilities of the Kingdom. Development ventures are ones that are in keeping with the five year Development Plans of the government. One attorney commented that "[a]ny foreign applicant will significantly increase its chances of obtaining a license if it demonstrates to the Foreign Capital Investment Committee a specific program for training Saudi Arabians in technical fields." However, the fact that a joint venture may meet the qualifications and fit in an approved category of development projects does not guarantee that it will receive a Foreign Capital Investment license. The discretionary powers of the Committee and the Minister of Industry and Electricity allow them to grant or reject licenses based on market conditions or policy considerations. Therefore, selective licensing occurs, and when the Minister determines that a development area has become crowded, further licenses will be denied.

A second example of the ability of the Committee to influence requirements of the code involves control of the classification of enterprises. Industrial enterprises enjoy a ten year tax holiday under the FCIC. Industrial projects have been defined as involving "processing of raw or semi-finished materials or the fabrication of finished or semi-finished products for industrial or consumer use." However, this definition is rather broad and, as with other regulations in this area, is subject to further expansion or restriction by the Foreign Capital Investment Committee. The Committee, therefore, has the power to limit the availability of the holiday to foreign investors simply by changing the definition. If the Committee should, without warning, re-

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101 Homsy, supra note 24, at 52.
102 Id.
103 Homsy, supra note 74, at 21.
104 A. LERRICK & Q. MIAN, supra note 58, at 65; Taylor, supra note 54, at 89.
105 Homsy, supra note 74, at 21.
107 A. LERRICK & Q. MIAN, supra note 58, at 66.
108 Id.; See also Homsy, supra note 74, at 21; Gray, supra note 106, at 20 (Some areas that have been reported to be closing to foreign investment are construction, general contracting and maintenance).
109 Foreign Capital Investment Code, supra note 2, art. 7(2).
110 Taylor, supra note 54, at 88.
111 Id. at 88-89.
strict the definition, it is possible that, after lengthy negotiations, the United States investor may have an enterprise which no longer fits the definition of an industrial enterprise.

Several categories of enterprises are not subject to the FCIC Regulations. One category encompasses those investments of foreign capital which were already existing at the time the regulations became effective. However, increases in the operations or capital of such enterprises are subject to the regulations. Since the code is almost ten years old and the maximum holiday under the code is ten years, this exception is of no practical use to a United States investor. A second category of enterprises exempt from the regulations includes projects that are permitted to operate in Saudi Arabia by virtue of special agreements by the government or its agencies. Other activities not covered by the regulations are those within the sphere of consulting or professional services, banking and certain activities permitted by the Minister of Commerce under Article 228 of the Companies Regulations. However, since a limited liability company cannot be formed in the area of banking, freedom from compliance with the regulations is of no value to United States companies.

Procuring a special agreement with the Saudi government, one of its agencies, or a corporation owned by the government can be a way to avoid meeting the requirement that the project be economically developmental. This approach could be extremely helpful if the United States company is interested in investing in an area where licenses are being granted sparingly or in the field of petroleum and mineral projects. However, making an agreement with the government is risky given the volatile state of affairs in the Middle East. Should the government change, a United States company may find that its interest in the joint venture is in jeopardy.

The tax holiday is not the sole benefit conferred upon foreign investment by the FCIC. Article 7 of the FCIC provides for acquisition of real estate by the foreign investor and confers additional benefits on industrial enterprises. However, as is the case with other Saudi regulations, the investor does not find these benefits enumerated in Article 7, but rather must go searching through other regulations to find them. Rules governing the acquisition of real estate by the investor, in all

112 Foreign Capital Investment Code, supra note 2, art. 9.
113 Id.
114 A. LERRICK & Q. MIAN, supra note 58, at 69.
115 Foreign Capital Investment Code, supra note 2, art. 9(2).
116 A. LERRICK & Q. MIAN, supra note 58, at 69.
117 Companies Regulations, supra note 60, art. 159.
118 Foreign Capital Investment Code, supra note 2, art. 7(1), (3).
likelihood a necessity for the limited liability company, can be found in
the Regulations concerning the Ownership of Real Property by Non-
Saudis.\textsuperscript{119} Benefits for industrial projects can be found in the Regula-
tions for Protection and Encouragement of Domestic Industries.\textsuperscript{120}

Although the FCIC directs the investor to these two regulations by
specifically naming them, one benefit for foreign investment that the
code does not refer to is the Saudi Industrial Development Fund\textsuperscript{121}
(hereinafter SIDF). Since the SIDF was promulgated before the FCIC,
like the two benefits mentioned above, it is quite possible that it may be
overlooked. Investors may not anticipate that substantial benefits for
foreign investment, like the SIDF, would have existed before the enact-
ment of the FCIC, because of the importance of the FCIC to the gov-
ernance of foreign investment. The SIDF is a desirable benefit because
it can provide industrial loans for up to fifty percent of a project cost at
minimal charges to enterprises with Saudi participation.\textsuperscript{122} Since the
participation requirement is the same for the tax holiday, some mention
of the SIDF in the code would have been appropriate to alert the for-
eign investor. The example of the SIDF demonstrates that there may
be other benefits lurking in Saudi laws if the investor is willing to
search diligently for them. However, attorney and consulting fees may
make such a search a costly endeavor.

4.1. Tax Holiday

The tax holiday is the premier benefit for foreign capital invest-
ment in Saudi Arabia. The holiday exempts industrial and agricultural
enterprises from corporate and income taxes for ten years, as long as
they comply with the FCIC.\textsuperscript{123} All other types of enterprises receive a
five year exemption.\textsuperscript{124} However, in order to obtain and maintain the
benefit, the foreign investor must carefully comply, not only with all
applicable regulations in the FCIC, but also with all “other laws and
regulations in force in the Kingdom.”\textsuperscript{125} Grants of the tax holiday, be-
because its benefit is so substantial, invoke intense government scrutiny on

\begin{itemize}
  \item \textsuperscript{119} Regulations Concerning the Ownership of Real Property by Non-Saudis, Royal Decree M/22, art. 2, 12/7/1390 (1970), \textit{reprinted in} 2 N. KARAM, \textit{BUSINESS LAWS OF SAUDI ARABIA} (1989).
  \item \textsuperscript{120} Law for the Protection and Encouragement of National Industry, Royal Decree M/50, 23/12/1381 (1962), \textit{reprinted in} 2 N. KARAM, \textit{supra} note 119.
  \item \textsuperscript{121} Saudi Industrial Development Fund Regulations, Royal Decree M/3 (1974), \textit{reprinted in} 2 A. KEESSEE, \textit{supra} note 2.
  \item \textsuperscript{122} Id. art. 4(6).
  \item \textsuperscript{123} Foreign Capital Investment Code, \textit{supra} note 2, art. 7(2).
  \item \textsuperscript{124} Id.
  \item \textsuperscript{125} Id. art. 8.
\end{itemize}
the limited liability company. The primary requirement before the tax holiday is granted is that Saudi capital in the company must comprise at least twenty-five percent of the total capital, and this percentage must be sustained throughout the exemption period. Through the tax holiday the government has, in effect, nullified the no minimum capital requirements of the Companies Regulations for limited liability companies. As a result, almost all limited liability companies will consist of at least twenty-five percent Saudi capital.

The tax holiday for all projects takes effect "as of the date on which production commences." Difficulties for the United States investor arise because production has not been defined for agricultural or industrial projects. It is therefore advisable to have someone from the Department of Zakat and Income Tax, the Ministry of Industry and Electricity or the Ministry of Agriculture witness the first day of production. Doing this will be easier than trying to prove production after the fact. However, for other types of enterprises, the date of commencement of production has been considered the date of registration in the commercial register.

Designating the date of production as the date of registration, the Saudi government has created a loophole which can be used to catch and tax some foreign investors. If the foreign investor must procure contracts and engage in preparatory activities before the final agreement with the Saudi partner is signed and the venture registered, then the contracts signed and activities undertaken before the registration are subject to taxation. The only solution to this problem would be to have the contracts taken in the name of the Saudi partner and then transferred or assigned to the joint venture once the holiday begins. However, because the Saudi and foreign partner have yet to sign an agreement, the Saudi partner may not want to undertake such a burden. Third parties as well may not want to enter into such contracts.

126 Id. art. 7(2).
127 Id.
128 El-Bayouk, supra note 90, at 13.
129 Id.
130 Taylor, supra note 54, at 90. But see Zerfas, supra note 64, at 15 ("[I]t should be noted that although there has been confusion in the past, based on a ruling from the Department of Taxation, it now appears that in construction projects the tax holiday commences on the date the first contract is signed after the joint venture receives its foreign investment license.") (emphasis in original).
131 Homsy, supra note 24, at 54; see also Zerfas, supra note 65, at 15 ("Profits from contracts signed before the license is received are not entitled to a tax holiday, even if the profits are actually received after the holiday commences.").
133 Homsy, supra note 74, at 23.
since it is still uncertain whether the joint venture will actually come into being. Because the holiday is for only five years after the registration of the company, the venture is at a disadvantage if contract negotiations that are necessary to commercially begin the enterprise take some time after registration. In order to get the full benefit of the holiday, the venture should hold off registering until a few days before signing the contract. In that way, no part of the holiday is forfeited. The amount of time between the granting of the license and the registration of the company cannot exceed six months however, or the Foreign Capital Investment Committee has the right to revoke the license.

Even though the limited liability company is exempt from taxes, the government requires it to file a tax return. It must file the same information as a company which is not subject to the exemption. Since August 1983, the Department of Zakat and Income Tax has required that all documents and submissions made to the tax authorities be made in Arabic. The tax authorities are to reject any filings prepared outside the Kingdom and “to assess tax arbitrarily on any company which does not present its accounts in the Arabic language certified by an accountant licensed to practice in the Kingdom.” The government further requires that all the books of the company be kept locally and in Arabic which, for complex transactions add substantial translation costs to the company. A primary purpose for requiring the tax holiday company to file income tax returns is, once again, governmental scrutiny. The government wants to examine all sources of profit to be sure they have been derived only from the objectives of the company. If any profits have come from sources outside the scope of the objectives, they will be subject to income tax. More important than being subject to income tax, if the government discovers that the company is operating outside the scope of its stated objectives, the company could be in jeopardy of losing the holiday, be subjected to tax penalties

134 El-Bayouk, supra note 90, at 13.
135 The license expressly provides that the Ministry may cancel it if the partners do not take the measures necessary to implement the license within six months from its date. A. Lerrick & Q. Mian, supra note 58, at 68.
136 El-Bayouk, supra note 90, at 13.
138 Id. (emphasis added).
139 Id.
140 Bil-'Arabi, Min Fadlak (In Arabic Please), 6 MID. E. EXEC. REP., Nov. 1983, at 25.
141 El-Bayouk, supra note 90, at 13.
and retroactive taxes on the unauthorized activities or lose its Foreign Capital Investment License altogether. 142

There are two unsettled areas of taxation facing the joint venture and posing potential legal complications for the United States investor. One area involves interest earned by the company. This interest has been treated as not covered by the holiday, resulting in the United States investor having to pay the tax on its proportionate share. However, no final decision has been made concerning this taxation and consideration is being given to exempting interest that occurs as a result of the normal course of business. 143 Secondly, the Department of Zakat and Income Tax has held that a joint venture of two or more companies may be considered a consortium and that profit realized from the consortium is subject to tax, although the joint venture is a tax holiday company. 144 No final decision has been made in this area either. Therefore, it is imperative for a United States investor to obtain accurate tax advice regarding both these situations before entering into a joint venture agreement.

Once the tax holiday period has ended, the foreign entity becomes subject to income taxes. 145 Extensions of the holiday are rare, but the possibility exists if the company can show substantial additions to the joint venture or an undertaking of a genuinely new project. 146

4.2. Profit Sharing

Although the Companies Regulations do not require the profit sharing of a limited liability company to equal the amount of equity ownership, 147 this is not true in the case of the FCIC. A conflict therefore exists between the two regulations, with a disadvantageous result to United States companies, as the FCIC regulations have been given priority. Restrictions have been placed on the unequal distribution right: "Ministry of Commerce Circular 11-1088 issued by the Committee for Classification of Contractors points out that to qualify under the Foreign Capital Investment Code, the Saudi partner must share proportionally in the ownership of fixed assets and have an effective role in the management of the enterprise." 148 This requirement provides the Saudi government with yet another means with which to catch the

142 Homsy, supra note 74, at 23.
143 El-Bayouk, supra note 90, at 14.
144 Id.
145 Id.
146 Id.
147 See supra note 76 and accompanying text.
148 Taylor, supra note 54, at 92 (emphasis added).
United States investor:

[T]here seems to be a basic, though not formalized, rule that if the distribution of profits differs more than ten percent from share ownership, the Foreign Capital Investment Committee will question the validity of the limited liability company. If the distortion affects the twenty-five percent minimum, the tax holiday could be disallowed.\textsuperscript{149}

Therefore, taking both the Companies Regulations and the FCIC together, the Saudi partner must not only be allocated a fair percentage of profit but also a proportionate percentage of duties of the venture. The United States company could probably not then effectively "buy off" the Saudi partner by giving it a large percentage of profits in return for a large percentage of managerial control of the business. Perhaps this is because the government wants the Saudi businessmen to have significant roles in the venture so that they can learn the skills necessary to operate such a venture in anticipation of the day when the government decides to restrict foreign investment altogether.\textsuperscript{150} Foreign investment is therefore serving the purpose of relieving the Saudi government and business sector of some of the costs of obtaining the necessary expertise and technological know-how to operate businesses on their own.

The only way to structure the company to achieve a significant variance of control and profit sharing is at the expense of foregoing the tax holiday. The United States partner could own fifty percent of the venture and could enter into a management contract with the venture. The taxes on the proceeds which flow to the foreign company as a result of the management contract, which are exempt from the tax holiday, are nonetheless eligible for reimbursement by the venture. Furthermore, the foreign company can deduct the reimbursements against its profits. Therefore, the tax burden of the management contract is

\textsuperscript{149} Santire, \textit{supra} note 56, at 11. \textit{But see} Cartwright & Hamza, \textit{Service Agents Regulation and Related Laws Affecting Foreign Companies in Saudi Arabia}, 17 \textit{INT'L LAW.} 203, 212 (1983) ("It is nearly universally recognized that [the requirement that Saudis own twenty-five percent of a company's capital] does not mean that Saudi shareholders must also be entitled to at least twenty-five percent of the profits of the joint venture company . . . .").

\textsuperscript{150} "We also believe that the intent [of the tax holiday legislation] is that the joint ventures will become truly independent companies, rather than mere legal cloaks under which foreign companies perform operations in the same manner they would with direct contracts. . . . [T]he regulations are having their intended effect. We are witnessing an evolutionary process in Saudi Arabia whereby many who were formerly passive commission agents are now becoming sophisticated businessmen with their own support staffs. . . ." Zerfas, \textit{supra} note 95, at 17.
distributed among the partners. 151

5. THE TENDERS REGULATIONS

The Saudi Arabian Tenders Regulations 152 apply to contracts made between companies, foreign and domestic, and the Saudi government. 153 Since the majority of foreign investment in Saudi Arabia is involved in government contracts, 154 compliance with the Tenders Regulations is important.

The Tenders Regulations provide for a preference in governmental contracts for Saudi Arabian goods, companies and individuals. 155 Such preference for Saudi goods is applicable even when the Saudi manufactured good is of lesser quality than a comparable foreign good. 156 The Saudi product need only be "satisfactory." 157 Evidence suggests that in the past, the rules had not been strictly enforced. However, government officials have been pushing for stricter observation of the requirements. 158

To further promote this "Buy Saudi" policy, the Ministry of Industry and Electricity publishes a list of locally manufactured goods for governmental projects. 159 Since "all government contracts are theoretically required to contain a clause obligating contractors to purchase goods on the list," 160 a limited liability company which is contracting with the government must likewise include such a clause. Oversight of this requirement or ignorance of the "Buy Saudi" rules could jeopardize the license of the limited liability company. Since the FCIC requires compliance with "other laws and regulations in force in the Kingdom," 161 the tax holiday benefit could also be in jeopardy if a company fails to abide by the "Buy Saudi" rules. A contractor cannot even import goods similar to those on the list, 162 and foreign companies cannot import supplies and consumer products for their employees. A Saudi firm must import the product for the limited liability company, if the

151 Santire, supra note 56, at 11.
152 Tenders Regulations, supra note 77.
153 Id. art. I(a).
154 L. Glick, supra note 48, at 170.
155 Tenders Regulations, supra note 77, art. I(d).
156 Id. art. I(e).
157 L. Glick, supra note 48, at 165 (quoting Resolution of Council of Ministers No. 1977 dated 17.11.1396 (Nov. 17, 1976)); see Simpson, supra note 6, at 17.
158 L. Glick, supra note 48, at 166.
159 Id. at 168.
160 Id.
161 Foreign Capital Investment Code, supra note 2, art. 8.
162 L. Glick, supra note 48, at 168.
good is not available locally. 163

The watchful eye of the government has placed an enforcement mechanism for the "Buy Saudi" requirements in the Tender Regulations Implementing Rules. 164 The rules require that a company which has submitted a bid must include on its price list whether the items on the list are produced or manufactured in the Kingdom, another Arab League country or a foreign country. 165 This section serves two purposes: 1) to monitor compliance with the "Buy Saudi" rules, and 2) to monitor compliance with the Israeli Boycott rules.

The Tender Regulations, however, do give limited liability companies a significant advantage. These companies have second priority in dealing with the Saudi government, provided that Saudi ownership of the company is more than fifty percent. 166 Limited liability companies wishing to engage in the business of regularly procuring government contracts must therefore be willing to give the Saudi partner(s) majority ownership control in order to obtain the bid preference. The United States partner may want, in return for minority ownership, to retain majority managerial control or a majority share of profits. As was discussed above, 167 share of the majority of managerial control and profits does not have to coincide with equity ownership so long as the Saudi partner is meaningfully participating in the operation of the company and the distribution of profits. 168

While the Tenders Regulations provide the limited liability company (and hence the United States investor) with a significant benefit, it comes at the expense of the freedom to design the company as it desires and as the Companies Regulations permit. 169 If the company anticipates needing or desiring to procure government contracts on a regular basis, it must give the Saudi partner(s) majority ownership control. Failure to grant majority ownership control will place the company on the bottom of the totem pole for government contracts. Given the government's preference for supporting Saudi business and the growing sophistication of Saudi businessmen as a result of the government policies regarding foreign investment, the limited liability company with less than fifty percent Saudi equity may effectively have no chance at all for these contracts in the near future.

163 Id. (discussing Saudi Port Authority Release dated Aug. 1, 1978).
165 Id. art. 7(b).
166 Tenders Regulations, supra note 77, art. I(d).
167 See text accompanying note 76.
168 See text accompanying note 147.
169 See text accompanying note 76.

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6. Arbitration

A provision for the settlement of disputes should be included in the Memorandum of Association; these provisions should address not only disputes between the partners, but also disputes in contractual relations between the company and third parties. Before forming the limited liability company, it is important to discuss how each partner anticipates disputes will be resolved and according to what methods and procedures. This is especially important given the Saudi view that no Saudi can be bound to any other law but the Shari'a. A growing trend for dealing with disputes in Saudi Arabia is the use of arbitration. A historical analysis of arbitration clauses in articles of association of Saudi companies from 1966 to 1980 found that “mixed companies, both on the basis of absolute number and percentage proportion, tended to provide for arbitration in their articles of association more than purely Saudi companies did . . . ”

In order to avoid being trapped and left with no choice but to apply Saudi law, some companies have instead chosen to provide for international arbitration. However, this is not a guaranteed cure-all: “It is widespread practice to include arbitration clauses for international arbitration in private contracts. Such clauses are generally regarded as lawful but unenforceable.” Saudi Arabian law regarding the lawfulness and enforceability of arbitration clauses is currently in a state of confusion. This confusion can be hazardous to the United States investor seeking to protect himself.

6.1. Place of Arbitration

Whether or not arbitration must be held in Saudi Arabia in order for the award to be enforceable in the Kingdom is an unsettled question of Saudi law. It is also a question of great interest to United States investors and attorneys counselling them. It is important to know what law will govern the resolution of disputes before one enters into the business relationship.

Between 1975 and 1979, the trend among limited liability companies was to specify, in their Memorandum of Association, that arbitration was to take place outside the Kingdom. These companies were

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170 See text accompanying note 13.
171 A. Lerrick & Q. Mian, supra note 58, at 177.
172 Id.
174 In 1975, only three companies provided for arbitration outside the Kingdom.
allowed to register with the Commercial Register Office of the Kingdom with this provision included in the Memorandum of Association. However, in 1979, the Deputy Ministry of Commerce directed all branches of the Ministry and the Commercial Register Office in Riyadh not to approve or register any articles of association of Saudi companies containing a clause providing for the resolution of disputes between the partners or the partners and the company by means of arbitration outside the Kingdom. The circular further stated that “arbitration shall be performed inside the Kingdom in accordance with effective regulations and instructions.” Finally, the circular declared that an arbitration clause contained in the articles of association of Saudi companies which provided for the submission of any disputes arising between contract parties to an arbitration committee outside the Kingdom is “considered absolutely void.” As a result of that resolution, in 1980 no articles of association provided for arbitration outside the Kingdom nor did any call for the application of non-Saudi law. The Saudi government went a step further in regulating arbitration clauses, by promulgating the Arbitration Regulations in 1983 and, in 1985, the Arbitration Regulations Implementing Rules.

Looking at the regulation, it appears that all arbitration clauses must therefore provide for arbitration in Saudi Arabia. Strangely enough, however, the government did not so specify when it promulgated the Arbitration Regulations or the Implementing Rules: “[The Arbitration Regulations] are silent on the issue of whether the...

In 1976, 1977, and 1978, twenty-two, twenty and twenty-six companies, respectively, provided for arbitration abroad. During those same years, only nine, ten, and ten companies, respectively, provided for arbitration within Saudi Arabia. In 1979, the number of companies specifying for arbitration outside the Kingdom had again dropped to only three. However, that drop can be somewhat attributed to a promulgation by the government, in 1979, condemning memoranda of association containing clauses calling for arbitration outside the Kingdom. A. LERRICK AND Q. MIAN, supra note 58, at 177-83.

The Office of the Commercial Register is the agency of the government which issues the necessary registration in order for the company to operate in the Kingdom. See text accompanying note 46.


Id.

Id. at 166-68.

Arbitration Regulations, Royal Decree M/46, 1, 9, 12/7/1403 (April 25, 1985)(note that the regulations were published in the Gazette Umm A1-Qura on 22/8/1403 (June 3, 1983)), reprinted in 2 A. KEESEE, supra note 2.


See Arbitration Regulations, supra note 180.

See Arbitration Regulations Implementing Rules, supra note 181.
arbitration proceedings must be held within Saudi Arabia in order for the parties to be able to obtain a stay of judicial proceedings or to obtain enforcement of the award under the Regulations." One authority has commented:

[I]f the arbitration proceedings are carried out in accordance with the procedural formalities provided in the [Arbitration] Regulations and the Implementing Rules and Saudi law is applied in the proceedings, the parties would be permitted to hold the arbitration proceedings in a place of mutual convenience outside the Kingdom and to obtain an award enforceable under the Regulations.  

It cannot, however, be assumed that because the Arbitration Regulations and Implementing Rules do not expressly exclude arbitration outside the Kingdom, that the 1979 Ministry of Commerce Circular is no longer good law. Regulations promulgated in the form of Ministry memoranda or circulars carry the same weight as royal decrees unless they are inconsistent with the royal decrees. Although the government promulgated the Arbitration Regulations and Implementing Rules with no restriction on a situs outside the Kingdom, the government, in the circular, directed all branches of the Ministry and the Commercial Register office to reject companies which included arbitration clauses providing for arbitration outside Saudi Arabia. This, in essence, specifies that all arbitration must be held in the Kingdom, just as if it were expressly stated in the Arbitration Regulations providing yet another example of a situation in which a United States investor seeking to invest in Saudi Arabia must go beyond the royal decrees to fully comply with Saudi law. The government has hidden a relatively important restriction in a memorandum from one of its Ministries instead of including it in the official promulgation of regulations. The result of non-compliance with this provision can be costly to the United States investor as the Memorandum of Association may be rejected. If the time spent reaching agreement on this provision was substantial, the monetary loss alone will be great.

6.2. Choice of Law

Saudi law regarding choice of law for arbitration is equally unclear. The Arbitration Regulations do not explicitly call for Saudi Law

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184 A. Lerrick & Q. Mian, supra note 58, at 160.
185 Id.
186 Asherman, supra note 11, at 325.
187 See A. Lerrick & Q. Mian, supra note 58, at 507.
to be the choice of law in the arbitration proceedings. However, Article 39 of the Implementing Rules provides that arbitration awards "shall be made in accordance with the provisions of the Islamic shari'ah and regulations in effect." Although it has been asserted that shari'a is divine law and no Saudi national or company can agree to be bound by any other law, the government's actions have not always been in keeping with this principle. Most significantly, Saudi Arabia's ratification in 1980 of the Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States (hereinafter Convention), is contrary to the position that shari'a is supreme. Saudi Arabia's endorsement of the Convention leaves United States investors once again wondering what Saudi law does and does not allow in this area.

The Convention established the International Centre for Settlement of Investment Disputes ("ICSID"). The ICSID is a forum for the resolution of disputes between signatory governments and parties who are nationals of other States. The ICSID provisions only apply to contracts in which the government and the party explicitly agree to submit disputes to the ICSID. Although the Convention went into force in 1966, the Saudi government did not ratify it until 1980. Parties that are signatories to the Convention agree to waive local jurisdiction and agree that the ICSID arbitration decisions are binding in the courts of the signatories. While Saudi Arabia ratified the convention, the government reserved the right not to submit to the ICSID questions "pertaining to oil and pertaining to acts of sovereignty. . . ." There has been no interpretation of this reservation yet, and "acts of sovereignty" remains a vague, undefined term thought to mean the discretionary rights of the government.

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188 A. LERRICK & Q. MIAN, supra note 58, at 163. But see Arbitration Regulations, supra note 180, art. 20, (enforceability of arbitrator's order is conditioned on the absence of provisions contrary to the Shari'a point of view).
189 Arbitration Regulations Implementing Rules, supra note 181, art. 39, at 505.
189 See text accompanying note 17.
191 A. LERRICK & Q. MIAN, supra note 58, at 169 n.84.
193 Id. art. 1(1).
194 Id. art. 1(2).
195 Id. art. 25(1).
196 A. LERRICK & Q. MIAN, supra note 58, at 169 n.84.
197 Convention, supra note 192, art. 54(1).
198 Taylor, supra note 54, at 93 (quoting from Saudi Arabia: Into ICSID-with Reservations, 3 MID. E. EXEC. REP., June 1980, at 13, 24.).
199 Id.; A. LERRICK & Q. MIAN, supra note 58, at 169 n.84.
The ratification of the Convention, after the Ministry of Commerce circular,²⁰⁰ appears to contradict the directives of that circular. Furthermore, it appears to contradict the exclusive jurisdiction given to the Board of Grievances over disputes to which the government is a party.²⁰¹ The ramifications of the ICSID ratification, the Board of Grievance jurisdiction, and the willingness of the Saudi Arabian government to apply the principles of both to arbitration clauses and arbitration proceedings between the government and a foreign party has not yet been tested.²⁰² It is not clear, therefore, whether United States investors can contract with the government or an agency of the government with a provision for arbitration providing for the application of non-Saudi law.

This dilemma provides an interesting twist with regards to the limited liability company. If the Saudi government were to allow full application of the Convention, a limited liability company in a contract with the government would, therefore, be allowed to provide for application of non-Saudi law in its arbitration clauses.²⁰³ However, the government has constructed yet another loophole by which it can require the United States/Saudi limited liability company to apply Saudi law. The limited liability company, in order to operate in the Kingdom, exists as a Saudi juristic person,²⁰⁴ thereby making inapplicable the provisions of the Convention, which governs disputes between a government and a foreign party: “Practically speaking, even in cases involving majority foreign participation, it is improbable that the Saudi Government will agree to treat a Saudi juristic person as the national of another State.”²⁰⁵

Given the inconsistencies in the rules regarding arbitration, the United States company wishing to invest will find it most desirable to use arbitrators in the Kingdom. A statement made by two attorneys in 1981, noting that “[t]he government of Saudi Arabia has yet to take a uniformly consistent position on arbitration,”²⁰⁶ still rings true today even though the Arbitration Regulations and Implementing Rules have

²⁰⁰ See supra note 176.
²⁰¹ The Board of Grievances has jurisdiction over disputes to which the government is a party; this jurisdiction includes contract disputes. A. LERRICK & Q. MIAN, supra note 58, at 240. The Board of Grievances derives this jurisdiction from regulations promulgated in 1982. Id. at 238 n.334.
²⁰² Taylor, supra note 54, at 94.
²⁰³ See id.
²⁰⁴ Id. at 87.
²⁰⁵ A. LERRICK & Q. MIAN, supra note 58, at 172.
²⁰⁶ Moore & Lott, supra note 173. The statement was made by Miami attorneys, Moore and Lott, who have practiced in Saudi Arabia with the firm of Hassan Mahassni, Burlingham, Underwood & Lord.

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been promulgated since that statement was made.

7. CONCLUSION

This comment has attempted to examine the various aspects of Saudi Law which present challenges to a United States investor wishing to establish a joint venture with a Saudi partner in the Kingdom. These challenges have developed as a result of what appears to be governmental attempts, in piecemeal fashion, to curtail foreign investment. While strong incentives for United States/Saudi Arabian joint ventures still exist, limitations on the structure of such ventures continue to show up, not in the regulations specifically dealing with foreign investment, but rather in other regulations governing commercial activity in the Kingdom. The regulations emerge not only in the royal decrees of the monarch, but also in a maze of memoranda and circulars of delegated authorities. The United States investor must search for regulations and directives in widely scattered locations throughout the government. A substantial monetary loss is the risk of failing to adequately familiarize oneself with the Saudi laws.

It is not clear exactly why the Saudi government appears to be stepping back from its policy of encouraging foreign investment as embodied in the Foreign Capital Investment Code of 1979. Perhaps the Saudi markets have become overcrowded and the government is attempting to protect Saudi local business. More importantly though, perhaps the Saudis have gained the technological and economic development the foreign capital was designed to stimulate, and the Saudis may now want to become major foreign investors themselves. If this is true, one can probably look for continued restrictions placed on foreign investment in Saudi Arabia and one can expect more Saudi participation, like the Texaco/Saudi Arabian Star Enterprise, in business opportunities outside the Kingdom.