

AN OVERVIEW OF LEGAL STRUCTURES IN THE GCC COUNTRIES

Issues of Risk and Strength

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The legal systems of the nations that comprise the Gulf Cooperation Council -- Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates -- have undergone dramatic, radical and progressive change and development in the past 25 years, which is continuing. The major trend has been greatly increased codification of law and administered regulation which entail increasing substitution of institutionalized procedures for the traditional informal, discretionary exercise of authority. The changes have been very beneficial to foreign investors and businessmen, generally decreasing risk and unpredictability and increasing more conventional legal protections.

This presentation will provide a brief historical background to the legal systems of these countries, a summary of their basic legal institutions and legal forms for foreign companies doing business in the Gulf region, some consideration of the oil and gas sector and a discussion of the principal risks and safeguards.

Brief Historical Background

The legal systems in this area have a complicated and rich shared history. One starts with the legal developments reflected in the Old Testament, culminating in the directives revealed to the Prophet Muhammad set forth in the *Quran*, which laid the foundation for the great Arabic jurisprudence that developed through seven or eight centuries after the death of the Prophet. Thereafter came the strong influence of Ottoman legal scholarship and practice, followed in the nineteenth century by the introduction from Europe of the Napoleonic Code into Egypt. As other Arab legal structures have been developing during the twentieth century, the Egyptian influence has been very strong (particularly the influence of the great Egyptian legal scholar Sanhuri), although the British and other European colonial powers also had some influence. The recent transformation of the legal systems in all six countries reflecting the various strands of this historical tradition was a by-product of the post World War II nationalistic and

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independence movements combined with the discovery and exploitation of oil and its generation of substantial revenues and two decades of very rapid economic growth.

The Current Legal Structures

Five of the member countries, Kuwait, Bahrain, the UAE, Qatar and Oman, have written constitutions, while Saudi Arabia does not. In all six of the member countries supreme executive, legislative and judicial authority is vested in the central government and ultimately in the ruler and his family, although in the UAE authority is divided between the federal government and the seven constituent emirates, each with a ruler. While all six countries have separate, substantially independent judicial systems, only in Kuwait and Bahrain is there a clear distinction between the legislative and executive branches of the government. The distinction is observed in the UAE, Qatar and Oman, but the legislatures there are accorded primarily a consultative role. Arbitration procedures are available and generally are respected and encouraged as a means of resolving disputes, although local procedures are normally preferred to foreign facilities. *Sharia* courts exist side by side with civil courts, but in practice the *Sharia* courts and the body of *Sharia* law is increasingly restricted to family matters, succession, property and to some extent torts and criminal law. In commercial matters one way or another interest is normally recognized, although with limitations. With the re-emergence of Islamic finance, which for example is finding a role in project finance, the *Sharia* is having a new impact.

Other Trends and Considerations

In addition to the major underlying trend away from arbitrary exercise of authority to increased codification of law and administered regulation, recently a second important development has taken place in all the countries: highest level government policy decisions to permit and stimulate the private sector, involving both domestic and foreign elements, to replace the government in fundamental economic activities, including infrastructure development. At the same time, partly in concert with the foregoing development, all the governments have taken decisions (implemented in various degrees of fullness and effectiveness) to develop their private capital markets and to commence opening these capital markets to foreign investors. In cases of privatization of existing governmental economic activity these two developments are combined. These policies will not only influence the further development of the legal systems but eventually will probably have some effect on the political climate of the countries.

A third general consideration underlying the legal systems of the six countries is worth mentioning, which involves the tension that exists between the deeply felt need to protect and advance the economic and business interests of the governments and the nationals, on the one hand, and the competing dependency on worldwide demand for their vital oil and gas resources and need for foreign technology and professional training

and experience. The need to provide legal protection for the local interests and ensure their fair participation in the economic benefits of oil and gas wealth is deep-rooted and was partly based on the disequilibrium between the educational, professional, technical and business skills and experience of the West and those of the Gulf, caused by the earlier isolation, poverty and centuries of colonial influence (apart from Saudi Arabia), which is now being corrected. But this insistence on local interests' fair participation is reflected in the legal systems in a number of ways: the requirement that commercial agents and distributors be nationals; that local companies must be majority-owned by nationals; that with few exceptions local offices must be sponsored by nationals; and that until recently foreign interests could not invest in shares of local companies.

Forms of Doing Business in the Gulf for Foreign Companies

No Presence or Representative

A certain amount of business may be done without opening an office or appointing an agent in the country. Examples include sales from outside the countries directly to buyers in the countries, performing services in the countries through management and/or technical services agreement with a local company and secondment of personnel. This latter approach may be combined with a licensing agreement and is also sometimes used by subcontractors. Contractual joint ventures and consortiums are also available as an option in limited circumstances. At least one of the joint ventures or consortium members must be licensed locally and may sponsor others.

Selling Products into the Countries Through Commercial Agents

A greater commitment and involvement is reflected in establishing a commercial agency with a local individual or company for the distribution and sale of the products of the foreign principal, which is a prominent feature of the Gulf commercial landscape.

Commercial agencies are regulated by commercial agency statutes. All commercial agencies must be registered with a central authority, usually the Ministry of Commerce, and in each of the GCC states commercial agencies are limited to national citizens, and only in Bahrain, Kuwait and Oman may local companies which are not 100 percent locally owned be commercial agents (51% local ownership being required). In all except Kuwait, an agency is automatically deemed to be exclusive for the specified territory. With respect to military procurement and oil and gas activities, foreign companies are normally precluded or discouraged from using local agents.

Perhaps the most significant feature of the various GCC commercial agency laws is their express provision for compensation to the agent in the event of termination without justification. In practice, justification is seldom found in the absence of gross neglect of the agency or substantial breach of the agency contract. Compensation for

termination is intended, according to the statutes, to reimburse the agent for his efforts and expenditures leading to the success of the agency, but it has largely become a weapon for commercial leverage to prevent the free transfer of agencies.

The increasing need of the region to attract foreign exports and the increased competition among local businessmen for the desirable commercial agencies when combined with the unfavorable consequences of the commercial agencies laws to the foreign principal has resulted in the increasingly frequent practice of foreign principals willing to appoint commercial agents only if the local agent agrees not to register the agency under the laws. This practice exposes both the principal and agent to the risk that the courts may not enforce the agency contract and the principal is at some risk that the courts will apply the provisions of the commercial agency law even though the agency has not been registered.

Branch Offices

Foreign companies may establish permanent operating branch offices in Bahrain, Qatar and the UAE but except in certain special exempted situations (normally professional firms or firms having government contracts) the sponsorship of local citizens is required. The branch office option is generally available in other GCC states only on a temporary basis in connection with government projects, or by special exemption. Representative or liaison branch offices may be established more quickly and easily than operating branch offices. Only local sponsorship is required, which increasingly may not be required. However, the functions of rep offices are strictly limited—they are limited to marketing and support services, may not enter into contracts and cannot generate income. The sponsor is normally paid a sponsorship fee, either on a fixed fee or percentage basis. The sponsor may or may not be expected to provide ancillary services, such as marketing assistance or government access.

Subsidiaries

Each of the GCC states has enacted a companies law providing for the organization of a number of different kinds of entities, most of which provide for foreign parties. Foreign companies normally use the limited liability company form. Investment by foreign companies and individuals in companies organized within the GCC states is subject to restrictions. Except in Bahrain, Oman and Saudi Arabia in certain circumstances, foreigners are not permitted to hold more than a 49 percent interest in a local company and then only with respect to certain business activities. Some businesses in all six jurisdictions are restricted to companies 100% owned by nationals. All business enterprises are centrally registered and a separate “doing business” license, usually from the Ministry of Commerce, is normally required. Companies having foreign participation may require the approval of additional bodies established for that purpose.

More liberal corporate governance regimes (particularly from the point of view of a foreign company) have been established in free zones to attract foreign business, such as the Jebel Ali Free Zone at the Port of Jebel Ali, Dubai. For example, if a foreign company can meet the requirements of the Jebel Ali Free Zone, it can establish a 100% owned company, free of local involvement.

Some Observations on the Oil and Gas Sector

Except for the very important oilfield supply and service business sector, the world of oil and gas in the Gulf countries exists to a large extent outside the ordinary structures of business and law. It is largely conducted outside the private sector by the central governments through their ministries of petroleum or other instrumentalities, such as ADNOC in Abu Dhabi. Production and operating companies and related ancillary activities are largely owned or controlled by the governments. International economic and political factors and domestic policies and needs predominate with laws and legal process, apart from contractual relationships, in the background.

However, tenders by the government ministries or oil companies, such as ADNOC in Abu Dhabi, may deserve some comment. Taking ADNOC tenders as an example, there is no statutory UAE or Emirate law that governs these tenders (unlike other public sector tenders). The rules for tendering and contracting are based on ADNOC policy and are available in the bid package itself. Most significant contracts are awarded on the basis of either public or limited tenders. In some cases there are formal prequalification and/or contractor classification requirements for bidders. The standard tender procedure requires a bid bond in an amount of one to five percent of the contract value (normally closer to one percent). Award of a tender requires a performance bond, usually in the amount of 10 to 15 percent of the contract value, and there may be a maintenance bond of five to ten percent. Local law is normally the required choice of law and dispute resolution by local courts is regularly required, although local arbitration may be an alternative.

Contracting may be restricted by status to national citizens and companies. At least in the UAE, this requirement is not rigidly enforced where specialized foreign expertise is required. Where foreign companies are invited to tender, national companies may be given certain preference or advantages. More recently, however, cost conscious governments have modified some of these local company preferences.

Issues of Risk and Strength

Issues of Risk

Before we discuss the strengths and advantages of doing business in the Gulf, let us deal with the risks -- real and perceived.

It is normal for businessmen accustomed to democratic institutions to be wary of a governmental structure that places ultimate authority in a ruler and his family, and to believe that there is business risk involved; the perception that an investment may be lost because of arbitrary, capricious political decision-making from which there is no legal recourse. This possibility also exists, of course, in democracies, including the United States, and is present in varying degrees around the globe. So it is a question of comparison, particularly comparison of this risk among developing countries. In this context the underlying instinct and preference for consensus, the deeply rooted commitment to private business and entrepreneurial activity and the further commitment made more than a generation ago to education and the development of modern legal systems successfully hedges this risk in the Gulf area, although not eliminating it altogether.

At a more technical level involving the judiciary there is also some risk due to the substantial absence of meaningful judicial review of governmental action and the continuing difficulty of predicting judicial results. The latter problem is partially a consequence of the fact that court decisions are published haphazardly and the doctrine of stare decisis (i.e., that judgements reached in previous cases involving comparable issues of law and fact are controlling precedent for subsequent cases) is not recognized formally and as a practical matter is inconsistently followed. More generally, the effective administration of the legal systems still awaits the further development of standards and more experience related to modern commercial requirements to provide the desirable levels of professionalism at the lawyering, administrative and judicial levels and to wean the region from expatriate resources. But to be fair and accurate it must be quickly added that it is truly remarkable that so much progress has been made in these respects in such a short period of time.

A significant deficiency in the statutory legal systems that have been constructed is the failure to establish throughout the Gulf countries practical and functioning mechanisms for the recordation of security interests in moveable property, such as intellectual property, furniture and equipment and accounts receivable. Although there are well-established legal facilities for the recordation of security interests in real property, its utility for foreign creditors is substantially diminished because foreign companies and individuals (apart from the GCC nationals) are disqualified from owning interests in real estate and thus would not be entitled to foreclose on a mortgage. (It is to be noted that this problem is being dealt with by retaining a local bank, for example, to

take title to the real estate on behalf of the foreign person enabling foreclosure by the agent, but this has not yet been thoroughly tested in the courts and in any event is not entirely satisfactory.) (It is also to be noted that at least recently in Dubai a mechanism has been established to record a “mortgage” or pledge on the moveables of a business, but so far the mechanism remains largely untested.) It may be that the dearth of legal facilities for recording security interests in moveable property is explained by the fact that there has been no strong commercial need. Until quite recently a major part of the financial and business activity involved the governments, directly or indirectly, as creditor or debtor and therefore in either capacity security interests were not considered so important. To the extent governments were not involved it was likely that a family owned trading company was involved, so that a personal guarantee of one or more members of the family was considered adequate. However, business in the Gulf has become more sophisticated with more and different kinds of players involved. For example, with an increasing proportion of infrastructure development being allocated to the private sector and much of it being done on a non-recourse basis there will be a greater need for adequate mechanisms for the perfection of security interests.

From the point of view of a foreign company investing or doing business in the Gulf there are risks involved in the event a dispute arises that cannot be settled by negotiation or mediation. This is particularly true if the dispute is with a government or an instrumentality of the government.

If the dispute relates to a contract with a government or government instrumentality, it is unlikely that the foreign party has been given any leeway to negotiate choice of law, choice of forum or choice of arbitration mechanism. It is highly probable that the government will insist on local law and dispute resolution by the local courts, although a local arbitration mechanism may be an alternative. Careful negotiation of the contract to reduce the possibility of disputes and a conciliation or mediation clause, or at least a requirement for a significant “cooling off” period to be used for negotiation, may be the best practical safeguards.

If the dispute relates to a contract with a private sector local party without significant overseas assets (or with another foreign party which only has assets in the local jurisdiction), there remain some risks and problems. Let us assume that the foreign company has been able to negotiate into the contract foreign choice of law and foreign court choice of forum provisions, and let us further assume that the foreign company obtains a favorable judgement in the foreign court. Under our assumptions this judgement must be brought to a court in one of the Gulf countries for purposes of enforcement and collection. It is quite possible that if the local court can conclude that local law should be applicable (regardless of the foreign choice of law provision) or that the local courts could have taken jurisdiction or that the courts of the country in which the judgment was obtained do not recognize and enforce judgement of the courts of the Gulf country, the decision of the foreign court may be ignored or reopened. Even when a Gulf country has a treaty with another country relating to the enforceability of court judgments

in each other's country, as is the case with the UAE and France, there remain difficulties. For example, in a recent case in spite of the treaty it took almost 10 years for a French company with a favorable final decision from the French courts to enforce it in the UAE.

Would it reduce or eliminate the risk if the foreign company successfully included in the contract a foreign arbitration clause? Not necessarily; there is still risk, at the point that the foreign company (let us assume a foreign arbitration award in its favor) brings the award to the Gulf country court for enforcement and collection. Generally, the courts will grant enforcement orders for awards that are rendered in jurisdictions that accord reciprocal treatment to their awards, if the original panel for arbitrators had jurisdiction, if due process was observed, if the arbiter's award represented a final disposition of the dispute, if the award is not offensive to the laws and policies of the Gulf country involved (it could be if offensive to the *Sharia*) and if enforcement would not result in conflict, in the cases of Bahrain, Kuwait and Saudi Arabia, under the New York Convention of 1958, to which such countries are parties. In view of these conditions and an underlying disfavor of foreign arbitration awards it may be necessary to submit the award for reconsideration on the merits.

The Gulf countries acknowledge the concern of the foreign countries with dispute resolution mechanisms and in the past few years have attempted to deal with the issue by establishing local arbitration mechanisms with internationally recognized rules of procedure. It remains to be seen whether these facilities will attract the confidence of the foreign business community.

These concerns with dispute resolution issues frequently cause foreign companies to look for other ways to protect their interests in the event of contractual disagreement, such as requiring the other party to provide security for the performance of its obligations located outside the Gulf countries.

Elements of Major Strength

On balance it may be submitted that the strengths and safeguards of the Gulf countries' legal systems substantially outweigh any risks, and I would like to close my remarks with a brief identification of some of the most important of these positive factors:

- the ruling authorities are committed to the principle that countries should be governed by institutions, laws and consensus and not by individuals, which has been evidenced by the extraordinary, perhaps unique, development of modern statutory legal frameworks for the conduct of modern business in such a short period of time

- the ruling authorities place fundamental importance and value in private business enterprise, which is reflected in the legal systems
- the underlying political and structural stability of the six Gulf countries and the further stabilizing effect of the legal structures that have been put in place
- the absence of exchange control and the low incidence or absence of taxation
- the comparative infrequency of commercial dispute, perhaps occasioned by the tradition of resolving disagreement through negotiation and conciliation

If there may be some deficiencies with the legal systems of the GCC countries, let us consider how far and how fast the progress has been, and the fact that it is combined with a deep commitment to further development.