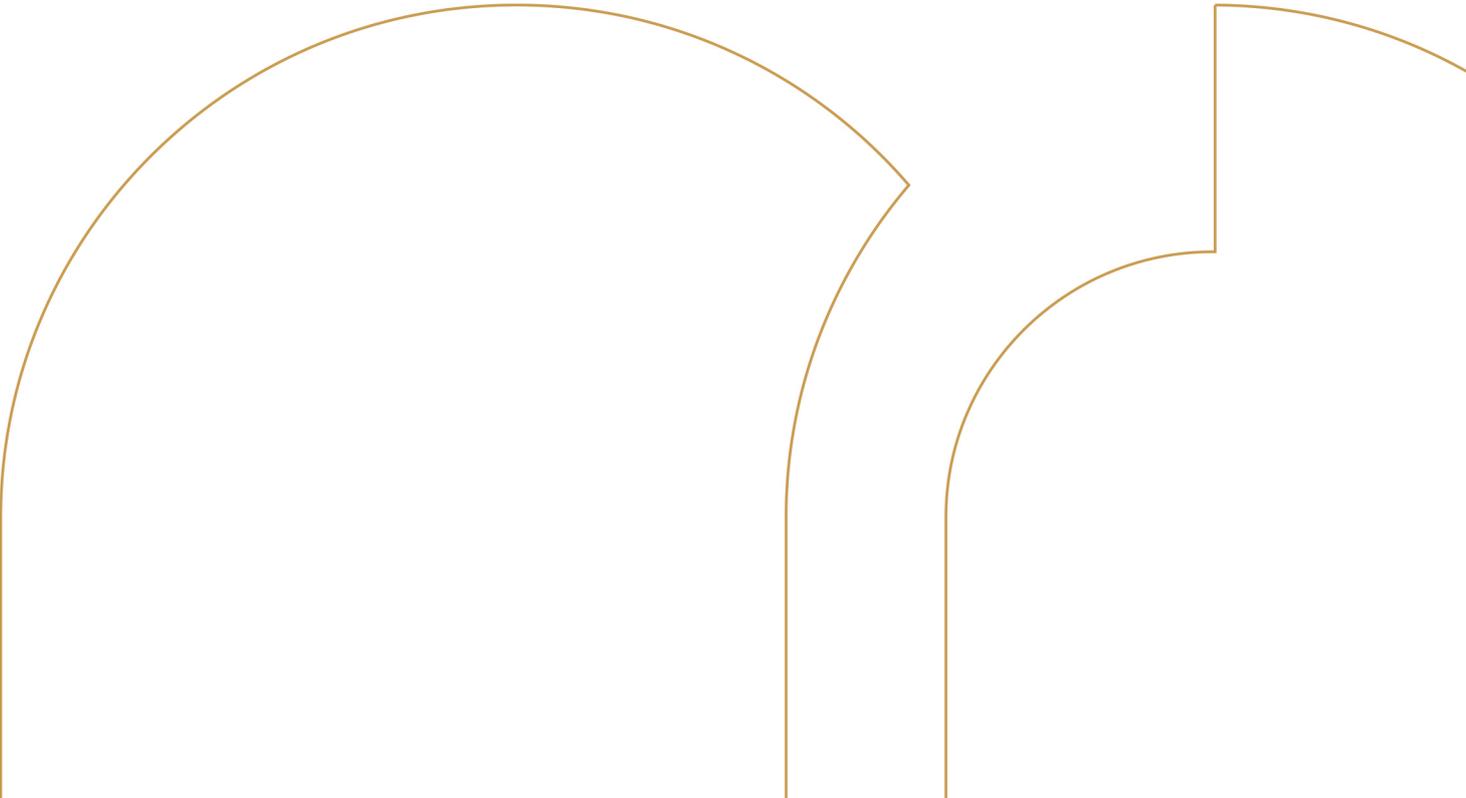




# The Surety Right of Subrogation in Bankruptcy Proceedings under Saudi Law: A Comparative Study



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## Foundations of the Problem

Suretyship constitutes one of the principal forms of personal security for debts. It is achieved by attaching an additional financial liability to that of the debtor in order to secure the creditor's right. Personal securities may take the form of placing one liability alongside another on an equal footing. Such forms include joint and several liability among debtors, the indivisibility of the debt, and the direct action available to the creditor.

Alternatively, personal security may take the form of attaching a subsidiary liability to a principal one, as is characteristic of suretyship. In this context, recourse against the subsidiary liability may be sequential, whereby the creditor is required to pursue the principal debtor first and may only resort to the guarantor thereafter, as is the case in ordinary suretyship. Recourse may also be concurrent, allowing the creditor to proceed against either the principal debtor or the guarantor at his discretion; this is the defining feature of joint and several (solidary) suretyship.

The nature of the surety's obligation under the provisions governing the contract of suretyship in the Civil Transactions Law is that it is ancillary to the obligation of the principal debtor. Accordingly, it is the principal debtor's obligation that determines the scope and extent of the surety's obligation. On this basis, the Law has established several legal effects, including the following:

1. The surety's obligation may not exceed or be more onerous than that of the principal debtor. Thus, the surety's obligation may not be immediate and due where the principal debtor's obligation is subject to a condition or deferred. However, the suretyship may be limited to a lesser amount, such as where the surety guarantees only part of the debt, or may be subject to less onerous conditions. If the suretyship is undertaken for an amount exceeding the principal debt, or subject to more burdensome conditions, it shall not be

formed or deemed valid except within the limits of the debt and in accordance with its terms<sup>1</sup>.

2. The surety's obligation may not subsist after the extinction of the principal debtor's obligation<sup>2</sup>.

Another consequence of the ancillary nature of the surety's obligation to that of the principal debtor is that the surety may raise several pleas against the creditor's claim, as follows:

1. The plea of prior recourse against the principal debtor, unless the suretyship is joint and several<sup>3</sup>.
2. The plea of excussion of the debtor's assets or *beneficium excussionis*, that allows the surety to demand that a creditor exhaust all legal remedies against the principal debtor unless the suretyship is joint and several<sup>4</sup>.

It should be noted that neither the plea of prior recourse nor the plea of excussion constitutes a matter of public policy; rather, the surety must expressly invoke either defense for the court to rule thereon.

3. The plea requiring the exhaustion of real security before enforcement against the surety's assets<sup>5</sup>.
4. The surety may raise against the creditor all defenses and objections available to the principal debtor, whether relating to the invalidity of the debt or to its extinction<sup>6</sup>.
5. The surety may seek discharge from liability to the extent of any security lost by the creditor due to the creditor's own fault<sup>7</sup>.

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<sup>1</sup> Article (584) Civil Transaction Law.

<sup>2</sup> Article (603) Civil Transaction Law.

<sup>3</sup> Article (591) Civil Transaction Law.

<sup>4</sup> Article (591) Civil Transaction Law.

<sup>5</sup> Article (594) Civil Transaction Law.

<sup>6</sup> Article (603) Civil Transaction Law.

<sup>7</sup> Article (588) Civil Transaction Law.

6. The surety may seek discharge from liability where the creditor delays in claiming the debt despite having been formally put in default by the surety<sup>8</sup>.
7. The surety may invoke the lapse of the creditor's right of recourse against the surety in the event that any liquidation proceedings are opened pursuant to the relevant statutory provisions, and the creditor fails to submit its claim within such proceedings, to the extent that the creditor would have recovered had it submitted a claim against the debtor<sup>9</sup>.

This latter defense raises several issues concerning its scope, the conditions for its application, and the manner in which it may be reconciled with the relevant provisions of the Bankruptcy Law.

Moreover, where the surety satisfies part of the debtor's obligation and subsequently seeks recourse against the debtor by way of subrogation, it becomes necessary to examine how this effect operates in the event that liquidation proceedings are opened against the debtor under the Bankruptcy Law<sup>10</sup>.

## The Effect of the Commencement of Liquidation Proceedings under the Bankruptcy Law on the Subrogation Claim

Article (599) of the Civil Transactions Law provides that where the surety satisfies the debt, he shall be subrogated to the creditor in respect of the rights held against the debtor. Where the surety satisfies only part of the debt, he may not exercise recourse in respect of what he has paid until the creditor has recovered the entirety of his claim from the debtor.

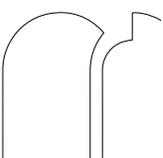
The import of this provision is that a surety's subrogation claim arising from partial payment of the debt does not prejudice the creditor. Rather, the creditor is given priority over the surety in

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<sup>8</sup> Article (589) Civil Transaction Law.

<sup>9</sup> Article (590) Civil Transaction Law.

<sup>10</sup> Article (599) Civil Transaction Law.



recovering the remaining balance of his claim, before the surety is subrogated to the extent of the amount paid.

This provision constitutes an application of the general principle whereby, if a person other than the debtor satisfies part of the creditor's claim and is subrogated thereto, such payment must not operate to the detriment of the creditor. Accordingly, the creditor remains entitled to priority in recovering the balance of his claim over the person who has effected payment, as reflected in the general rules governing subrogation and the recovery of debts from the debtor<sup>11</sup>.

It should be noted that the Bankruptcy Law provides that where a surety of the debtor's obligation, or any other person, satisfies part of the debt owed to the creditor either before or after the commencement of liquidation proceedings, the creditor must deduct the amount received from the claim submitted to the trustee. The Law further provides that the paying party—whether a surety of the debtor or a third party—may submit a claim to the trustee in respect of the amount paid<sup>12</sup>.

The provisions of Article (111) of the Bankruptcy Law do not conflict with the rules governing the subrogation claim set out in the Civil Transactions Law; rather, they affirm them. Payment by the surety or by a third party results in the substitution of that party for the creditor in submitting a claim to the trustee, whether in respect of the full amount of the debt in the case of full payment, or in respect of the portion of the debt that has been satisfied in the case of partial payment.

However, in cases of partial payment by the surety, the creditor must not be prejudiced thereby. Accordingly, the surety who has satisfied part of the debt may submit a claim to the trustee pursuant to the rules of subrogation. Nevertheless, upon the distribution of the liquidation proceeds, the priority of claims set forth in Chapter Twelve of the Bankruptcy Law must be applied in such a manner that the creditor is given precedence over the surety where both fall within the same class of creditors as enumerated in Article (196) of the Bankruptcy Law. In such

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<sup>11</sup> Article (263/2) Civil Transaction Law.

<sup>12</sup> Article (111) Bankruptcy Law.

circumstances, no pro rata distribution shall take place between them; rather, the surety's recovery pursuant to the subrogation claim shall occur only after the creditor has received full satisfaction of his claim.

This does not constitute an amendment to Article (196) of the Bankruptcy Law. This is because Article (76) of the Implementing Regulations of the Bankruptcy Law provides that the order of priority of debts within each of the categories set forth in Article (196) shall be determined in accordance with their order under the relevant applicable laws. Consequently, the provisions of Article (599) of the Civil Transactions Law apply where the creditor and the surety—who has made a partial payment and seeks recourse against the debtor through subrogation—fall within the same priority class. In such a case, the creditor is to be given priority over the surety in recovering his claim, and no *pari passu* distribution shall occur between them.

## The Effect of the Creditor's Failure to Submit a Claim against the Debtor on the Subrogation Claim in Bankruptcy Proceedings

### In Liquidation Proceedings

The Civil Transactions Law provides that where any liquidation proceedings are commenced against the debtor pursuant to the applicable statutory provisions, and the creditor fails to submit its claim for the debt within such proceedings, the creditor's right of recourse against the surety shall lapse to the extent of the amount that the creditor would have recovered had it submitted its claim against the debtor<sup>13</sup>.

This provision raises the need to determine the scope of its application, as its literal wording suggests that it applies to any form of liquidation proceedings under the Bankruptcy Law, the Companies Law, or any other statute that provides for the liquidation of the debtor.

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<sup>13</sup> Article (590) Civil Transaction Law.

The difficulty arises from the fact that liquidation under the Companies Law does not involve a formal procedure for inviting creditors to submit their claims in the same manner as under the Bankruptcy Law. Rather, the liquidator inventories the company's assets and liabilities and settles its debts before returning any remaining value to the partners or shareholders, or distributing any surplus proceeds of liquidation among them.

Many comparative legal systems containing similar provisions restrict their application to cases where the creditor neglects to submit its claim in the debtor's bankruptcy proceedings. This is the approach adopted, inter alia, in Egyptian, Syrian, Libyan, Iraqi, Lebanese, Kuwaiti, Jordanian, and Swiss law, among others.

It appears from the context of the provision and from the use of the phrase "the commencement of any liquidation proceedings" that the provision is intended to apply to liquidation proceedings under the Bankruptcy Law, rather than to other forms of liquidation.

On the other hand, the provision limits the lapse of the creditor's right of recourse against the surety to the amount that the creditor would have recovered had it submitted its claim against the debtor. This gives rise to a further question concerning the scenario in which the creditor submits its claim belatedly, after one or more distributions of the bankruptcy estate have already been made, thereby affecting the creditor's share of the distribution as a result of such delay. In such circumstances, the creditor would be unable to recover its claim after the implementation of a single or final distribution decision unless there are remaining assets in the estate or the debtor acquires assets after the distribution and before the termination of the liquidation proceedings<sup>14</sup>. This raises the question of whether the sanction provided for in this provision applies only in cases of a complete failure to submit a claim, or whether it also extends to delayed submission.

Given that the purpose of this provision is to eliminate the harm suffered by the surety as a result of the creditor's negligence in submitting its claim in the debtor's bankruptcy proceedings, the

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<sup>14</sup> Article (117) Bankruptcy Law.

provision should be applied in both situations: whether the creditor entirely fails to submit its claim, or submits it belatedly in a manner that causes prejudice to the surety by depriving the creditor of the opportunity to recover the debt in full, or by reducing the amount recovered to the extent of the remaining distributions of the bankruptcy estate.

### In Financial Restructuring Proceedings

Article (590) of the Civil Transactions Law does not explicitly address the scenario in which a creditor fails to submit its claim in financial restructuring proceedings under the Bankruptcy Law, and the impact of this failure on his claim against the surety.

It should be noted that the consequences of failing to submit a claim in financial restructuring proceedings under the Bankruptcy Law include the exclusion of the creditor from voting on the financial restructure proposal (FRP), as provided by Article (64) of the Bankruptcy Law. The FRP may include a reduction of the creditor's rights by the debtor, and the creditor may be unable to vote on the plan due to its failure to submit a claim in the debtor's bankruptcy or due to a delayed submission. Once approved by the court, the plan becomes binding on both the debtor and the creditor.

This raises the question: Does the creditor have the right to claim the remainder of the debt from the surety if, under the financial restructuring proceedings, it recovers only a portion of the debt due to its failure to submit a claim in the debtor's bankruptcy, combined with the approval of other creditors in favor of the plan and the subsequent court ratification?

Although neither the Civil Transactions Law nor the Bankruptcy Law explicitly addresses the extension of the sanction under Article (590) of the Civil Transactions Law to cases where the creditor's own negligence results in a reduction of the amount it can recover, either by failing to submit a claim, by failing to participate in the vote in the financial restructuring proceedings, or by voting in favor of a proposal that reduces its rights, the principle is that the surety should not bear the consequences of the creditor's negligence in claiming the debtor.

This principle constitutes an application of general tort rules: the creditor's fault in failing to properly claim the debt against the principal debtor causes harm to the surety. Accordingly, the remedy should be a reduction in the creditor's right to recover from the surety, to the extent of the loss caused by the creditor's negligence. This reflects the general principle, as articulated in Rule Sixteen of the general rules set forth in Article (720) of the Civil Transactions Law, that harm must be removed.

Furthermore, the provisions of the Civil Transactions Law indicate that harm caused by the creditor's negligence in impairing or diminishing its rights against the principal debtor is not considered a matter of public policy. Therefore, parties may agree otherwise. The surety must, however, assert its discharge or raise a defense based on these provisions when responding to the creditor's claim.

Many comparative legal systems adopt a similar approach. The French Civil Code, for example, establishes a general rule exonerating the surety to the extent that the creditor's negligence affects the surety's subrogation claim, treating it as a matter of public policy, such that it cannot be contracted around<sup>15</sup>. Spanish law adopts a comparable position, even extending it to joint and several guarantees so long as the creditor's conduct affects the subrogation claim<sup>16</sup>. The Egyptian Civil Code likewise provides that, in the event of the debtor's bankruptcy, the creditor must submit its claim in the bankruptcy; otherwise, its right of recourse against the surety is reduced to the extent of the harm caused to the surety by the creditor's negligence<sup>17</sup>.

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<sup>15</sup> Article 2314 du Code Civil Français prévoit: “*La caution est déchargée, lorsque la subrogation aux droits, hypothèques et privilèges du créancier, ne peut plus, par le fait de ce créancier, s'opérer en faveur de la caution. Toute clause contraire est réputée non écrite*”.

<sup>16</sup> Article 1852 Spanish Civil Code provides that: “*The guarantors, even if they are joint and several, shall be released from their obligation if, as a result of any act of the creditor, they cannot be subrogated in the rights, mortgages and privileges thereof*”.

<sup>17</sup> Article (786) Egyptian Civil Code.

It appears that the Saudi Bankruptcy Law and Civil Transactions Law adopt a similar position to these comparative systems: the creditor bears the consequences of its failure to claim the debtor, to the extent that this affects the surety's subrogation claim. The creditor's right of recourse against the surety is thus reduced to the amount it could have recovered had it properly submitted its claim. While the Civil Transactions Law explicitly addresses this scenario in liquidation proceedings, its application to financial restructuring proceedings follows naturally from general principles of tort liability.

### Final Observations

Given that personal guarantees play a critical role in facilitating access to credit—by enabling financing for enterprises that cannot provide sufficient real security—and that the Saudi legal system protects the surety from competition by the creditor in claiming the debtor through the subrogation mechanism, creditors should not rely solely on the solvency of the personal surety, to the extent that it encourages negligence in claiming the debtor during bankruptcy or restructuring proceedings, thereby prejudicing the surety's rights under the subrogation claim.

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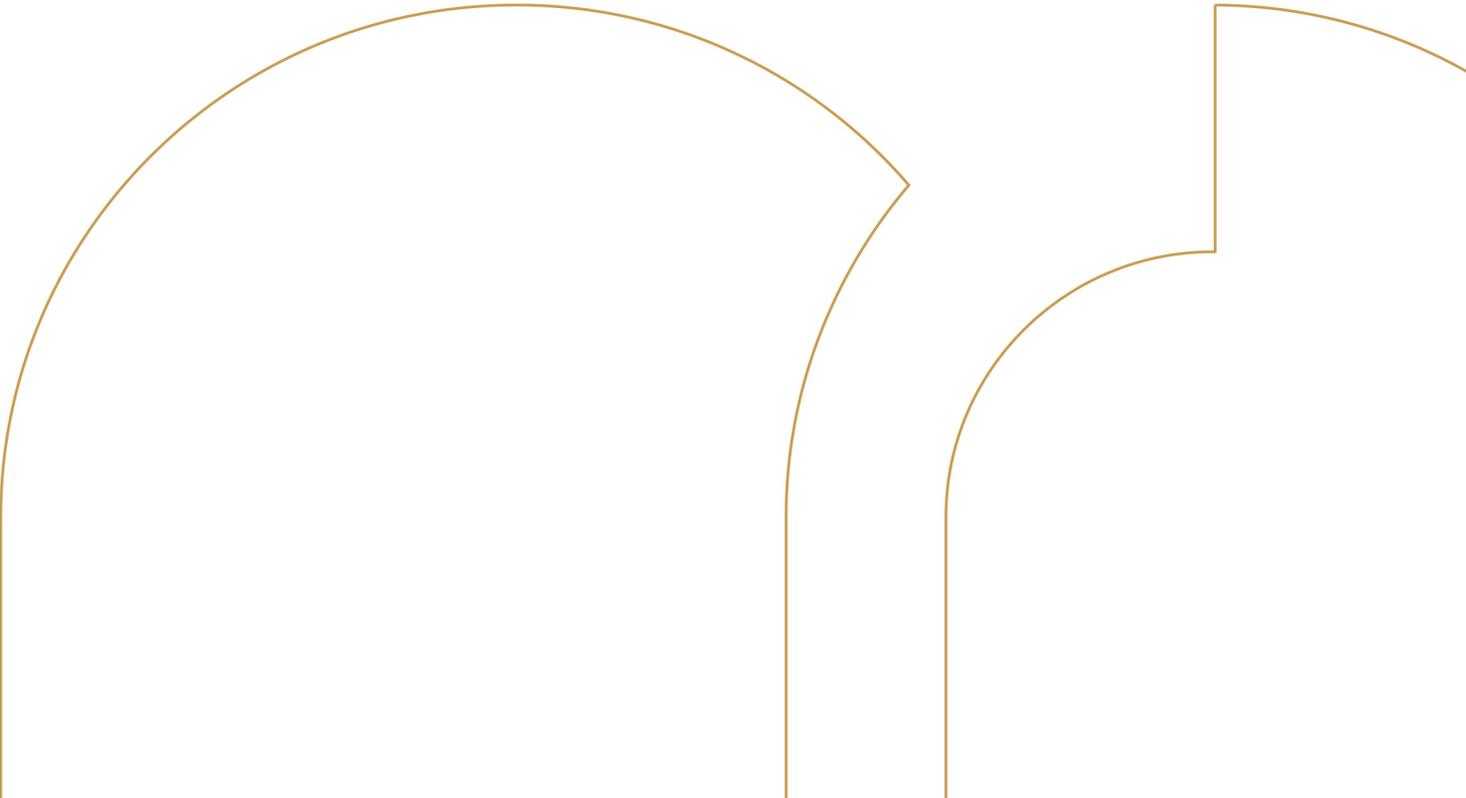
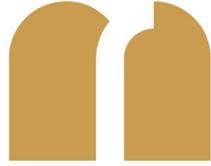
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