The Islamic Finance industry continues to see rapid growth with assets valued at $1.7 trillion at the turn of the year. So-called Sukuk or Islamic Participatory Certificates are a major factor of the continuing success of Islamic Finance worldwide. Whereas several Sukuk defaults in the aftermath of the financial crisis have shone light on the difficulties that may arise when Sukuk’s default due to their complicated nature which continues to pose an inherent “sharia risk”, perhaps too little attention is being paid to what happens when things go wrong. The buoyed growth of Sukuk and the recent return of innovative structures worldwide should be viewed with a level of caution, which in hindsight would have been beneficial when banks developed complex financial products as a precursor to the 2008 financial crisis. The Islamic finance industry should take heed not to make the same mistakes lest it also fail.

Islamic law principles underpin the Islamic Finance industry

Sukuk are said to comply with Islamic law principles, which have the overarching objective of social justice at their core. In financial transactions, as understood today, those principles may be summarised by the prohibitions of (1) illicit gain (Ar. riba), (2) excessive risk taking (Ar. gharar), (3) speculation (Ar. maysser), (4) sale of assets one does not own, and (5) funding matters prohibited by Islamic law (e.g. pork products) as well as the requirements that (1) risks and profits be shared and (2) transactions be based on real assets.

If risks and profits are to be shared between the parties and transactions based on real assets, a preference of Islamic Finance for equity structures appears to be a foregone conclusion. The development of Sukuk and Islamic capital markets comes accordingly as a surprise, particularly when considering that many interpretations of the Shariah explicitly prohibit debt trading as a form of speculation. The risk and profit sharing requirement also suggests that the law of bankruptcy should enjoy a special place within the Islamic finance industry.

Sukuk – simply “Islamic bonds”?
The Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”) defines Sukuk as:

“Certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity”.

In other words, Sukuk are certificates that give the investor rights of ownership of underlying revenue-generating assets and rights and/or services (the “Sukuk Assets”) and of the income stream they produce. Compliance with this definition may be achieved in different ways, the choice of structure primarily depending on the underlying Sukuk Assets. In contrast, the returns to conventional bondholders denote the right to receive coupon, interest and principal on specific dates. In compliance with the prohibition of riba, commonly interpreted as a prohibition of interest, Sukuk do not pay interest but are to provide a return in the form of the profit generated by the Sukuk Assets.

What is important in terms of Shariah-compliance is that the investor has an ownership interest in the underlying assets. Therefore, Sukuk often involve at their core a form of asset monetisation: The underlying assets are isolated from the originator enterprise and transferred to a SPV, the issuer, who sells Sukuk to investors in turn financing the asset transfer. For example, in the case of Lease Sukuk, a very common structure in the industry, the originator sells the Sukuk Assets to the SPV, in order to lease them back in return for periodic lease payments, which are used to finance the profit passed on to the investors. Generally, the ‘profits’ are so structured that they reflect coupon rates and payment cycles of conventional bonds.

Islamic Finance categorises Sukuk as asset-based or asset-backed instruments

But not all Sukuk are equal: they are commonly categorised as either asset-based or asset-backed. In the case of asset-based Sukuk, i.e. the majority of Sukuk issued worldwide, only beneficial as opposed to legal ownership of the underlying assets passes to the investors. The assets stay...
on the balance sheet of the originator and payments to investors primarily originate from the originator's cashflows. Since no true sale occurs, there is no direct recourse to the underlying assets in case of bankruptcy. The structure of asset-based Sukuk generally dictates that at bankruptcy, investors may only compel the originator to purchase the issued Sukuk, allowing Sukuk owners to rank at best pari passu with unsecured creditors, however without direct asset recourse. Since no true sale occurs, the creditworthiness of the Sukuk depends on the rating of the originator. In theory, in the case of asset-backed Sukuk, legal title to the Sukuk Assets passes to the investors with direct recourse to the Sukuk Assets. As a true sale transaction, the creditworthiness of the Sukuk should accordingly only depend on the issuer, not the originator, payments to investors being made from revenue generated by the underlying assets. However, in practice, even asset-backed instruments rarely offer holders direct recourse to the assets. In fact, the mistaken belief that Sukuk ownership provided direct recourse to the underlying assets was probably one of “the most significant misunderstandings” about Sukuk in the market.

Many experts consider asset-based Sukuk to flout the Shariah; only a minority of scholars consider beneficial ownership of assets to suffice to ensure compliance. Notwithstanding the preference for asset-backed Sukuk, the large majority issued to date are de facto asset-based. The uncertainty as to their permissibility however creates a “Shariah Risk”, the impact of which is well illustrated by the effect of a 2008 statement by Sheikh Muhammed Taqi, a leading scholar, on the Sukuk trade volume. In 2008 he announced that he considered 85% of Sukuk issued worldwide to fall foul of the Shariah. Although the timing of the statement coincided with the financial crisis, the fall in Sukuk volume of $30.8 billion in 2007 to $1.4 billion in 2008 cannot be blamed on the crisis alone.

Sukuk defaults highlighted the distinction between asset-based and asset-backed Sukuk

The categorisation between asset-based and asset-backed Sukuk only crystallized when courts tasked with Sukuk defaults struggled to deal with their complex structures. Little attention had been and is being paid to what happens in the case of default of the originator or issuer. Given the issues discussed above and the explicit bankruptcy rules the Holy Quran lays down, this is striking.

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8 S.E. Hidayat, Int’l Samann J. of Finance & Accounting, A comparative Analysis between Asset Based and Asset Backed Sukuk: Which one is More Shariah Compliant (July 2013, Vol 1, No.2).
9 Ibid.
12 Supra, fn 8.
The Holy Quran, as interpreted, decrees it a sin for a debtor to withhold unpaid debt when able to pay, while simultaneously calling upon lenders to show leniency and accept late payment. The practical result of this dichotomy in the Islamic classical period was an ad hoc system that expected both sides to compromise depending on the circumstances of the debtor and its motivations, without encouraging the development of a systematic bankruptcy system. Like traditional bankruptcy systems, the aim of the court proceeding was the distribution of the bankrupt’s estate, not the rehabilitation of its affairs. In contrast to modern bankruptcy systems, Islamic law did not allow a judge to order debt forgiveness without the creditor’s consent. At best, the existence of inflation meant that the debt decreased in real terms over the debtor’s lifetime.

When Western influences swept Islamic lands in the 19th century, the Islamic bankruptcy provisions fell out of use. Instead, many states adopted Western transplants. Despite the increasing regional lip-service being paid to the supremacy of the Shariah today, no one jurisdiction has restructured its bankruptcy laws along Islamic lines. Given the lack of separate corporate personality under Islamic law and the absence of efficient debt relief, this is unsurprising.

Likewise, the Islamic Finance industry has failed to develop modern Islamic bankruptcy laws. Whereas the practice of Islamic Finance has adopted an increasingly cosmopolitan and privatised character, bankruptcy systems continue to be embedded in national legal systems so that the task of clarifying the treatment of Islamic finance instruments and their professed Shariah-compliance falls largely to national courts.

**National courts struggle with the treatment of defaulted Sukuk**

Sukuk are now being issued in many states with very different legal systems. Often one of the reasons they are being issued is to attract Muslim money. Often they are implicitly marketed as a safer option than conventional bonds. But a series of recent defaults illustrates the difficulties surrounding Sukuk when things go wrong.

The bankruptcy of East Cameron Partners (“ECP”) in 2008 in Louisiana offers a glimpse of what may happen when the Sukuk originator faces bankruptcy. When ECP filed for protection under Chapter 11 of the US Bankruptcy Code, the originator tried to wrap the Sukuk Assets, which were royalty interests in oil and gas revenues held by an offshore SPV, into its estate, although the Sukuk issuer had been advertised as bankruptcy remote, the assets having been transferred in a seemingly Shariah-compliant true sale. Accordingly, the Sukuk holders were forced to defend their interest before the court, which in turn had to consider how to treat their interests under US bankruptcy laws. In effect, the ECP issuer had raised money in the Islamic finance market paying lip service to the Shariah in order to obtain capital, only to argue later that the Sukuk defied the Shariah after all. In March 2010, the court accepted that the originator had sold the underlying assets in a true sale transaction.

The Investment Dar (“TID”) was the first GCC Company to default under a $100 million Sukuk in January 2009. The Sukuk was governed by English law using an offshore SPV, whereas the underlying assets were located in Kuwait. The Sukuk was asset-based, providing investors with the option to sell the assets if TID defaulted in theory only. To be able to do so, the prospectus specified that Sukuk holders were to present a put option to TID, with the accompanying risk to rank pari passu with other unsecured creditors.

In March 2010 TID got court protection under Kuwait’s new Financial Stability Law, which halted all insolvency-related lawsuits against TID. TID thereafter agreed with Sukuk holders to restructure the debt over a six year period.

In summer 2009, Saad Group, a Saudi conglomerate defaulted on a $650 million Sukuk issued in Bahrain due to a severe internal liquidity crisis after the Saudi Arabian Monetary Authority had frozen the group’s assets. It is reported that Saudi creditors were repaid after a settlement sanctioned by the Saudi authorities. However, foreign lenders argued that their entitlements had been entirely ignored and by 2013 a settlement had yet to be agreed.

When in November 2009, Dubai World requested a restructuring of its $26 billion debt, investors feared that its $4 billion Nakheel Sukuk would also default. The Sukuk was governed by English law and structured using English trust law concepts to bestow only beneficial ownership on the investors in the form of leasehold rights. Importantly, leasehold rights are not considered real rights under UAE law, where the assets indirectly owned by the government

14 Surah 5:1: O you who believe, you shall fulfill your covenants.
15 Surah 2:280: And if someone is in hardship, then postponement until ease. But if you give charity, then it is better for you, if you only knew.
16 Supra, fn 13, 975, 977.
17 Idbid.
18 Idbid.
19 Supra fn 11, p. 23.
21 Reuters, Kuwait’s Dar defaults on $100 million Sukuk (12 May 2009) at http://uk.reuters.com/article/2009/05/12/dar-sukuk-idUKLC28153620090512
22 B. Goud, TID Sukuk Default, Business Islamica (26 July 2009).
23 The Investment Dar: Creditors Stand by for ‘Problem Child’ Payment (24 Apr. 2013) at http://www.ft.com/cms/s/0/dec383a6-a80b-11e2-b031-00144feabdc0.html#axzz37jAX8RY
were located. Government assets may not be attached under UAE law. Ultimately, a default was prevented by Abu Dhabi funding full repayment.

Given the proliferation of Sukuk issuances, more Sukuk are bound to fail. At this point in time, the market worries that Dubai World which in August announced its intention to restructure its debt yet again may also seek to restructure the Nakheel Sukuk, which matures in 2015, and that rising US interest rate may start to depress the market.

Non-alignment of substance and form of the Sukuk instruments increases uncertainty

When it comes to Sukuk, courts struggle to reconcile substance and form. This is not surprising, because perceived substance is often inadequately reflected in the actual text of the instrument. This is consistent with wanting to offer Muslim investors alternatives, which “mimic, in both legal and economic terms, their conventional counterparts”.

Independent of the location of originator, assets or issuer, most Sukuk are governed by English law owing to its versatile trust law provisions. Typical Sukuk may be originated by an entity in the UAE or Saudi Arabia, where the assets are located. The issuer SPV may be placed in a purely secular offshore jurisdiction, allowing for the choice of law of the transaction.

Standardization and new innovations in the industry

Since the decline in issuances post Sheikh Taqi’s statement, there has been a drive to increase compliance with Shariah law principles, while simultaneously offering standardized and tightened contractual provisions.

The latter is often done with a focus on waivers that deal with Shariah-compliance risk, e.g. disallowing disputes over the validity of the instrument under the Shariah. Additionally, to limit their structural difference from conventional bonds Sukuk may indicate that there is no direct recourse to the assets at bankruptcy. Alternatively, the instrument may state that it is an equity not a debt instrument.

Despite these developments differences will remain in the treatment of Sukuk when problems arise, depending on where assets, issuer, originator and investors are located. The formal reliance on ephemeral concepts of religious laws, which may or may not be recognised in the relevant jurisdiction, further complicates the jurisdictional mayhem. AAIOFI’s Sharia Standards continue to offer only limited guidance on default or when the underlying agreements are incomplete and need to be supplemented.

Non-alignment of substance and form of the Sukuk instruments increases uncertainty

Despite waiver in fine print, parts of the investor-base expect sharia law compliance. Sukuk are marketed accordingly. The recent defaults have brought about more forceful demands by scholars that Sukuk be structured as asset-backed instruments more in line with the Shariah’s underlying equity preference. Requiring more issuances to be structured as Securitization Sukuk however poses another Sharia Risk: excessive demand but limited availability of suitable assets. This in turn may increase the incentive to resort to excessively innovative ‘assets’ posing risks similar to those which the securitization industry experienced in the run-up to the financial crisis.

Currently, the market is buoyant and innovation in origination has returned. This includes the increased issuance of perpetual Sukuk akin to perpetual commercial paper programmes, which are to help capitalise banks in a Shariah-compliant way to meet Basel III requirements. Perpetual Sukuk are often classified as equity, without principal loss absorption or equity conversion features to ensure Shariah compliance. As the success of the Al Hilal Bank’s $500 Million Perpetual Additional Tier 1 Sukuk, which was 9 times oversubscribed, indicates, investors are not shy to invest in creative structures.

However, serious questions remain regarding Sukuk’s treatment in bankruptcy. Sukuk remain largely untested. What is clear is that when things go wrong, the jurisdictional mayhem and the interaction between religious and secular laws are bound to make any means of redress more uncertain and less straightforward than what we are used to when dealing with conventional bonds or equity structures.