LEGALSPOTLIGHT

Following recent events in Dubai, some commentators have suggested sukuk holders' rights and the resolution options available to them are no different from conventional bondholders'. Oliver Ali Agha and Claire Grainger offer a counter-argument to that perception

Sukuk: default or no default?

When defaults in market *sukuk* structures result from contractual covenants imported from conventional bonds, such defaults would not necessarily be enforceable in a *Shari'ah* adjudication, regardless of decisions made in foreign courts.

Islamic finance continues to develop as a viable form of investment, not only for Muslims but also as an alternative for non-Muslims. It would seem logical that as the products evolve – while holding true to their philosophical underpinning of risk-sharing and not risk transfer – both Muslim and non-Muslim investors will continue to invest in them. Blaming Islamic finance for *sukuk* defaults is both simplistic and misinformed. The 'defaults' occurring in instruments today would not necessarily qualify as genuine Islamic defaults because such provisions effect the kind of risk-transfer that is inimical to Islamic finance.

Condemning Islamic finance for provisions already identified as problematic by leading authorities, and which contravene the Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI)[1] *Shari'ah* guidelines, is actually an incrimination of disingenuous structures rather than Islamic finance itself. Islamic finance will continue to grow if it develops products that are genuine and offer the ethical foundation of risk-sharing rather than risk transfer.

This article addresses provisions imported from conventional bond structures and why their inclusion presents enforceability issues, and considers that *sukuk* holders may well be bound to their commitment to abide by *Shari'ah*, irrespective of the contractual terms agreed between the parties. Individual agreement does not transcend *Shari'ah* law.

Sukuk are certificates of equal value that represent an ownership interest in tangible assets. AAOIFI guidelines emphasise the difference between *sukuk* and conventional bonds. These guidelines note that *sukuk* do not represent a debt owed to the issuer by the certificate holder and that the owners share in the returns and bear the losses. Furthermore, the standards note the documentation must explicitly abide by *Shari'ah* and that a *Shari'ah* board must monitor its implementation.[2] Clearly, *sukuk* are meant to be equity-type instruments: any references to *sukuk* as being Islamic bonds are oxymoronic and misleading to investors who may believe they have certain bond-like remedies that, ultimately, may not be enforceable in some Islamic jurisdictions.

Scholars have raised issues with market *sukuk* structures that, *inter alia*: (i) guarantee the return of capital of the *sukuk* holders (either through manager or issuer covenants to redeem *sukuk* at face value, rather than market value); and (ii) provide for credit enhancement purchase guarantees by related companies.

In a release on *sukuk* structures in February 2008, the AAOIFI offered the following as additional guidance for *sukuk* issuers (as a supplement to the published AAOIFI standard on *sukuk*).

- *Sukuk* holders must own all the rights and obligations of the assets (tangible, usufructs or services), and the assets are to be transferred from the issuer to the *sukuk* holders' books;
- In order to be tradable, *sukuk* cannot represent receivables or debt except for trading/financial entity sales that unintentionally convey incidental debt;
- *Sukuk* managers may not cover loan shortfalls to *sukuk* holders, but reserve accounts established for such a purposes are permissible if disclosed in the prospectus;
- The purchase of assets at maturity is permissible at the market value rather than the nominal/face value; although *sukuk* issuers/managers can guarantee capital in the event of negligence;
- Lessees in *sukuk al-ijarah* may purchase the leased asset for its nominal value, provided the lessee is not a general partner, *mudarib* (working partner) or *wakil* (investment agent).[3] AAOIFI standards permit the redemption of *sukuk* for usufructs at fair market values or at a price agreed between the parties at the time of redemption;
- *Shari'ah* boards are to review all relevant contracts/documentation related to the transaction to ensure

[1] The AAOIFI is the leading Islamic supranational standards body. Through its *Shari'ah* and related boards and committees, The AAOIFI issues Islamic finance standards that, generally, delineate the parameters for Islamic finance structures and products. The AAOIFI is also responsible for developing accounting, auditing, ethics and corporate governance guidelines

[2] AAOIFI Shari'ah Standard No. 17 (Investment Sukuk) as adopted on May 8, 2003

[3] This provision pre-supposes the price for assets is in general congruence with market value conditions. In the event of an egregious mismatch, such a sale may well be questioned along *Shari'ah* lines that generally require the sale of assets at fair market value or at prices to be agreed, on an arms-length basis, at the time of the sale

compliance with *Shari'ah* and oversee that implementation and operation complies with *Shari'ah*.
On balance, the *sukuk* standards and rulings, when synthesised, reflect an equity-type instrument which cannot represent a debt owed to the holder.

Conventional bond default provisions that are frequently incorporated into *sukuk* documentation appear to give to investors an Islamic instrument that looks, at least contractually, like a bond. While *Shari'ah fatwas* are procured to provide comfort that instruments are *Shari'ah* compliant, such endorsements are subject to different interpretations. When *fatwas* contravene AAOIFI standards, their reliability becomes tenuous. Even where there may be compliance with a standard, which has been passed with a narrow majority, a structure may be called into question by the individual judge, who may subscribe to the strong minority view.

Fundamentally, the issue is not with Islamic structures but with attempting to import provisions that are conventional risk transfers. Different jurists will have a different tolerance level for such 'innovation', with many rejecting the egregious provisions that substantially replicate a conventional instrument.

Problems arise when *sukuk* investors are confronted with a situation where contractual agreements proffer bond remedies they find of questionable enforceability in a *Shari'ah* jurisdiction. In reality, s*ukuk* holders do have substantial remedies under *Shari'ah*: they are the beneficial owners of the underlying assets that would need to be excluded from the insolvency proceedings of the issuer.

Even if overseas judgments are obtained in relation to imported bond provisions, these would likely be scrutinised in an Islamic locale to ascertain whether the judgment had been made in accordance with *Shari'ah* principles. Case law in some jurisdictions highlights this. For example, in England the case of Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd. (No.1) held that, irrespective of the election of the parties to subject English law to '*Shari'ah*', English law applied because *Shari'ah* was not a governing body of law but merely embodied the Islamic religious principles to which Shamil Bank held itself out as doing business. The court noted that the Rome Convention 1980, scheduled to the Contracts (Applicable Law) Act 1990, only contemplated and sanctioned the choice of the law of a country, not a religious principle.

It is possible to incorporate provisions of foreign (presumably *Shari'ah*) law into the terms of a contract. However, in this case the documentation did not identify any specific aspects of *Shari'ah* law the parties intended to be incorporated into the agreement. Furthermore, the court held that "the reference to *Shari'ah* law was repugnant to the choice of English law and could not sensibly be given effect to." Given the importance of this case, Islamic jurists will invariably revisit English judgements on a '*de novo*' basis to determine whether there is genuine compliance with *Shari'ah* principles.

When drafting clauses that subject the laws of a country to *Shari'ah,* the parties need to identify the specific governing principles of *Shari'ah* that will apply to the contract, such as the exclusion of *riba*. This has not yet been tested but would seem a sensible solution to enhance the chances of such an appendix of relevant governing principles being incorporated in the country whose law is chosen.

Adoption of such an appendix of foreign law principles is subject to the judge's discretion and the case suggests that such adoption of foreign principles needs to be capable of being sensibly applied in the country. Some commentators have noted that if the foreign law is incorporated into the terms of the subject contract, it would mean no more than the court applying English law where certain black letter laws of a foreign jurisdiction were incorporated.[4] Such measures should be helpful in the incorporation of Islamic principles in the foreign adjudication. Furthermore, even though Islamic law would not prevail in the event of a conflict, such judgments would inevitably be accorded lesser scrutiny, depending on the circumstances, in Islamic *fora*.

However, for the purpose of enforcement or obtaining a judgment in a country that recognises and accepts the underlying principles of *Shari'ah* law, as well as the selected country's law being applicable to transactions that are Islamic in nature, a court will naturally visit (or revisit) the specifics of the dispute and the underlying documentation to evaluate whether it resonates with *Shari'ah* principles. Expert witnesses will in all likelihood need to be called to assist in the interpretation of *Shari'ah* with the governing law. The influence of such witnesses should rest with the consensus (*ijma*), as reflected in AAOIFI standards.

In short, purchasers of *sukuk* and other Islamic instruments need to be aware these products may be subjected to scrutiny at enforcement and certain non-conforming provisions may be excised or disregarded. While *sukuk* holders share in the rewards, they would take the risk of a depreciation of their capital in adverse business circumstances provided there was no negligence on the issuer's or manager's part.

Islamic finance is a permissive field and, apart from the fundamental prohibitions, a multitude of structures can be developed to serve varying commercial needs. However, referring to *sukuk* as Islamic bonds is like jamming a square peg into a round hole and then wondering why it doesn't fit.

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[4] *New Law Journal*, June 9, 2006, Juliette Levy