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Sukuk Defaults: On Distress Resolution in Islamic Finance

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Sukuk Defaults: On Distress Resolution in Islamic Finance

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Sukuk Defaults: on Distress Resolution in Islamic Finance

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Abstract

Islamic strictures require investors to share risks with the entrepreneurs they finance. *Sukuk* (Islamic securities) come mostly in two varieties, *musharakah* (basically a joint venture agreement) and *ijarah* (more like an operational lease agreement). Yet defaults did happen, even in the case of *musharakah* (joint venture) *sukuk* discussed in this study. So is Islamic finance failing to deliver on its promises? To answer that question, we analyse four major defaults on *Sukuk* that have happened recently in the aftermath of the worldwide credit crisis that has engulfed the world since 2007. These case studies make clear that in most cases, the problems can be traced back to clauses and structures that made the *sukuk* more like conventional bonds. Furthermore, once default happened, most of the *sukuk* discussed did not transfer the underlying assets to the *sukuk* holders. So, in the event of default, due to limited recourse provisions, *sukuk* holders often had nothing to resort to, as effectively there were no underlying assets in their ownership. The case studies highlighted the importance of the legal institutions of the country where the collateral is likely to be contested. Interestingly enough, strict adherence to *shariah* principles would have considerably simplified restructuring because *shariah* compliance implies a clear allocation of property rights: in *sukuk*, investors will receive full title to the underlying *sukuk* assets in distress situations. So the answer to the question we asked, is Islamic Finance failing to deliver on its promises, is a qualified *no*.

Keywords: Defaults; Islamic Securities; Islamic Finance

1. Introduction

In the last few years, some major *sukuk* defaults raised several questions about the underlying structures and viability of the *sukuk* as an alternative source of funding. One notion about the *sukuk* is that these instruments, like equity, are profit and loss sharing (PLS), so there should be no question of default in what was intended as a (limited liability) equity-like instrument. Moreover, *sukuk* are publicized as securities backed by real assets. In that case, the investors should only be exposed to risk of capital loss, the risk that arises due to fluctuations in the market value of underlying assets, and of the periodic returns (rentals) generated by these assets. But normally there would be no default of the entire principal *sukuk* amount, as *sukuk* holders are presumed to have recourse to the *sukuk* assets, being the legal owner of those assets. Thirdly, the *sukuk*, advertised with a religious notion, are assumed to follow more transparent processes and contain unambiguous clauses in their main contract. Accordingly, all the documentations in *sukuk* issuance are supposed to contain no inconsistencies and loopholes which can deprive the *sukuk* investors of the rights promised in the offering circulars.

Yet, defaults did happen, and *not* all were resolved in line with the expectations raised by these new capital market instruments. So what went wrong? If these principles were properly followed, then why did *sukuk* default in first place? Or are there any structures in which *sukuk* may default in spite of their equity-like characteristics? What were the main reasons for *sukuk* defaults? And how were the distress situations resolved? Did investors have any recourse to *sukuk* assets and if not, why not? Why did the originators issue the *sukuk* instead of conventional bonds? How have *sukuk* been restructured after default events? Does the analysis of these distress situations and their resolution offer insights on the future of Islamic Finance? Did the defaults happen because of flaws in the basic Islamic Finance approach or on the contrary because of imperfect compliance with the principles of Islamic Finance? Can the variety of distress experiences shed light on design improvements?

The focus in this paper is on the resolution process following default, not on the reasons why the default was triggered to begin with. We analyze the recent *sukuk* (near) defaults from an Islamic finance perspective. Specifically, after providing basic information on each *sukuk* (issuer,

arranger, SPV, term period, rate of return etc.), we present an exposition of the underlying contracts of each *sukuk*, their structure, reasons for defaults and restructuring process thereafter. Finally, we provide a discussion on the critical issues related to *sukuk* structures namely ownership of underlying *sukuk* assets, rights of the investors including recourse, if any, to core assets in case of distress, risk factors including legal and *shariah* risks regarding *sukuk* structures, purchase undertakings and credit enhancements. These clarifications are crucial if access to the capital markets is to be continued through *sukuk*. The recent turmoil in the conventional financial sector adds to the relevance of the topic.

The remainder of the paper is structured as follows. We first give a brief overview of the emergence of Islamic capital market instruments (Section 2). We then more sharply define the precise structure of the various instruments traded (Section 3). In Section 4 we present four case studies of major recent *sukuk* defaults and the ensuing resolution of the distress situation. Section 5 discusses the critical issues that emerge from this overview of major defaults. Section 6 concludes the paper. Basic information about four problem *sukuk* are provided in Table 1 in the Tables Annex. Most of the information about *sukuk* are acquired from the offering circular (OC) of the relevant *sukuk*, financial reports of the *sukuk* originators, related stock exchanges & central banks, IMF reports and newspapers.

2. The emergence of Islamic Finance capital market instruments: a short history

Sukuk issuance grew from zero to a cumulative USD350 billion from 1996 to mid-2012 and the issuance to surge with cumulative annual growth rate of 25% over 2012-2015 (Standard & Poor's 2012). The *sukuk* market is still in its infancy, but global issuance of Islamic capital market instruments (so-called *sukuk*) surged 55 percent during the first quarter of 2012 to reach USD43.5 billion (Halawi and Atamech (2012)). In February 2013, Dubai Electricity & Water Authority *sukuk* issuance was subscribed by more than \$5 billion of bids for the \$1 billion *sukuk* amount.¹ Similarly, in last week of May 2013, *sukuk* issued by Islamic Development Bank for five years got \$1.5 billion in bids for \$1 billion of securities and it offers a return as low as 1.535

¹<http://www.bloomberg.com/news/2013-06-05/goldman-breaks-drought-with-saudi-property-bond-islamic-finance.html>

percent.² Currently, *Sukuk* are issued by both Islamic and conventional corporate entities, financial institutions, and even sovereigns across the world.

Interestingly, the first corporate *sukuk* totaling USD30 million was issued by Shell, a conventional company, in 1990 after *sukuk* structure was approved in 1988 by the Organization of the Islamic Conference (International Islamic Financial Market (2009)). German Saxony-Anhalt was the first non-Muslim state to tap into this market: it issued 5-year *sukuk* to raise EUR 100 million in 2004 with AAA rating by Fitch³ (Stimpfle (2011)). Similarly, The World Bank issued its first *sukuk* in 2005 to raise 760 million Malaysian ringgit (RM),⁴ while its private sector arm, the International Finance Corporation, issued *sukuk* of RM 500 million in 2005 and USD100 million in 2009 (Iqbal and Tsubota, 2006). Currently, some big *sukuk* have been announced such as a sovereign *sukuk* by Ireland and Saxony-Anhalt and a corporate *sukuk* of USD2 billion by Goldman Sachs.⁵ Malaysia and Gulf Co-operation Council (GCC) countries played a leading role in *sukuk* issuance in the wake of economic expansion and booming oil and property prices (Boustany, Roula and Sayegh (2005)).

Sukuk were basically designed to facilitate the liquidity management of the Islamic banking sector (Usmani 2010) which otherwise needed to keep excess reserves to mitigate liquidity risk. *Sukuk* also emerged as an alternative investment opportunity for those desiring to capitalize their funds according to their religious beliefs. Since pious Muslims avoid investment in interest based securities, *sukuk* intend to tap into their funds through a kind of debt financing that is *Shariah*-compliant. These instruments attracted conventional investment banks and hedge funds as well because of the asset-backed structure of *sukuk* and promising returns offered by these securities. From the issuers' perspective too, *sukuk* appeared as an innovation in the capital market instruments through which borrower can raise funds from a wider range of investors.

For sovereign issuers there can also be a cost of capital advantage in *sukuk* issuance because of the higher credit rating owing to their asset-backed structure and because they offer a broader and diversified global investors base (Jobst, Kunzel, Mills and Sy (2008)). The Saxony-Anhalt *ijarah sukuk*, for instance, exhibits obvious price benefits of *shariah*-compliant *sukuk* issuance

² <http://www.reuters.com/article/2013/05/29/saudi-isdb-sukuk-idUSL5N0EA28620130529>

³ The corresponding SPV was established in Netherlands to get tax benefits.

⁴ Around USD200 million.

⁵ Source: Bloomberg, Reuters, Zawya.

over conventional bonds. In 2004, the German state borrowed USD1.2 billion through interest based covered bonds at EURIBOR plus 17 basis points on average, whereas its primary *sukuk* were priced at a spread of only 1 basis point, that saved USD192,000 per year for the State's Treasury (Jobst, Kunzel, Mills and Sy (2008)).

3. The nature and structure of Sukuk

3.1 What are "Sukuk"?

Sukuk is plural of the Arabic term *sakk* which means certificate, legal instrument or deed. In Islamic finance, the term *sukuk* refers to securities backed by real assets. We outline in what follows the general *sukuk* structure as suggested in the *theory* of Islamic finance. The contemporary practice regarding *sukuk* issuance often strays from these principles however, as we will highlight in the four case studies presented in the next section.

3.2 Stylized Sukuk Structure

Sukuk are based on specific contracts borrowed from Islamic modes of financing. Article 2 of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI (2008))⁶ defines *sukuk* as "*certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity.*"

The main difference between *sukuk* and conventional bonds is that *sukuk* do not involve any interest based transactions because of their prohibition in *shariah*. Like conventional asset-backed securities (ABS), *sukuk* are also backed by assets. However, the difference between *sukuk* and conventional ABS is that in the latter the underlying assets can be financial assets like loans or other receivables but in *sukuk* only real assets can be used as collateral. The sale of debt is not permissible in Islamic finance, except when it is traded at par.⁷

Although initially various structures were employed for *sukuk*, *ijarah* (similar to a conventional operational lease contract) and *musharakah* (joint venture/ co-ownership) have

⁶ The AAOIFI is an Islamic international standard issuing institution that prepares accounting, auditing, governance, and *shariah* standards for Islamic financial industry.

⁷ This is the viewpoint of majority of scholars. However, in Malaysia and some other countries discounted sale of debt is considered permissible.

become the most popular and commonly used *sukuk* because of their eligibility for trading in the secondary market according to Islamic jurisprudence. *Ijarah sukuk* (securities based on an operating lease contract), adopt the following process. The originator company, seeking financing, establishes a special purpose vehicle (SPV), generally a trust,⁸ incorporated as an offshore company. Subsequently, the SPV purchases certain assets (e.g. real estate, land parcels and/or building, leasehold rights) from the originator through a transaction,⁹ and funds this transaction with the proceedings raised through issuing trust certificates (*sukuk*). Pursuant to the transaction deed, assets of the originator are transferred to the SPV (the issuer) which holds these assets as a trustee for *sukuk* investors following a declaration of trust. Next, through a lease agreement, the same assets are leased back to the originator, being the lessee, on which periodic rent is paid by the lessee to the *sukuk* holders through the SPV. There is generally a repurchase undertaking by the originator according to which the originator is obliged to buy the assets back from the SPV on maturity of *sukuk* or upon an event of insolvency, at the market/fair price or at a price on which both parties agree at the time of purchase.¹⁰ The repurchase agreement is independent of the main *sukuk* agreement. The process enables *sukuk* redemption and reimbursement of the amount to the *sukuk* holders. Subsequently, the trust is dissolved. Thus the residual asset value risk is borne by the originator who undertakes to buy the asset on market price. An important restriction on *ijarah sukuk* is that the return (rent) should be *commensurate* with value of the underlying *sukuk* (assets). This was an issue in the case of East Cameron Partners, to be discussed below.

Another popular *sukuk* structure is *musharakah* (joint venture/co-ownership).¹¹ In this structure, the originator transfers the ownership of some of its assets, 50 percent for instance, to the SPV against the *sukuk* proceedings. A *musharakah* is established between the SPV and the originator in which the originator also contributes through investing funds/assets into

⁸ An SPV is created for bankruptcy remoteness by isolating the underlying assets of the transaction, for benefit of investors, from other liabilities of the originator. Thus in case of default of the originator, the investors are the sole claimants on the assets of the SPV. Some jurisdictions support SPVs by especial law. For instance, in the Cayman Islands, newly established SPV may be exempted from the taxes for 20 years (Khniifer (2010))

⁹ This is, when the *ijarah sukuk* are asset-backed.

¹⁰ This is what AAIOFI standard 12 suggests. However, market practice may be different in which originator/manager of the *sukuk* undertakes to buy the *sukuk* at their face value at the time of *sukuk* maturity. This strategy is declared un-Islamic by AAIOFI because this practice makes the structure of the *sukuk* similar to an interest bearing conventional bond.

¹¹ See (El-Hawary, Grais and Iqbal (2004)).

musharakah. Accordingly *musharakah* assets, jointly owned by the SPV and the originator, are invested in some business and the periodic streams of income generated by these assets are shared between the *sukuk* holders and the originator according to a pre-specified ratio. The loss is borne by the partners proportional to their investments.

The difference between *musharakah* and *ijarah sukuk* is that in the former the *sukuk* holders also share the ownership of the underlying *musharakah* assets with the originator if the assets are used for a business whereas in *ijarah*, *sukuk* holders are the sole owner of the underlying assets. The originator acts as manager of the assets on behalf of the SPV and *sukuk* holders, pursuant to a management contract. Like *ijarah*, an undertaking to repurchase the *sukuk* at the market price is also made by the originator. In this way *sukuk* are redeemed and the trust is dissolved. Clearly in *musharakah* the returns may fluctuate more than in an *ijarah* contract when market conditions change, unless there too the *musharakah* assets are leased out. For this reason, the return requirement are less stringent for *musharakah* *sukuk* than they are for *ijarah*: for *ijarah*, returns on the collateral and on the *sukuk* should be *commensurate*, but for *musharakah* the returns paid out should offer the expected return, which may be different from the ex post return. This gives more flexibility in designing the instrument. For example, in *musharakah* (joint venture) the return can be lower than the expected return offered to the investors, in which case the issuer can forgo some of its share in profit and transfer it to the investors as a gift to make the *musharakah* return equal to promised 'expected return' (cf the discussion of the ECP *sukuk* below). Both of the aforesaid *sukuk* types are backed by assets and are therefore called asset-backed *sukuk*.

There also exists another class of *sukuk*, the so called asset-based *sukuk*, where the initial sale of the original assets by the originator to the SPV does not take place, so the ownership (title) of assets remains with the originator of the *sukuk*. The *sukuk* holders are entitled to periodic cash flows from the underlying assets. An undertaking is also made by the originator to buy back the *sukuk* at their face value on the maturity date of *sukuk*. Further security can be given by providing collateral such as claims on shares of the originator, mortgages on structures owned by the originator or third party guarantees. But according to AAI OFI ((2008)) standards, such asset-based *sukuk* are not *shariah* compliant because there is no transfer of assets to the *sukuk* holders

which effectively makes asset based *sukuk* look more like conventional bonds¹². Investors in asset-based *sukuk* typically rely on the creditworthiness of the originator as indicated by a credit rating given by the rating agencies. Obviously, the different ownership structure may create problems regarding execution of the collateral.

3.3 *Shariah compliance: the theory*

In February 2008, the Board of AAOIFI attempted to bring order in the wide variety of products in the *sukuk* industry claiming to be *shariah*-compliant, and issued the following precise guidelines for *sukuk* to be in accordance with *shariah* principles:

1. *Sukuk* holders must own the real assets whether tangible, usufructs or services, capable of being owned and sold legally, with all rights and obligations of ownership, in those assets. Transfer of the assets from manager/originator is ensured by writing them off (*sukuk*) its books.
2. *Sukuk*, to be tradable, must *not* represent receivables or debts except in the case of a trading or financial entity selling all its assets, or a portfolio with a standing financial obligation, in which some debts, incidental to physical assets or usufruct, were included unintentionally¹³
3. It is not permissible for the manager of *sukuk* to undertake to offer loans to the *sukuk* holders, when actual earnings fall short of expected earnings.
4. While issuing *sukuk*, it is also not permissible that the manager of *sukuk* undertakes to repurchase the assets from the *sukuk* holders at initial value (face value), at the end of *sukuk*. However, it is permissible to repurchase the same at their market value, fair value or a price to be agreed, at the time of their actual purchase.
5. It is permissible for a lessee in an *ijarah sukuk* to undertake to purchase the leased assets when the *sukuk* are extinguished for its nominal value, provided he (lessee) is not also a partner or investment agent.

¹² In November 2008, AAOIFI announced that for this reason 85 percent of the *sukuk* issued in GCC countries did not comply to *shariah* rules. <http://www.gulf-daily-news.com/NewsDetails.aspx?storyid=200624>.

¹³ Although *Sukuk* must represent tangible assets, however, If the underlying assets of a *sukuk* is “an entire company” then it is okay if the assets of the company includes “real assets plus receivables”, because companies have receivables/payables as part of their normal business operations, so there is little choice but to allow the incidental intangibles.

6. Besides issuing fatwa (*shariah* rulings) about the validity of *sukuk* structures, *shariah* boards should also carefully review all the relevant contracts and documents related to the *sukuk* transaction and make sure that the actual means of implementation, operations and investments comply with *shariah* standards.

3.4 *Shariah Compliance: in practice*

Since the underlying idea of *sukuk* is religiously motivated, it has been argued that it will lead to more prudent, ethical and responsible financing (Howladar (2009)). However, the pursuit of profit and moral hazard problems cannot be ruled out in Islamic finance either. For example, one may exploit the *shariah* differences among various scholars/jurisdictions by claiming that a contract is against *shariah*, only to avoid one's obligations as a borrower. In some cases, debtors in distress have questioned the *shariah* compliance of the underlying contract and challenged contractual obligations on that basis. In two such instances, lawsuits about *murabahah* transactions were filed by Symphony Gems NV and Beximco Pharmaceuticals. In both cases however, English courts passed judgments against debtors of Islamic banks who claimed that their contracts effectively implied charging interest which is prohibited in Islam and thus should be cancelled. In both cases however, the courts allowed Islamic banks to collect accumulated interest (El-Gamal (2007)).

However there are also verdicts that seem to go in a different direction. In one case, Blom Bank of Lebanon placed its funds with TID as the bank's agent (*wakeel*), to invest the funds in some profitable venture. The *wakalah* (agency) agreement had an equity-like nature for investors, but since TID issued a promissory note ensuring principal amount and return (interest) on the investment, the contract *de facto* became an interest based conventional loan contract. When TID defaulted, it appealed in the English court to consider promissory note as void because it was against the *wakalah* contract and thus not allowed under *shariah*. The court delayed the case for detailed deliberation regarding the payment of return. However, the principal amount had to be paid by TID (see Hasan and Asutay (2011) for details on courts' decisions in Islamic finance).

3.5 *Performance in distress situations: Investor Rights and Legal Risks*

From the point of view of Islamic law, if a debtor defaults due to “natural factors” s/he should be given the opportunity to pay the debt when possible. Also if the debtor is not able to repay at all, the lender is encouraged to write off (discharge) the debt. But if the loan is backed by assets as security, the debt can be liquidated to recover the principal amount.

In the case of asset-backed *ijarah* and *musharakah sukuk*, the certificate holders have recourse to the underlying assets in the event of default provided that all the legal arrangements required to become a genuine owner of the assets are put in place. Thus the risk faced by the investors is at most the risk of capital loss due to a decline in the prices of underlying assets (market risk) and/or default of the lessee on rental payments. There are other risks involved in acquiring complete recourse to the *sukuk* assets namely, legal risks and risks related to the enforceability of the court ruling. Generally, *sukuk* are governed by the English law, but final recourse to the underlying asset unavoidably will depend on the law of the jurisdiction in which assets are located. The local courts may not allow recourse to the *sukuk* assets pursuant to any judgment of the English courts, thereby exposing investors to legal risk. Also, even if the law allows for the recourse, it may nevertheless not be applied because of the public policy of the concerned state about ownership of the assets (Ryan and Elmalki (2010)).

On the other hand, if the *sukuk* are asset-based, in which case *sukuk* assets are not transferred to the *sukuk* investors, there can be no question of recourse to any assets. Therefore, in the event of default of the originator, *sukuk* are given the status of unsecured debt subordinated to the originator's other obligations. Usually, in the event of default, *sukuk* holders can use their rights they acquire through repurchase undertaking by the issuer and ask the issuer to repurchase the *sukuk*. Moreover, if any other collateral has been given to the *sukuk* holders, for example in the form of a mortgage, claim on shares or lien, those can be called in to recover the *sukuk* investment. Furthermore, if there is any third party guarantee in the *sukuk* issuance, the guarantor can be approached, if necessary, through litigation. In practice however, and against the *shariah* principles, when *sukuk* defaulted, the investors were unable to have recourse to the issuers' (*sukuk*) assets as the assets were not transferred to the investors (International Islamic Financial Market (2009)).

3.6 *Performance in distress situations: Restructuring*

Although *sukuk* holders can go for litigation, they may instead prefer to enter into some sort of settlement through restructuring of the *sukuk* instead. *Shariah* also recognizes the concept in case the borrower/obligor is financial distress. Restructuring can be implemented in various ways: through extending the time period for repayment of *sukuk* investment, through recovering partial payments from the originators, thus incurring some loss (McMillen (2011)) or by actually writing off the entire loan. The bargaining power of the parties depends upon the validity of their claims recognized in transaction documents, recourse to *sukuk* assets, undertakings, securities and enforcement of the court's judgment. The regulatory authorities of the jurisdiction in which the originator is based also play active role as the default event can have a contagion effect due to financial sector exposure to the *sukuk*. Therefore, for instance, the central bank may intervene into restructuring and resolution processes, as was done by the Saudi Monetary Authority (SAMA) in the case of Saad *sukuk*. Also, there is an instance in which the issuer (Dubai Islamic Bank), called back a portion of its *sukuk* offering at 88percent of the face value. However the offer was not well received: less than 50 percent was eventually bought back (International Islamic Financial Market (2009)).

4. Prime Sukuk Defaults: 4 Case Studies

In developing the structure of *sukuk*, most attention was paid to making the financial instrument interest-free. Investors' expectations about possible *sukuk* defaults were rare, particularly when they were issued by state-owned companies. Although several risk factors were described in most of the *sukuk* offering letters, possible consequences in the event of default were given less consideration by the investors and even by scholars of *shariah* (Islamic law) who initially approved the product (Warde (2011)). But then the global financial crisis hit the economy in the regions where *sukuk* issuers operated, and some very visible *sukuk* defaulted on periodic payments in 2009. In 2008-2009, Islamic banking and capital markets were also affected adversely. There were some major events of *sukuk* defaults in the US and Gulf Cooperation Council (GCC) states. The first *sukuk* default occurred on October 16, 2008 when East Cameron

Partners (ECP), a US oil and gas company, filed for bankruptcy protection under chapter 11,¹⁴ claiming its inability to pay the periodic returns on its USD166 million *sukuk* issued in June 2006. Subsequently, the first *sukuk* default in the Gulf region occurred on May 12, 2009 when Investment Dar, a Kuwaiti Islamic investment company, declared its failure to pay biannual return on its USD100 million *sukuk* (Anwar and Patterson (2009)). Just few weeks after, Saad Group, a Saudi conglomerate failed to pay periodic rental payments on its USD650 million *sukuk*, issued 2007. Next, in the last week of November 2009, the Government of Dubai announced a standstill for 6 months for all its debts, including the largest *Nahkeel sukuk* of USD3.5 billion just few weeks before *sukuk* maturity. The default was prevented eleventh hour by the Abu Dhabi state through a USD10 billion bailout package. In what follows, we discuss these four cases in detail and the issues that emerged following the defaults.

4.1 East Cameron Partners' Sukuk Al-Musharakah

East Cameron Partners (ECP) issued *sukuk* of USD165.67 million in July 2006 with maturity period of 13 years.¹⁵ This was the first *sukuk* issued by a company based in United States and rated by Standard & Poor's. The underlying contract was *musharakah* (co-ownership/joint venture) in which *sukuk* investors own so called *Overriding Royalty Interest* (ORRI)¹⁶ in two gas properties located in the shallow waters offshore the State of Louisiana through an SPV acting as a trustee of *sukuk* holders. The SPV was called East Cameron Gas Company (ECGP) and incorporated in the Cayman Islands. The originator also contributed its funds into the *musharakah*. The assets of the *musharakah* were co-owned by the *sukuk* holders and the originator company ECP. The *sukuk* were secured by a mortgage on the assets of the issuer, which included the ORRI and secured accounts. The *sukuk* were rated CCC+ by Standard & Poor's.

¹⁴ Chapter 11 of the United States' Bankruptcy Code allows restructuring of the problem entity under the bankruptcy laws of the US. http://en.wikipedia.org/wiki/Chapter_11,_Title_11,_United_States_Code

¹⁵ The main sources for the *sukuk* are East Cameron Gas Co. Past-Closing Presentation and IFR 2006.

¹⁶ According to Louisiana law, de facto the law governing oil and gas leases, ORRI are considered 'real property'. <http://www.zawya.com/blogs/blakegoud/090215215223/>

The Originator's Details and Purpose of Sukuk Issuance

ECP was incorporated in Houston, Texas as a private oil and gas exploration company in 2002 and acquired leasehold interests in oil and gas production, in federal oil and gas leases administered by Minerals and Management Services of the US Department of Interior (MMS)(Boustany (2006)). The purpose of the originator was not *shariah* compliant financing *per se*. ECP simply saw this as an affordable and flexible finance opportunity through which it could raise the funds needed to purchase of shares from its non-operating partner, Macquarie Bank who wished to sell its share in the business. Finding limited opportunities in conventional finance, the owner of the company judged issuing *sukuk* a better choice.

ECP's Sukuk Structure

The original plan was to issue an *Ijarah* (leasing) *sukuk*, but the return on the assets to be financed through the *sukuk* issue were not commensurate with the *sukuk* return deemed necessary for a successful placement of the *sukuk*. Therefore, the *sukuk* was structured as *musharakah*, which allowed ECP to pay a higher return on the *sukuk* than the return on the shares whose purchase was to be financed through the *sukuk*. The difference between equity shareholding and *musharakah* *sukuk* is that the *sukuk* are redeemable within some time period as well as have limited recourse to underlying *musharakah* assets. ECP presumably was willing to pay a premium return to its financiers because through this transaction it would get complete control of the shares after expiration of the *sukuk*. *Ijarah* *sukuk* would not have allowed such a financial structure.

The structure of the *sukuk* works as follows (see Figure 1):

1. The issuer SPV, East Cameron Gas Company (ECGP), incorporated in Cayman Islands issued USD165.7 million of *sukuk* whose proceeds would be used to buy the ORRI from the Purchaser SPV following a Funding Agreement for USD\$ 113.8 million. The remaining amount was appropriated for development plan, a reserve account and the purchase of put options for natural gas to hedge against the risk of fall in gas prices.
2. The originator contributed his share of the capital in the form of a transfer of ORRI into the purchaser SPV.
3. Next, the purchaser SPV, holding ORRI in the properties, would be entitled to around 90 percent of ECP's net revenue generated through gas production.

4. The production would be sold to two off-takers with Merrill Lynch as a backup off-taker.
5. Proceedings of the oil and gas sale would be transferred to an allocation account. After paying around 20 percent to government and private ORRI, the remaining amount would be transferred to the Purchaser SPV. Next, the purchaser SPV would allocate 10 percent for the originator and the remainder for payment of expenses, periodic *sukuk* returns and redemption amount. Any excess amount would go to originator and early redemption of the *sukuk* equally.
6. Upon maturity of *sukuk*, the issuer SPV would redeem all the *sukuk* against the amount left to be transferred to the *sukuk* holders.

The repayment of the *sukuk* was

Figure 1, Panel A: Transaction Schematic

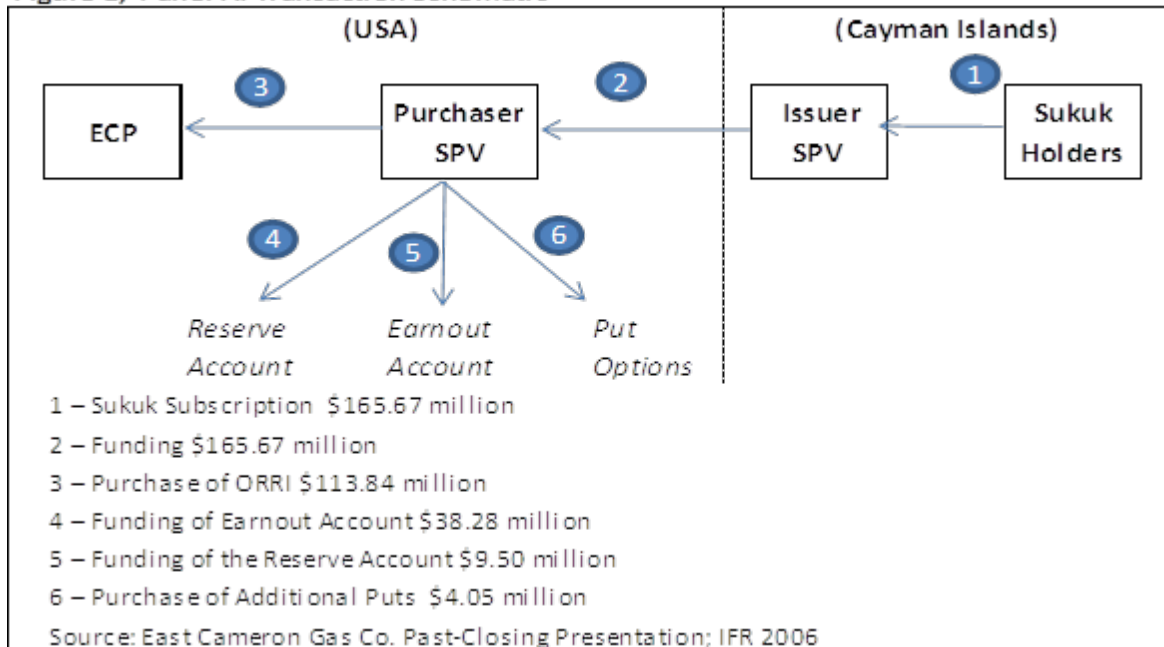
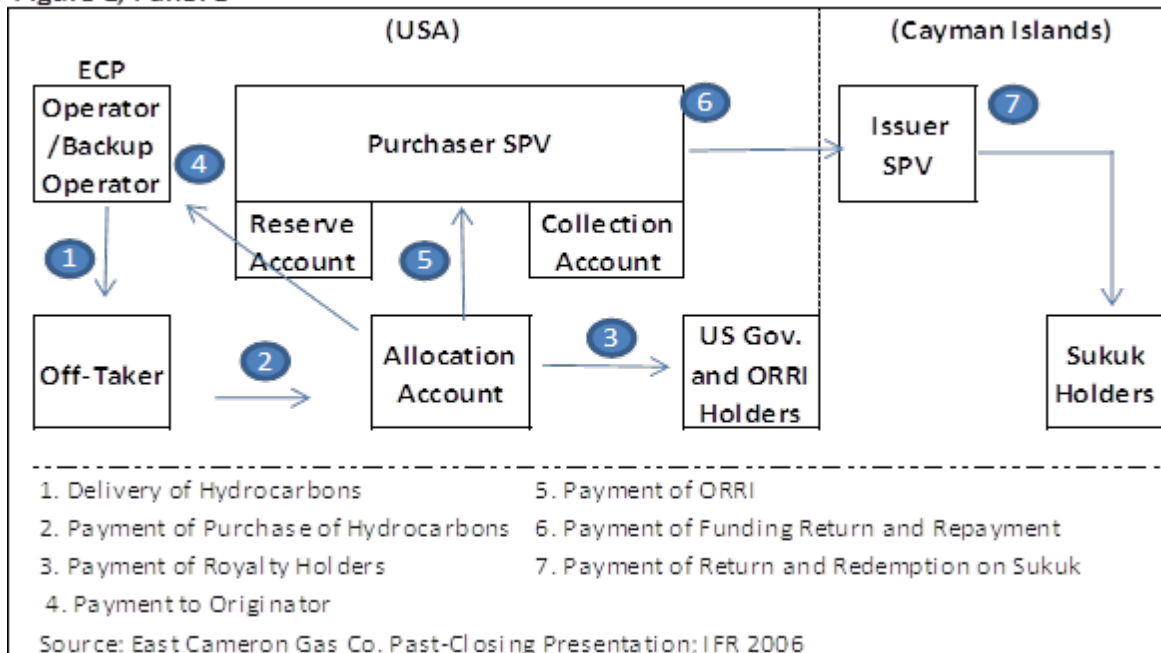


Figure 1, Panel B



scheduled quarterly depending upon the production and sale of the hydrocarbons to the buyers. An expected return of 11.25 percent was offered to the *sukuk* investors, to be paid quarterly too. A reserve account was also maintained as a credit enhancement, dedicated to meet any shortfall

in return with the moneys reserved in the account. Furthermore, put options were bought to acquire the right to sell the oil and gas at the strike price, thereby providing a hedge against a falloff gas prices below the strike price.

Shariah compliance of the ECP Sukuk

Of the four cases discussed in this section, only the ECP *sukuk* can be considered as an asset backed *sukuk* and only that structure fulfills (most of) the requirements of *shariah* principles described by AAOIFI (2008).

- Ownership of the Musharakah Assets

The *sukuk* holders were declared as the owners of underlying assets which are claims on oil and gas reserves through registered ownership of ORRI and which are deemed as real property in the related jurisdiction.

- Credit Enhancements

Credit Enhancement was provided through an USD9.5 million reserve account which is in accordance with the *shariah* principles mentioned by AAOIFI 2008.

- Put Option

Although *Sukuk* structure use conservative commodity price projections there could be fluctuations in the oil and gas market price. To mitigate downside price risk, commodity price hedges are often put in place. Moreover, a backup offtake agreement was made with Merrill Lynch to hedge the risks related to demand for gas production.

Restructuring the ECP Sukuk

ECP, the originator company, defaulted on periodic payments to the *sukuk* holders not because of low prices but due to financial problems arising from the shortfall in oil and gas production triggered by damage after a Hurricane in the area in September 2008.¹⁷ On 16 October 2008, East Cameron Partners, the originator, filed a petition for bankruptcy protection under chapter 11

¹⁷ The United States Securities and Exchange Commission report (Form 10-K) annual report 2008 [http://www.wikininvest.com/stock/TEL_Offshore_Trust_\(TELOZ\)/Filing/10-K/2009/F3243816](http://www.wikininvest.com/stock/TEL_Offshore_Trust_(TELOZ)/Filing/10-K/2009/F3243816)

of the United States Bankruptcy Code in the United States Bankruptcy Court in Louisiana to reorganize their debts and operations.

Also, ECP filed ‘adversary proceedings’ and requested the court to consider the primary *sukuk* transaction with the purchaser SPV as ‘secured loans’ and not as ‘true sale’ of assets (McMillen (2011)). This would imply that *sukuk* holders were to share the assets with other creditors of the originator in liquidation process if the transaction is considered secured loan. The bankruptcy court apparently rejected East Cameron’s argument saying that “ *[sukuk] holders invested in the sukuk certificates in reliance on the characterisation of the transfer of the royalty interest as a true sale*” (Fidler (2009)). This was a very important precedent about protection of *sukuk* holders’ rights and would subsequently have a positive impact on *sukuk* growth in US since it set the precedent that asset backed *sukuk* are in fact bankruptcy proof, the transfer of assets to the Sukuk SPV was shown to be safe from bankruptcy of the originator company.

Then, East Cameron Partners filed a revised lawsuit but, subsequently the stakeholders preferred to resolve the case through negotiations. Finally, the underlying *sukuk* assets were transferred to the issuer for the benefit of *sukuk* investors. According to the terms of the sale the assets of East Cameron Partners were sold to the *Sukuk* investors (Latham and Watkins (2011)). But the originator was given a subordinated ORRI on future production, which would contain some value once the principal amount of *sukuk* holders have been repaid. In a sense the originator received a call option on its own assets with as strike price the principal amount of the *sukuk*.

Thus in the US, *sukuk* holders’ rights are protected due to a well-developed legal system of collateral and recognition of all the contracts by the courts of law. Then situation in the GCC countries turned out to be very different, as will become clear from some of the other case studies.

4.2 *Musharakah Sukuk of Investment Dar Company (TID)*

The first *sukuk* default in the Gulf region occurred on May 12, 2009, when Investment Dar (TID), a Kuwaiti Holding Company, failed to make the periodic payments on a USD100 million *sukuk*. Subsequently, the holding company went through a restructuring process because of its inability to service its debt of around USD3.5 billion, including two *Sukuk* for a total of

USD250 million *sukuk*¹⁸. The first *Musharakah sukuk* of USD100 million was issued October 27, 2005 for 5 years. This *sukuk* was registered on Bahraini and London stock exchanges. In 2006 TID issued another five-year *Musharakah sukuk* for an amount of \$150 million. The company effectively defaulted on the second *sukuk* as well: shortly after the default on the first *sukuk*, the company entered into a restructuring process and demanded a standstill on all its debt for a temporary period.

Originator Details

TID was established as an Islamic investment company in 1994 with KD 22.8 million (USD83.3 million) capital and started its activities in accordance with the *shariah*. The company was registered with the Central Bank of Kuwait in August 1995 as an investment company and its shares were listed on the Kuwait Stock Exchange in April 1999. Within ten years, the company became a large lucrative holding company, offering Islamic services in consumer financing, portfolio- and funds management, Islamic banking and insurance, corporate and residential property development and logistics. In 2005 it still made a profit, of KD80.5 million, more than a threefold increase over the previous financial year, whilst total assets and equity were KD669.6 million and KD177 million, respectively. About 50 percent of its income is coming from investment activities while some 32 percent came from real estate; the rest was generated by financing activities. TID acquired a 50 percent stake in Aston Martin Lagonda Ltd, a luxury car company, in 2007.

The structure of the TID Sukuk

The first 5-year *musharakah* (co-ownership) *sukuk* was issued by TID with the collaboration of ABC Islamic Bank (Bahrain) in 2005. It offered 6-month LIBOR plus 2% annual, whereas the 2006 *sukuk* issue promised LIBOR plus 1.25 percent for the first 3 years and LIBOR plus 1.75 percent for the rest of the time period, distributed semi-annually. The *Sukuk* issued in 2005 was registered on the Bahraini Stock Exchange while the 2006 *sukuk* issue was registered in Dubai International Financial Exchanges. Both the *sukuk* issues were structured as *musharakah*.

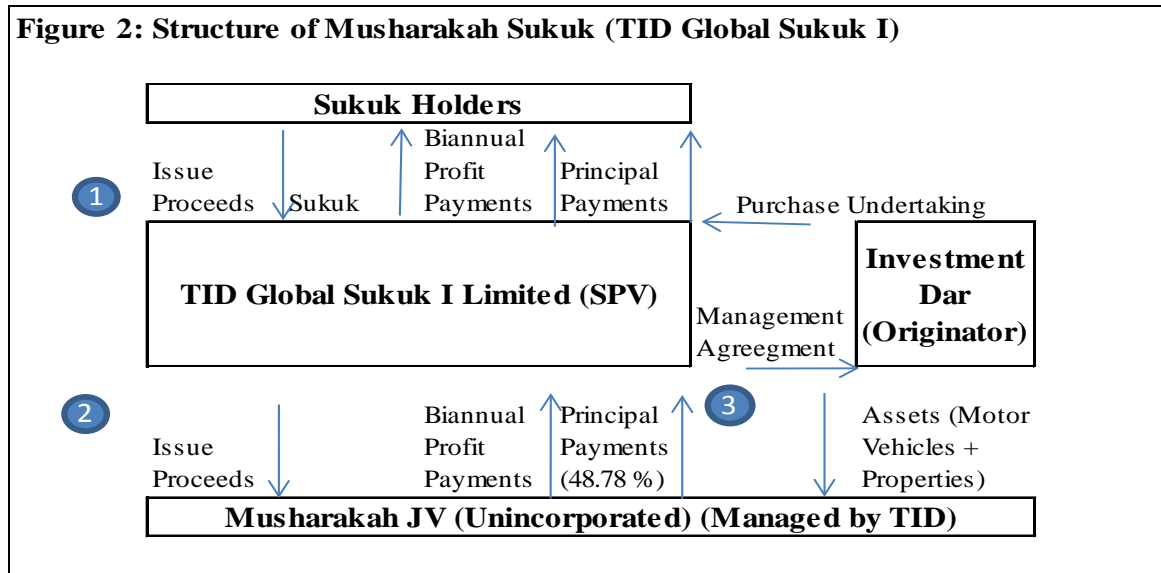
We have been unable to obtain the details of the first Sukuk emission, the one that took place in 2005. The details of the *sukuk* structure issued in 2006 is provided in Figure 2. Initially, an

¹⁸ The two *sukuk* issues were made in 2005 and 2006, for amounts of USD100 million and USD150 million respectively, both based on *Musharakah* (co-ownership/joint venture) contract.

SPV, TID Global *Sukuk* I Limited, was established in the Cayman Islands. Next, *sukuk* are issued by the SPV to *sukuk* investors, initially against the proceeds of the *sukuk*. In step 2, pursuant to a Trust Agreement with *sukuk* holders, the SPV entered into a *musharakah*/joint venture through *Musharakah* Agreement, in which the SPV invested the proceeds of the *sukuk* to hold 48.78 of *musharakah* capital. Simultaneously, the originator, TID, contributed its share by transferring ‘all rights, benefits and entitlements to the TID vehicles and property’ to *musharakah*, valued at \$157.5 million valuation as indicated by a third party and agreed by the partners, thereby acquiring the remaining 52.22 percent of capital in *musharakah*. The total amount of capital, USD305.7 million, was invested in the motor vehicles and in property assets.

The *musharakah* assets were converted into 150 units, in which TID acquired 76.83 units and the issuer held 73.17 units. In step three, returns on the underlying assets were to be shared between the SPV and TID. SPV’s share was to be transferred to the *sukuk* holders every six months. As additional security for the investment, the originator also provided an undertaking to repurchase the SPV share in the underlying assets at the end of *sukuk* period or upon any earlier insolvency event. Pursuant to a Management Agreement between the originator and the SPV, management of the *musharakah* would be carried out by the originator, charging a management fee and an ‘incentive fee’, if the *musharakah* accounts would show a net profit during a given period. The structure of the *sukuk* was approved by the *shariah* boards of both the partners.

Figure 2: Structure of Musharakah Sukuk (TID Global Sukuk I)



Shariah compliance of the TID Sukuk

- profit distribution rules

The very first page of the preliminary OC of the *sukuk* states that the issuer would make a payment of periodic distribution profit amounts to *sukuk* holders equal to LIBOR plus 1.25percent annually for the first three years and LIBOR plus 1.75percent per annum (called generally LIBOR plus margin) for the rest of the *sukuk* period. Further, the same document (p. 3) mentions that in return for the management services, TID is entitled to ‘incentive fees’ if, at the end of an accounting period *musharakah* accounts show a net cash profit payable to the issuer greater than the periodic distribution profit (LIBOR plus ‘margin’) amount. This is contrary to the *shariah* injunctions as the *musharakah* contract always offers a return subject to the actual performance of the *musharakah* proportional to the investors shareholding (El-Hawary, Grais and Iqbal (2004)). According to aforesaid statement, TID is entitled to two returns, a fixed LIBOR plus margin and the amount over and above the periodic distribution profit amount as an incentive fee. Conversely, section 2.9 of *Musharakah Agreement* states (p. 3) that, “*Each Partner shall be entitled to share in the profits of the Muskahara, and bear losses in respect of the Musharaka*” proportional to their investments in total *musharakah* assets. This specifies that *sukuk* holders have to share profit or loss with the originator/obligor company. The *musharakah* assets may generate a fixed return, if the same leased out for instance, nevertheless *musharakah*

sukuk cannot guarantee a fix return on *sukuk* ex-ante. However, only an *expected*, return can be offered to the investors, as was done in the ECP *sukuk*.

- *Accounting treatment of the sukuk amount.*

The total *sukuk* amount of the two issuance was KD 350 million.¹⁹ When calculating the total debt of the company in the consolidated balance sheet of 2008, TID *sukuk* were treated as debt in the annual accounts. The consolidated income statement and its details of revenues do not show the management fees expected from the *musharakah* management and the profits of the *musharakah* separately. According to *musharakah sukuk* (2006), TID is majority owner of the total assets of *musharakah*. Therefore, it can be argued that the *musharakah* accounts should be consolidated in the balance sheet of TID associates, like its other associates in which it has majority stakes.

Reasons for Default

Until 2007, business conditions for TID, the originator of the *musharakah sukuk* , remained good; the holding company earned a KD132 million net profit in that year, with total assets touching KD 1.27 billion assets against KD 387 million owners' equity. But in (financial year) 2008, TID reported a net loss of KD 80. 3 million, for the first time since its inception. The company's consolidated income statement shows this was for two reasons. First, there were unrealized losses of KD 88.14 million owing to impairment in the value of investments in associates (KD 61.6 million),²⁰ funds placed in financial institutions (KD 12.1 million), receivables (KD 8.2 million) and impairment in goodwill. And second, there were actually realized losses of about KD 9.3 million on investments, which in the end caused the downfall of the company.

¹⁹ However, the amount due to the *sukuk* holders was KD 10.7 million and 39.9 million for the first (2005) and the second (2006) *sukuk* issue respectively.

²⁰ These are Boubyan Bank K.S.C., Bahrain Islamic Bank B.S.C., AI Dar National Real Estate K.S.C.C., Safwan General Trading Company K.S.C.C. Some loss in one associate was occurred due to the a disputed repurchase transaction by TID with a Commercial Bank of Kuwait (CBK) in which TID transferred its shares in Bouyan Bank (BB), its associate, to CBK for its advisory services to TID. However, due to termination of advisory services by CBK, TID revoked the repo agreement but CBK settled the shares of KD 94 million against its debts payable by TID of KD 74.6 million. Accordingly, TID filed a lawsuit against CBK in 2009 but still the case is in the Kuwaiti court. <http://www.reuters.com/article/2012/06/20/boubyan-nbk-idUSL5E8HK4XU20120620>

And so in October 2008, TID defaulted on its debt obligations because of acute liquidity problems; its short term liabilities significantly exceeded its liquid assets. In January 2009, the TID engaged a financial advisor to execute a debt restructuring plan. Total assets of TID and its owners' equity had decreased to KD 1.2 billion and KD 168.5 million respectively.

The company in the end went under crisis because of the high concentration of investments in related parties, clearly exceeding 'the credit concentration limit stipulated by the Central Bank of Kuwait.'²¹ Auditors showed their apprehension about the ability of one of TID's associates, The Investment Dar Bank Bahrain BSC, to continue as a going concern due to the *"difficulties in recovering significant balances placed with the Parent Company [TID] and its related entities and court cases filed by investors."* The bank placed a large amount, KD 253 million, in its parent company on an unsecured basis, leading to a further increase in concentration risk. Further, the report shows that the ability of another associate of TID, involved in property development in the UK, to meet capital commitments, was contingent on its ability to get enough external finances/liquidity. All the debts as of 31 December 2008 of that associate were secured through pledging its assets to the banks as collateral.

In 2009, the company observed a second year of net losses, equal to KD 15 million, due to further as yet unrealized losses on the value of the company's assets. The assets of the company declined further to KD 971 million against total liabilities KD 766 million. The company had to make further provisions in 2009 for another KD 118 million. Trading in Dar's shares was suspended on Kuwait Stock Exchange in April 2009, when the company could not submit its financial statements on time.

Restructuring

In January 2009, the TID hired Credit Suisse Group AG as a financial advisor for restructuring TID's debt obligations. In September 2009, TID made an agreement with its creditors and investors to freeze claims temporarily till the end of the year which was subsequently extended by TID till 31 March 2010. Meanwhile, in September 2009, the Central Bank of Kuwait appointed a supervisor to monitor the debt restructuring and more in general the

²¹ Auditors' report of consolidated Financial Statements of 2008.

company's financial accounts. TID needed to borrow around USD1 billion to refinance its debt obligations. In March 2010, a Kuwaiti court granted protection to TID from creditors under the Financial Stability Law (FSL)²². This FSL stipulates that no lawsuit or execution of any court judgment against TID from minority banks and investors would proceed until the court has approved it. In January 2011, an enhanced restructuring plan was approved both by the creditors' coordinating committee and also approved by the shareholders. The plan, effective from June 2011, included repayment of the debt in tranches of senior facility (KD 405 million payable in 3-4 years) and junior facility (KD 600 million payable in 6 years). Also some part of the debt was converted into equity in the company. Besides, injection of fresh liquidity up to KD 20 million had to be made by shareholders in a year.

Payments

The first payment of KD 82 million was made to the creditors two months ahead of the scheduled time of end year 2011.

4.3 Golden Belt 1(Saad) Ijarah Sukuk²³

The third *sukuk* default happened on June 2, 2009 when a Saudi business conglomerate defaulted on periodic payments. Subsequently, Moody's downgraded the rating of the company to junk status. Some Gulf banks were affected severely by the Saad *sukuk* default because of their exposure to the heavily indebted Saudi conglomerates Saad Group and Ahmad Hamad Al Gosaibi and Brothers.²⁴

The USD650 million *Ijarah* (leasing) *sukuk* was issued on May 15, 2007 for five years maturing on May 15, 2012 and offered an annual return of LIBOR plus 0.85 percent. The corporation issued *sukuk* to finance investments and property purchases in London and Saudi Arabia.

²² Kuwait's FSL was approved in 2009 to support to investment sector of the country during the global economic crisis by offering liquidity and resources to restructure strong companies in the business.

²³ Main source for the *sukuk* details is the official circular of *sukuk*, available at http://ae.zawya.com/researchreports/p_2006_10_19_10_26_01/20080226_p_2006_10_19_10_26_01_113805.pdf

²⁴ Abu Dhabi Commercial Bank (ADCB) had around USD600 million exposure on two Saudi conglomerates, for which extra provisions had to be made. The Central banks of Saudi Arabia and UAE directed banks to make provisions on their exposure to Saad and Algosabi companies ([Reuters](#)).

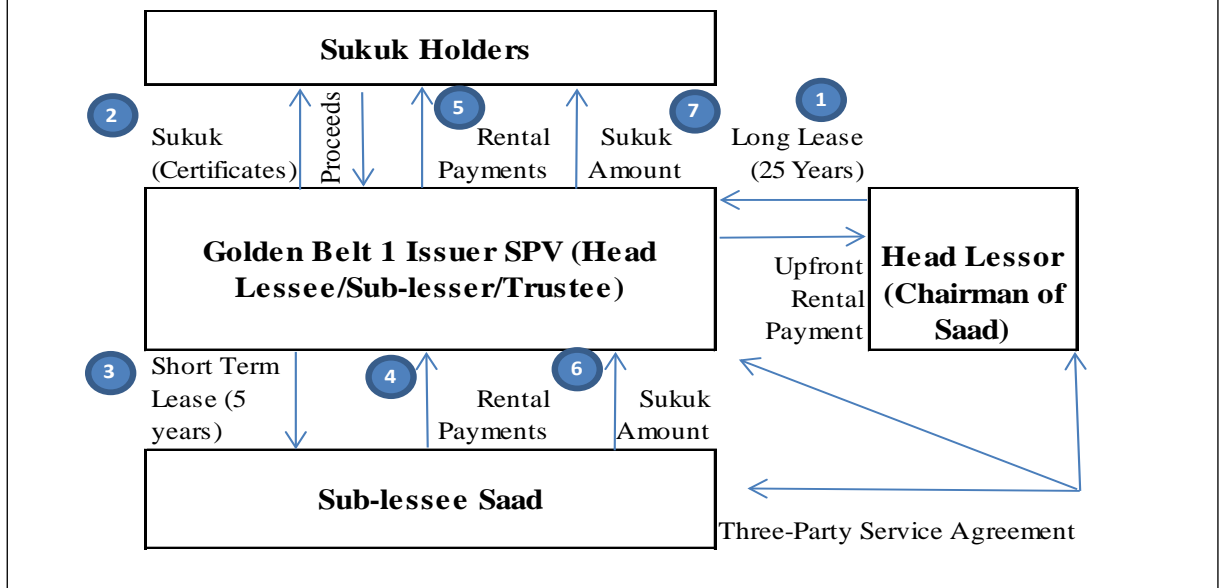
Saad Sukuk Structure:

The *sukuk* structure is based on lease and sublease contracts (figure 3). The transaction worked as follows:

1. Pursuant to a Head Lease Agreement, Golden Belt 1 *Sukuk* Company, an SPV registered in the Kingdom of Bahrain, entered into a long Head Lease Agreement with the chairman of Saad (Saad Trading Contracting & Financial Services Company), in which the SPV, as head lessee, acquires certain land parcels on lease from the Head Lessor, Mr Al-Sanea, for 25 years. The net proceeds of the *sukuk* would be used to pay the total rental amount due in advance by the issuer/head lessee to the head lessor.
2. Golden Belt 1 issues *sukuk* of USD650 million against the leasehold rights on the land parcels and pays full rental payment upfront to owner of Saad Group (Figure 3).
3. Subsequently, pursuant to a Sub-Lease Agreement, Golden Belt 1 sub-leases the land parcels to Saad for five years against semi-annual rental payments at LIBOR plus 0.85 percent margin, the same return as paid out on the Sukuk, since this was an Ijara contract..
4. Saad transfers semi-annual rental amounts to the SPV at the promised rate.
5. SPV transfers the periodic rental amount to the *sukuk* holders.
6. Upon maturity when *sukuk* are redeemed by the *sukuk* holders, Saad transfers the *sukuk* amount to the SPV.
7. The SPV pays out the *sukuk* amount to the investors.

Also, initially, Saad entered into a service agreement with the owner of the Saad and the SPV in which Saad provides certain services regarding land parcels. The service fee charged from the SPV was deducted from the rental payments paid to the SPV by the Saad. Whereas, fee paid by the chairman of Saad to Saad was equal to the initial amount raised from *sukuk* holders ,i.e., USD650. With this technique Saad becomes able to pay the *sukuk* amount to the SPV at redemption of the *sukuk*.

Figure 2: Golden Belt 1 Sukuk Structure



Shariah compliance of the Saad Sukuk

- Promissory Notes

To secure the *sukuk* holders' investment and return, Saad also provides promissory notes for each payable rental promissory note and for *sukuk* principle amount. This feature of the *sukuk* treats *sukuk* holders equal to the general creditors in case of Saad's default as the promissory notes are governed by the Saudi law.

- Dissolution Event

If the sub-lessee, Saad, defaults on any of its periodic rental payments or, inter alia, some violation of contracts, the trust can be dissolved on the issuers request provided that *sukuk* holders of at least 25 percent of total *sukuk* amount approved the dissolution event. Upon such event, *sukuk* become due and repayable at face value by the sub-lessee on requested date. However, the repayment of the *sukuk* depends upon the financial capacity of the obligor.

- Risk Related to *Sukuk* Returns.

Return on *sukuk* is offered at LIBOR plus a margin of 0.85 percent earned from the trust assets as “the sole source of payments on the Certificates.”²⁵ Primarily, the return on the *sukuk* is coming from rental amounts of the sub-lessee Saad, pursuant to the sublease agreement²⁶. However, according to *sukuk* OC, the determination of the rental amount is not related to the actual value of properties and thus can be challenged by the sub-lessee in Saudi Islamic courts on the equity and fairness principles. This risk is mitigated through issuance of a payable rental promissory note in favor of sub-lessor by Saad.

Reasons for Default

The Saad company defaulted on USD15.7 billion, including its Islamic bonds. The company faced a severe liquidity crisis in early 2008 and could not meet its debt service obligations on time. The originator company was singularly intransparent; proper information was not even provided to the regulators (S&P (2009)). Because of that, the Saudi Arabian Monetary Authority (SAMA) froze the assets of the Saad group in May 2009. Also, corruption and fraud charges of USD10 billion were filed against a Maan al-Sanea, the head lessor and owner of Saad, for misusing the funds of Algosaibi Investment Holding company, the formal owner of the SPV.²⁷ Accordingly, accounts of the Saad in Cayman Islands, valued at around USD9.2 billion, were frozen by the local courts in November 2009.²⁸

Restructuring

On May 18 2010, the *sukuk* holders exercised their right to dissolve the trust and voted for dissolution²⁹. However, there were legal issues which needed to be resolved before the *sukuk* investors were even given the status of unsecured creditors of the Saad. Upon dissolution of the trust, Saad, the guarantor of the repayment of the *sukuk* would have to repay the *sukuk* amount of USD650 million, but its assets were frozen. The litigation has dragged on for three years but the

²⁵ For instance, six month LIBOR rate in December 2007 was 4.91 percent (Fannie Mae). So for that period total *sukuk* return amount USD0.187 million for the six months.

²⁶ Payable Rental Amount= *Sukuk* Return (LIBOR+ Margin) + fixed service charges (called Supplement Return)

²⁷ Algosaibi Investment Holding company, formal owner of the issuer SPV with nominal capital of Bahraini Dinar 1000.

²⁸ <http://www.bloomberg.com/news/2011-11-09/saudi-arabia-s-algosaibi-wins-cayman-judgment-against-al-sanea.html>

²⁹ http://www.zawya.com/story/Golden_Belt_sukuk_holders_approve_dissolution-ZAWYA20100518100453/

case is still in Saudi Courts. In April 2012, of Citicorp Trustee Company Limited, the agent of the issuer of the *sukuk*, communicated that legal proceeding were still in progress and there were issues that still needed to be resolved. On May 28, 2012, the agent informed the *sukuk* holders about the hearing before the Commission for the Settlement of Negotiable Instruments Disputes (CSNID) in the Kingdom of Saudi Arabia on 28 May 2012 in which the defendant (Saad) demanded that the original promissory note be submitted to the CSNID, and that previously provided promissory note was not genuine as the signature on the copy was not of MR Al-Sanea.³⁰ Clearly, this structure was not bankruptcy proof.

4.4 The Nahkeel Sukuk

The *Nahkeel sukuk* was Dubai-based, high profile and the largest ever. It was issued on December, 14 2006 for a period of 3 years maturing on 15 December 2009 to raise USD3.5 billion. The *sukuk* were listed on the Dubai International Financial Exchange. The main objective of the *sukuk* was to finance a property development project of one of the public sector enterprises of Dubai, *Nahkeel Co. PJSC*. For this purpose, a special purpose vehicle (SPV), *Nahkeel Development Limited*, was incorporated with limited liability in the Jebel Ali Free Zone. The originator, *Nahkeel Holdings 1*, was a subsidiary of *Nahkeel World*, which, in turn, was owned by another public sector company, Dubai World. *Nahkeel Holdings 1*, *Nahkeel Holdings 2* and *Nahkeel Holdings 3* hold cumulative shares of 100 percent in *Nahkeel Co. PSJS*. Therefore, since they were issued by a public sector enterprise, the *sukuk* were given the status of a sovereign bond by the rating agency: investors assumed an implicit government guarantee for the *sukuk*. This is also clear by the high ratings given to the *sukuk* by Moody's (A1) and Standard & Poor's (A+).

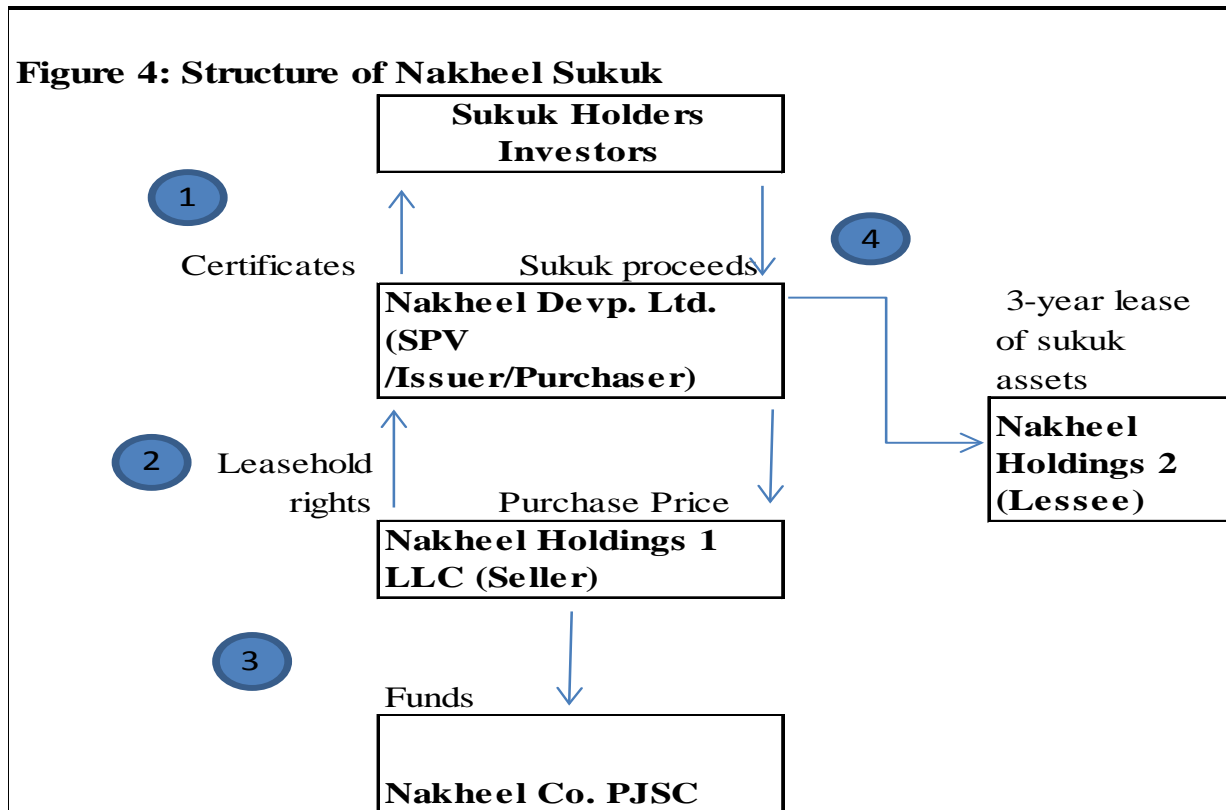
The Structure of the Nakheel sukuk

The *Nahkeel sukuk* were issued as asset based *Ijarah manfaa* (Salah (2010)) in which *sukuk* holders, via an SPV, buy the leasehold interest of the primary assets without transferring the title of the assets to them. Therefore, *Sukuk* holders only had rights on the stream of income generate by the assets and not on the assets themselves.

In *Nahkeel Sukuk* the structure was as follows (see Figure 4)

³⁰ http://static.mubasher.info/File.Story_File/SUKUK_20120603_PR.pdf

1. *Nahkeel* Development, an SPV, issues *Nahkeel sukuk* to raise USD3.5 billion to purchase the leasehold interest/rights in certain land, building and other property at the Dubai Waterfront, valued at AED 15.5 billion dated October 31, 2006 by Jone Lang Lassalle.
2. The SPV transfers the proceeds of the *sukuk* to *Nahkeel* holding 1 and purchases leasehold rights of the underlying properties from *Nahkeel* Holding 1, for 50 years.
3. Further, the SPV, as a trustee of *sukuk* holders, leases the underlying *sukuk* assets to *Nahkeel* Holding 2 for a period of 3 years. Half of the lease amount is paid to *sukuk* holders via the SPV and the other half is deferred till maturity of the *sukuk*.
4. The lessee, *Nahkeel* Holding 2, also makes a unilateral undertaking to purchase the leasehold rights from the SPV upon maturing of the lease period at certain price and with payment of the other half of the rental payments.



Shariah compliance of the Nahkeel Sukuk

The misperceptions about the *Nahkeel Sukuk* were related to government guarantees for the originator. The investors wrongly perceived that the *sukuk* had a guarantee of the Dubai government (Warde 2011) as the deal was guaranteed by Dubai World, a state-owned company.

This implied that *sukuk* investors expected that the government of Dubai would bail out the *sukuk* if the obligor, *Nahkeel* Holding 1, and then Dubai World, would default on their payment obligations. The perceptions about the *Nahkeel sukuk* was not justified according to the extensive 237- page OC of *Nahkeel sukuk*³¹. The document explicitly comments on these aspects. While disclosing the risk factors related to Dubai World (the guarantor) and co-obligors, the OC says ‘*that the Government of Dubai does not guarantee any indebtedness or any other liability of Dubai World*’. Also, it mentions that Dubai world is a holding company and it is dependent on the performance of its subsidiaries and, therefore, claims of the Dubai World creditors are subordinate to direct creditors of its subsidiaries (p. 36). However, the rating agency, Standard & Poor's, gave an A+ rating to *sukuk* with a view ‘*that the purchase undertaking provided to DP World Sukuk from its parent [Dubai World] also benefited from strong implicit government support*’(S&P 2007). Considering the clear disclaimer about the government guarantee and absence of any other indication that government of Dubai would pay to the investors in case of insolvency, ‘A+’ rating appears to be ‘exaggerated’ and ‘unwise’ to some Islamic Finance experts³². This became evident when the government of Dubai requested the creditors of Dubai World for a 6-month standstill, on November 25, 2009.

Reasons for Insolvency/default

In the aftermath of the global financial crisis 2007-09, the macroeconomic situation led the Dubai government to seek a standstill for USD59 billion debt owed by one of the state-owned companies Dubai World, including Islamic *sukuk* of 3.5 billion (Smith and Kiwan (2009)). There were various factors which caused Dubai World to in effect default. Huge short term borrowings, falling oil prices, the bursting of the real estate price bubble due to excessive supply of residential and commercial properties, and a liquidity mismatch owing to short term liabilities and long term receivables from the property development, all contributed to the failure of Dubai World, the guarantor of the *Nahkeel sukuk*, and its daughter companies (IMF (2010)).

There were ambiguities about the actual worth of *Nahkeel* properties used for execution of the transaction. Dubai Waterfront was valued around USD4.2 billion in 2006, more than the *sukuk*

³¹ The document is available at <http://www.kantakji.com/figh/Files/Markets/m135.pdf>

³² For details see <http://www.islamicfinance.de/?q=node/719>.

amount, based on *proposed* development on 2 idle strips of land as yet generating no income (*Sukuk Focus* 2010). Moreover, the guarantee of Dubai World became troublesome as the holding company itself was also negatively affected by the financial crisis. Also, being a holding company, Dubai World may have superior creditors than *sukuk* holders. *Nahkeel* holding 2 actually used liquidity from other resources to pay the return on *sukuk* instead of the return on the underlying assets of the *sukuk* which were negligible.

In the end the *sukuk*'s default was triggered by the specific financial condition of the obligor. The financial account of the *Nahkeel* PJSC, show that for the first half of year 2009, the company had a net exposure of AED 12.8 billion to the parent company Dubai World. The amount is more or less equal to the payment due on 14 December 2009 for the *sukuk* final payment (AED 12.9)³³. It is more than likely that, if the concentration of funds in related parties had been managed prudently, the standstill request for at least the *Nahkeel sukuk*, could have been prevented.

Bailout

Outright default was eventually prevented through the bailout by Abu Dhabi at the eleventh hour and all the *sukuk* holders were paid out accordingly (IMF (2010)).

5. Discussion and overview

In the previous section we sketched the details of the originator, underlying *sukuk* structure, reasons for *sukuk* failure and discussed the restructuring process, if any, of the four *sukuk* defaults. In this section we discuss the general issues that arise out of the analysis of these four default episodes, issues that are clearly related to the structure of the *sukuk*, the extent to which these structures deviated from *shariah* standards as provided by the AAOIFI and best market practices, and we ask the question whether imperfect compliance to *shariah* standards played a role in the way the restructuring process evolved and the eventual outcome.

5.1 Governing Law and the enforceability of Foreign Courts' Ruling in cross-border contracts

While *sukuk* were essentially designed to comply with *shariah*, they were in practice governed by the English law, because some concepts, like SPVs, commonly used in conventional

³³ For more information see <http://suqalmal.blogspot.nl/2009/12/nakheel-intercompany-funding.html>

financing, do not give the same rights to investors in some GCC jurisdictions following civil law. This has created problems for *sukuk* issuance in jurisdictions like Bahrain and UAE (Nazar (2011)). In some states non-recognition of a SPV may render various contracts void.³⁴ Especially the investors' right of recourse to underlying *sukuk* assets in the event of default proposed in the offering circulars then becomes ambiguous. There may be conflicts in some clauses of contracts governed by the English law with Islamic law (*shariah*). Several recent rulings of English courts clarify that in case of any contradiction between Islamic law and English law, the latter would prevail³⁵.

The *sukuk* issued in GCC countries have some common characteristics and associated issues owing to the specific laws of jurisdictions and provisions made in the offering letters that exposed investors to legal and credit (*sukuk*) default risk. Moreover, *sukuk* issued from various countries may have similar underlying contracts, but the implications of the contracts regarding investors' rights may be different because of the differences among the legal systems of the concerned jurisdictions. For instance, though both Kuwait-based TID and US-based ECP *sukuk* follow *musharakah* structure, but only in the latter case the *sukuk* holders could have recourse to the underlying *sukuk* asset thanks to US court ruling under common law system. Also, these *sukuk* have peculiar features which differentiate them from each other due to distinctive business nature of originators and clauses embedded in the *sukuk* contracts. Both the common and individual issues in the *sukuk* structures need to be addressed to avoid the anomalies in the *sukuk* industry and to protect the rights of the *sukuk* investors. Table 2 summaries all the features and issues related to the four *sukuk* being studied.

The best business practices require the contracts to be transparent and enforceable in order to protect the interests of the parties involved. Similarly, *shariah* endorses only those contracts which are free from *gharrar* (excessive uncertainty and speculations in the contract or transaction).³⁶ On the contrary, there were some gray areas in the *sukuk* OCs issued in GCC region, which are the cause of *gharrar*. These *sukuk* are governed by the English laws as the main

³⁴ In Saudi Arabia declaration of trust is not recognized and therefore the contract in which trust (SPV) is a party may not be considered valid in the relevant courts (source: Saad *sukuk* OC).

³⁵ For instance, in one such case, the two parties involved were Beximco Pharmaceuticals Ltd vs Shamil Bank of Bahrain. The client defaulted on repayments of Murabahah loan, but it took stance that the transaction was not *shariah* compliant and thus should be cancelled by the court. However, court ruling rejected the argument of the Beximco declaring that English law is the governing law of the contract (Yean (2009))

³⁶ The instruments which are rendered void because of Gharar are forwards, futures, insurance, options, and other derivative securities ((Mohieldin (2012)))

sukuk documents like lease contracts, transaction documents and trust agreements are prepared under that law. The concepts in the English law may not exist in the relevant jurisdiction due to different legal system, causing legal risks to the investors. Moreover, any judgment under English law by a foreign court may not be implemented fully in GCC countries. Courts of the relevant jurisdictions may review the judgments in accordance with public policies of the state. For instances, in case of TID *sukuk* governed by English law, the English courts have jurisdiction to resolve the conflicts arising from the *sukuk* but their judgments may not be vetted by the Kuwaiti courts in the absence of any agreement between Kuwait and UK for enforcement of courts' ruling reciprocally. (El-Gamal (2007))

Likewise, in Golden Belt I (Saad) *sukuk*, the OC points out that Saudi Arabian law does not recognize the concept of trust as common law jurisdictions do (p. 30). Therefore, any agreement made in the capacity of the trust may not be legally recognized in Saudi law. It means that in the case of default *sukuk* investors may not claim their rights ordained in *sukuk* documents. However, authenticity of the trust would eventually depend on the discretion of the Saudi courts as there are some related concepts which do exist in Saudi Arabian law like *wakalah* (Agency Agreement). However, under the *wakalah* all the assets are registered in the name of agent/attorney and there is no exclusive entity for the trust. Moreover, English law governs the documents of head lease, sub lease, *sukuk* purchase agreement and service agreement in which Saad needs to pay for maintenance of the *sukuk* properties. In Saudi Arabia, similar to Kuwait, enforcement of the English courts' judgments has its limitations as the Saudi courts applying Islamic law may not recognize these rulings, especially in the absence of any precedent as well as bilateral treaty between Saudi Arabia and United Kingdom about these matters. Consequently, in the event of default if for example Saad fails to fulfill its obligations, *sukuk* holders may have insufficient assets of the obligor on which they have legal claims, since most of the assets of Saad are located in Saudi Arabia.

Similarly, concerning *Nahkeel sukuk*, UAE law does not recognize the concept of trust or beneficial interests and, therefore, terms of the Declaration of Trust may not be enforced by the courts of Dubai, though the agency concept does exist in UAE law (OC p.137). Also, the official circular noticeably mentions the uncertainties related to the UAE bankruptcy law in the wake of *sukuk* default and states that “*There is little precedent to predict how claims by or on behalf of the Certificateholders would be resolved, and therefore there can be no assurance that*

Certificateholders would receive repayment of their claims in full or at all.” Moreover, although English law is considered as the governing law of the *Nahkeel sukuk*, yet its enforceability in Dubai faces the same challenges as in Saudi Arabia and Kuwait, especially if government properties are involved in the dispute: no debt or other obligations owed by the government or rulers may be recovered through confiscating the properties of the government regardless of any foreign judgments.

5.2 Ownership of the Sukuk Trust Assets: are the contracts bankruptcy proof?

For *sukuk* to be *shariah* compliant, *sukuk* holders must have the ownership of the underlying real assets implying “*tangible, usufruct rights or services, capable of being owned and sold legally*” (AAOIFI (2008)). However, the GCC origin *sukuk* do not fulfill this requirement as the ownership of the underlying assets was not transferred to the *sukuk* holders properly from a legal point of view.

In the TID *sukuk*, however, the originator did contribute to *musharakah* (joint venture) through transferring “*all rights, benefits and entitlements to the TID vehicles and property*”. However, section 2.5 (c) of *musharakah* agreement mentioned that “*registered title to the TID vehicles and property [musharakah assets] is held in the name of ‘Investment Dar Company’*” (p. 4) and the registration of the vehicles and property would remain in the name of TID with ‘*Traffic Department*’ and with ‘*Registration of Property Department in the Ministry of Justice.*’ So in the event of *sukuk* default, the investors did not have any direct recourse to the underlying assets of *musharakah*. Furthermore, section 2.5 (d) explained the status of this title retention, stating that TID “*shall hold and maintain such registered title as agent for the Musharaka.*” Similarly, OC states (p. 11) “*The certificates represent entitlements solely to the trust assets [in musharakah proportionally].*” These last two points go in favor of the property rights of the *sukuk* investors in the underlying trust assets, but the final position can be determined through Kuwaiti court’s ruling.

Similarly, in the Saad *sukuk*, the *sukuk* documents stipulated that following a dissolution or default event the *sukuk* holders would have recourse to so called trust assets only. These assets were defined as issuer’s rights, interest and benefits under the Head Lease Agreement, the Sub-Lease Agreement and the Promissory Notes. Thus *Sukuk* holders had a leasehold interest in the land parcels, but title of the land parcels remained in the name of chairman of Saad. Likewise, it

was mentioned in the OC that being the head lessee the SPV has obtained only “limited representations”, i.e. leasehold interest, in land parcels³⁷. Ownership of the assets was also clear under the head lease agreement as the chairman of Saad, being the owner, is responsible for all “*all obligations, liabilities, rights and remedies, [...], including for loss of use, revenue or profit (as applicable) with respect to each of the Land Parcels,[...]. The Chairman of Saad will be responsible for the performance of all Major Maintenance.*”

There was thus an incorrect perception that these *sukuk* were backed by real assets (Warde 2011). In practice, *sukuk* holders had rights only to the cash flows generated by the underlying assets and not to the assets itself as the title of the assets was not transferred to the buyer in the registers of the concerned departments of the government (e.g. Land Department). Further, leasehold rights were not considered as property right under Dubai law which restricts investors’ claims and prosecution of law (Hassan and Kholid (2010)). Therefore, in case of default there was no recourse for the creditors to the original assets, the transfer of rights turned out not to be bankruptcy proof. So these *sukuk* essentially had the status of uncollateralized debt. Furthermore, though the prospectus declared a purchase agreement between originator and the SPV about *sukuk* assets (i.e. leasehold interest) against the price equivalent to the total amount of the *sukuk*, there are no regulations in UAE regarding the registration of these rights with Dubai Lands Department (OC-p 130). Thus the original contract was a lease and lease back contract instead of a sale and lease back contract. Logically therefore, the *sukuk* were considered as *asset-based* by the Moody’s (Howladar (2009)), not as *asset backed*.

The only instance in which the ownership of the *sukuk* was in fact transferred to the *sukuk* investors in a bankruptcy proof manner, was in the case of the US based ECP *sukuk*. In that case too, while applying for the chapter 11 bankruptcy protection, the originator asked the court to consider the primary transaction of ORRI in the contract as a secured loans and not as true sale, but the court did not accept the stance of the originator and considered the transaction as ‘true sale’. Eventually, *sukuk* investors were considered the owner of ORRI.

³⁷ On the other hand, it is also mentioned (p. 26) that “*The Issuer will have no material assets other than the Land Parcels which will be sub-let to the Sub-Lessee pursuant to the Sub-Lease Agreement.*”

5.3 Residual risk and Repurchase Undertakings as part of Sukuk

Shariah principles do not allow an agreement to repurchase the *sukuk* at face value (repo) upon maturity as this arrangement renders *sukuk* identical to conventional bonds which are not permissible under Islamic law (AAOIFI (2008)). Because of this, credit risk became an issue for all of the *sukuk* amount plus outstanding rentals in case of an *ijarah sukuk* while it would otherwise have been limited to outstanding rentals and a risk of capital losses once the underlying assets are repurchased by the originator at the market price. Similarly, in *musharakah sukuk* equity of *sukuk* is transformed into debt but residual risk remains for the full amounts issued because of this stricture against repurchase agreements at fixed prices.

The three GCC based *sukuk* cases violated the abovementioned AAOIFI criterion. In the case of the TID *musharakah sukuk*, the originator company TID provides an undertaking in preliminary OC of to purchase the *musharakah* share of the issuer pursuant to:

- (a) An ‘Exercise Notice’ by the issuer to purchase the issuer’s units at ‘Dissolution Distribution Amount’ which was equivalent to the face value of *sukuk* plus any unpaid periodic distribution amount.
- (b) Redemption notice to purchase the issuer’s units at ‘Early Redemption Amount’ that was also equivalent to the face value of *sukuk* plus any unpaid periodic distribution amount.
- (c) Occurrence of Dissolution Event, to purchase the issuer’s units at ‘Dissolution Distribution Amount’.

The purchase undertaking thus provided a put option to *sukuk* holders at the face value plus any unpaid periodic payment on *sukuk*. In practice, the credibility of this undertaking in Kuwait depends on the recognition of the ‘trust agreement’ by Kuwaiti courts and whether these courts consider a repurchase agreement as a guarantee. If so, the value of the implicit put depended on the financial position of TID. If the TID would be unable to meet the obligations under the repo, then *sukuk* would be ranked *pari passu* with other unsecured debts of the obligor since no ownership rights existed on the underlying assets.

Likewise, in the Saad *sukuk*, there was a repurchase undertaking by the Saad according to Sub Lease Agreement maturity date of the *sukuk*. There was also an early redemption option pursuant to which *sukuk* holders could ask the issuer to terminate the sublease contract if they

would hold more than 25 percent of *sukuk* amount. Accordingly, the *sukuk* holders can ask Saad to pay the *sukuk* amount plus accrued rental payment using its rights under various promissory notes by Saad. The *sukuk* would be redeemed at face value plus any unpaid Periodic Distribution Amounts on the maturity of the *sukuk*. For further security Saad also issued a promissory note of USD650 million to support this repo.

5.4 Credit Enhancement

Credit enhancement is a technique through which the borrower increases its credit worthiness or at least the credit standing of the debt issued, in order to achieve better subscription, credit rating and pricing of the loan. Credit enhancement usually takes place through external guarantees, insurance and/or provision of collateral. In *musharakah sukuk*, it is not permissible for the manager of *Sukuk* acting as partner in *musharakah* to undertake to offer loan contracts with guaranteed returns when actual earnings fall short of expected earnings (AAOIFI (2008)), as the investors are obliged to share in profit and loss with the originator. However, a reserve account can be established to cover any shortfall in expected earnings.

Though in the TID *musharakah sukuk*, there is no explicit statement in OC stating that if the return on the *sukuk* are less than the offered rate ‘LIBOR plus margin’, the shortfall would be covered by TID or any third party. However, it is mentioned generally in OC (p. 11) that “*The Issuer [...] would have direct recourse against TID to recover payments due to the Issuer from TID pursuant to the Transaction Documents to which it is a party.*” This indicates that if the actual return of the *sukuk* holders is short of the LIBOR plus margin, issuer would have direct recourse to the TID. However, since the return of on the *sukuk* is ambiguous (see TID, *Profit Distribution*), *sukuk* may not have credit enhancements other than preferred access to a reserve account.

The US based ECP *sukuk* did establish a reserve account to cover any shortfall in the expected earnings in accordance with (AAOIFI (2008)) instructions.

Also, in the Saad *ijarah sukuk*, there was an explicit credit enhancement through payable rental promissory notes and promissory notes against (re)purchase undertakings.³⁸ A promissory note about rental payments ensures the payment of promised *sukuk* returns if the sub-lessee fails

³⁸ Payable rental promissory notes are permissible under Islamic law but promissory notes against purchase undertaking to by the *sukuk* at face value are not.

to pay the rental payment. These promissory notes make *sukuk* holders' claim *pari passu* to general creditors as these are governed by the Saudi laws. Similarly, *Nahkeel sukuk* had credit enhancement as the co-obligor guarantees the obligations of each co-obligor under the transaction documents (which also include lease documents) in which one of the obligation of co-obligors was to pay rental amount equal to payments to 6.345 percent per annum of the *sukuk* amount.³⁹ Moreover, the Dubai World, the parent company, also guaranteed all of the co-obligors' payment obligations under the Transaction Documents.

5.5 Limited Recourse

There is thus only limited recourse to the *sukuk*'s underlying assets in all GCC region *sukuk*. This means that *sukuk* represent beneficial ownership rights only in the trust assets and the *sukuk* investors have no recourse to the originator's assets nor the creditors of the originators have rights on the *sukuk* assets. However, as mentioned before, to have a recourse to the trust assets the ownership of the assets needs to be transferred to the SPV, acting as trustee of the *sukuk* holders. This was not done in the *sukuk* issued in GCC region.

TID *musharakah sukuk* mentions that proceeds of the trust are the only source of payments to the investors (p.7) in case of *sukuk* default. Thus, *sukuk* investors would *not* be treated *pari passu* with general creditors if the originator does not fulfill its obligations and thus defaults. In principle, a *musharakah sukuk* cannot default as the *sukuk* holder shares profit and loss with the originator. However as the originator promised a fixed return in TID *sukuk* contrary to *musharakah* principles, it can default on its obligations. In Saad's case, the only remedy was that *sukuk* holders can invoke their rights under sub-lease agreement and ask Saad (the sub-lessee) to pay the *sukuk* amount USD650 million plus accrued payable rental amounts. On the other hand, pursuant to transaction documents to which Saad was a party directly to the issuer, the issuer had a direct recourse against Saad to recover the accrued payments from Saad. However, getting an order for enforcement of Saad's obligations depended upon the courts' discretion. Also, because of the Promissory notes, recourse of the *sukuk* holders would not be confined to the SPV assets only but would include the obligor's assets as well.

³⁹ It is mentioned in the OC that 50 percent of the six-month rental payment would be at the end of *sukuk* period. So the amount to be paid to the *sukuk* holders at the end of every six periods is equal to USD55,836,000 (i.e. $3,520,000,000 \times 0.5 \times 0.06345/2$)

Similarly in *Nahkeel sukuk* it is disclosed in the OC that rights of the *sukuk* holders are limited to the trust /SPV assets, however due to the presence of various guarantees the investors did get claims on the assets of the obligors. But in case of an actual default, *sukuk* holders could not have recourse to the underlying assets.

5.6 Role of the Shariah Boards

Apparently, while deciding about the *Shariah* compliance of underlying *sukuk* structures, the administrative and procedural issues were generally overlooked by the *shariah* boards, especially in GCC originated *sukuk*. For instance, lawful transfer of the ownership of *sukuk* assets to *sukuk* holders, the status of the trust entity in concerned jurisdiction and earning capacity of the underlying *sukuk* assets to generate returns offered in *sukuk* documents was apparently ignored by the *shariah* board, with adverse implications when the *sukuk* issuers defaulted. In practice, the transfer of the ownership of the underlying *sukuk* assets was not accomplished legally in any of the three GCC based cases. In *Nahkeel sukuk* the property was overvalued and did not generate the proceeds in accordance with the returned offered on *sukuk* (Sukuk Focus 2010). Clearly, the potential capacity of the assets to generate the offered *sukuk* return was not checked adequately ex-ante. Also, in the TID *musharakah sukuk*, the transaction was backed by a credit enhancement mechanism in which the originator/manager of *musharakah sukuk* ensured the return by providing guarantees, against *shariah* strictures. *Shariah* compliance of the *sukuk* is the responsibility of the *Shariah* board, as is rightly emphasized by the AAOIFI ((2008)), but the board's performance seems to have been deficient in many cases. Hayat, Butter and Koch (2012), show that around twenty *shariah* scholars hold more than half of the market, and the top 3 receive about USD4.5 million as fees annually; it is clear that this market is beset by the same sort of incentive conflicts that we have seen in the case of regular rating agencies in Western finance: a strong incentive to be excessively lenient in certification i.e. a conflict of interest problem, sub-standard governance practices, lack of consensus regarding certification standards, and added to that in the case of the Sharia boards, limited knowledge of finance.

6. Conclusions

Islamic finance instruments occupy a rapidly growing niche in world capital markets. *Sukuk* in particular have been presented as an alternative to interest based conventional bonds. They are often seen as asset backed securities free of interest and meeting the criteria of Islamic finance. Issued by Islamic and non-Islamic entities alike, *sukuk* promised access to a large pool of capital in the Islamic world while eliminating some of the high risk taking incentives characteristic of more conventional financial instruments.

Islamic strictures require investors to share risks with the entrepreneurs they finance. Thus, Islamic debt instruments are more equity-like than traditional debt instruments: Islamic debt instruments have loss absorption capacity and are thus more like hybrids, debt with equity characteristics. In the end *Sukuk* investors are supposed to share profit and loss in the underlying venture to a considerable extent. *Sukuk* come mostly in two varieties, *musharakah* (basically a joint venture agreement) and *Ijarah* (more like an operational lease agreement). In particular for *musharakah* (joint venture) *sukuk*, there should not have been any defaults, since all payments are contingent on profits and none are due if there are no profits. In the case of *ijarah sukuk*, the risks of *sukuk* investors are limited to default on periodic rental payments by the lessee and residual risk. These risks can be potentially mitigated through creating a reserve account and managing it prudently. Yet defaults did happen, even in the case of *musharakah* (joint venture) *sukuk* like the TID and ECP *sukuk* discussed in this study. So is Islamic finance failing to deliver on its promises?

To answer that question, we analyse four major defaults on *Sukuk* that have happened recently in the aftermath of the worldwide credit crisis that has engulfed the world since 2007. These case studies make clear that most of the problems that triggered defaults or blocked smooth resolution of distress afterwards, arose from ill-defined property rights and conceptual mismatches between relevant jurisdictions and the legal structures chosen. In most cases, the problems can be traced back to clauses and structures that made the *Sukuk* more like conventional bonds. For example, (i) in some cases, return on capital was ascertained with some promissory notes or guarantees by the originators or third parties (ii) repurchase undertaking by the originator/obligor to purchase the *sukuk* at face value on *sukuk* maturity date and (iii) credit enhancement.

Such features rendered *sukuk* almost identical to conventional bonds which pay periodic interest and face value on redemption of the securities at the end. But introduction of conventional characteristics in *sukuk* created a situation in which there was a possibility for *sukuk* to default, like is the case with a conventional bond.

Furthermore, once default happened, most of the *sukuk* discussed did not transfer the underlying assets to the *sukuk* holders. So, in the event of default, due to limited recourse provisions, *sukuk* holders often had nothing to resort to, as effectively there were no underlying assets in their ownership. As a consequence, *sukuk* were treated as subordinated debt from the obligor/guarantor in distress situations. The case studies highlighted the importance of the legal institutions of the country where the collateral is likely to be contested. In the case of the US based ECP *sukuk*, underlying assets were in fact assigned to the Sukuk holders. This was a very important precedent about protection of *sukuk* holders' rights and would subsequently have a positive impact on *sukuk* growth in US since it set the precedent that asset backed *sukuk* are in fact bankruptcy proof: the transfer of assets to the Sukuk SPV was shown to be safe from bankruptcy of the originator company. Thus in the US, *sukuk* holders' rights are protected due to a well-developed legal system of collateral and recognition of all the contracts by the courts of law. But the situation was very different for the Sukuk issued under the jurisdiction of the Gulf countries. In the GCC countries, there is no historical precedent regarding *sukuk* holders claims which might protect the interest of the investors (Ryan and Elmalki (2010)).

Interestingly enough, strict adherence to *shariah* principles would have considerably simplified restructuring because *shariah* compliance implies a clear allocation of property rights: in *shariah* compliant instruments, investors will receive full title to the collateral in distress situations.

So the answer to the question we asked, is Islamic Finance failing to deliver on its promises, is a qualified no. Mishaps have happened and resolutions have been more mired in controversy than expected. But strict compliance to *shariah* principles of ownership and risk sharing would have reduced incidence of defaults and facilitated restructuring, as in particular the history of the ECP *Sukuk* demonstrates. The asset-backed structure of *sukuk* accompanied with a ban on derivatives and sale of debt, can thus potentially make the world a less risky place. However, the experience of the four default episodes shows clearly that benefits from the *sukuk* in accessing a wider investor base can only be achieved if the *sukuk* strictly follow the rules prescribed by the

Islamic jurisprudence called *shariah*. These principles need *sukuk* to be asset-backed and free of interest, *gharrar* (excessive uncertainty/ambiguities) and gambling (Jobst (2007)). Also *sukuk* and all the legal constructs that form part of the arrangement should be recognized in the law of the jurisdiction concerned. Eligibility of *Sukuk* for secondary market trading would make them more liquid and so increase their attractiveness.⁴⁰ An additional point that emerges from the case studies is the damaging impact of ambiguity concerning the *shariah* compliance status. In that respect, both the transparency of *Sukuk* and the resolution of distress situations would doubtlessly profit from further standardization. Increased codification of the requirements *shariah* compliance implies, and a further professionalisation of the Boards that decide on compliance are thus developments that would most likely increase acceptance of Islamic Finance in global capital markets and unlock the growing pool of capital in Islamic countries.

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⁴⁰ Debt based *sukuk*, like *murabahah*, are not eligible for secondary market trading according to most of the Islamic scholars except in East Asian countries as Malaysia and Indonesia.

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Annex I: Tables

Table 1: Key Terms of Various *Sukuk*

Table 2: Claims of *Sukuk* holders and Risks in Various *Sukuk* Issues

Table 1: Key Terms of Various *Sukuk*

<i>Sukuk</i> Name	East Cameron Partners' <i>Sukuk</i>	The Investment Dar Company <i>Sukuk</i>		Golden Belt 1 <i>Sukuk</i>	<i>Nahkeel Sukuk</i>
Year	2006	2006	2005	2007	2006
Amount	USD165.67 million	USD150 million	USD100 million	USD650 million	USD3,520 million
Certificates Structure:	Sukuk al-Musharakah	Sukuk-al-Musharakah (co-ownership/joint venture)	Sukuk-al-Musharaka (co-ownership/joint venture)	Sukuk Al-Ijarah (leasing)	Sukuk Al-Ijarah (leasing)
Security	Right on oil and gas over-riding royalty interests ("ORRI")	Unsecured, unsubordinated	Unsecured, unsubordinated	Promissory Note for the benefit of the SPV by the Sub-Lessee equal to the sukuk amount of USD650 million and for the periodic payable rental amount.	Mortgage on Trust Assets, Guarantees
Closing Date	July 2006	20-9-2006	27-10-2005	15-5-2007	
Tenor	13 years	5 years	5 years	5 years	3 years
Listing		Dubai International Financial Exchanges	Bahrain Stock Exchange.	Bahrain Stock Exchange	Dubai International Financial Exchange
Final Maturity	2019	5 Years from closing date	5 years from closing date	15-5-2012	12-14-2009
Rating	CCC+ (Standard & Poor's)	A- by Moody's	Unrated	BBB+ by S&P and baa1 by Moody's	
Return	11.25 percent	Years 1-3: 6-month LIBOR + 125 bps p.a.	6 month LIBOR plus 2 percent p.a. on an	6 month LIBOR+ 0.85 percent (Margin)	6.345 percent p.a.

		Years 4-5: 6-month LIBOR + 175 bps p.a.	actual/360 day basis		
Governing law	USA	English law	English law and Bahrain law	English law governs Trust, Agency and Lease agreements. The Services Agreement is governed by Bahrain law. Saudi law governs promissory notes.	English law
Key Parties					
Originator /Obligor	East Cameron Partners (Texas, USA)	TID	TID	Saad Trading, Contracting and Financial Services Company	Nahkeel Holding 1
Issuer	East Cameron Gas Company (Cayman Islands SPV)	TID Global Sukuk I Limited (SPV) incorporated in Cayman Island	The Investment Dar Sukuk Company (SPC), incorporated in Bahrain.	Golden Belt 1 Sukuk Company (SPV)	Nahkeel Development Limited (SPV)
Arranger & Administrator & Bookrunner	BSEC Bemo Securitisation (Beirut, Lebanon)	Unicorn Investment Bank B.S.C (c) and West LB AG, London Branch	ABC Bank	BNP PARIBAS	Dubai Islamic Bank PJSC
Trustee	The Issuer	The Issuer	The Issuer	The Issuer, which then appointed Citicorp Trustee Company Limited as trustee delegate.	The Issuer

Table 2: Claims of *Sukuk* holders and Risks in Various *Sukuk* Issues

<i>Sukuk</i> Features	Claims	Risks	Remedies	Comments
Common	All rights under Declaration of Trust, the Agency Agreements with Issuer	<ul style="list-style-type: none"> • Legal risk, as Declaration of Trust is not recognized in the concerned Jurisdictions. • Trust documents may be considered as void then all rights of <i>sukuk</i> holders become invalid. • Investment loss risk. 	<ul style="list-style-type: none"> • Risks disclosed in OCs • Promissory note issued to pay the obligations (only by Saad <i>Sukuk</i>) 	<ul style="list-style-type: none"> • Courts of the relevant jurisdictions have discretionary powers regarding validity of the trust documents.
	Claims under English Governing Law	<ul style="list-style-type: none"> • Only useful if concerned jurisdictions have bilateral agreements. • If the originator/obligor have enough assets in jurisdictions functioning under English law. • There is no precedent of <i>sukuk</i> investors claims resolution. • Risk of loss of Investment 	<ul style="list-style-type: none"> • Risks disclosed in OCs 	<ul style="list-style-type: none"> • Courts of the relevant jurisdictions have discretion about applicability of the foreign law.
	Judgments of the English Courts	<ul style="list-style-type: none"> • Limitations exist related to enforcement of English court's ruling • May be against the public policy of the relevant jurisdictions. • Risk of loss of Investment 	<ul style="list-style-type: none"> • Risks disclosed in OCs 	<ul style="list-style-type: none"> • Courts of the relevant jurisdictions have discretion about applicability English courts' judgment.

Recourse to Underlying <i>Sukuk</i> Assets in Case of Default	<ul style="list-style-type: none"> • Recourse is limited to the underlying <i>sukuk</i> assets. • Value of <i>sukuk</i> assets may depreciate subject to market conditions. • Title of <i>sukuk</i> assets not transferred to <i>sukuk</i> investors. • Possession of assets may not be acquired in relevant jurisdictions in case of <i>sukuk</i> default. • Risk of loss of Investment • No recourse to assets of originators/obligors. 	<ul style="list-style-type: none"> • Risk of depreciation of value of underlying <i>sukuk</i> shifts to the obligor pursuant to purchase undertaking which ensures repurchase of the <i>sukuk</i> at face value. • Promissory notes in Saad <i>sukuk</i> and guarantees in <i>Nahkeel sukuk</i> extends the recourse to the obligors assets. • Risks disclosed in OCs 	<ul style="list-style-type: none"> • Titles of trust assets were not transferred to <i>sukuk</i> holders in records of the government departments. Therefore, eventually <i>sukuk</i> holders did not have any resource to underlying assets.
Underlying <i>Sukuk</i> Assets	<ul style="list-style-type: none"> • Property valuation is inherently subjective and uncertain. • Ownership/Title of the <i>sukuk</i> assets remain in the name of the originator/ obligor. • Effectively treated as debt Subordinated to obligors assets (in case purchase undertaking is recognized by the courts). • Risk of loss of investment. 	<ul style="list-style-type: none"> • Disclosed formally in OCs. 	<ul style="list-style-type: none"> • OCs show that issuer does have underlying physical assets but ironically the ownership of the assets remain with the originator/obligor. • That means in the case of default <i>sukuk</i> holders own no assets legally.
Purchase Undertaking by the originator to buy the <i>sukuk</i> (<i>sukuk</i> redemption) at face value.	<ul style="list-style-type: none"> • Risk of obligors' default. • Risk of non-recognition of repo as guarantee. • Risk attached to limited recourse to the trust assets • Risk of becoming subordinated debt. 	<ul style="list-style-type: none"> • Promissory note against purchase undertaking of the <i>sukuk</i> amount (only in case of Saad's Golden Belt 1 <i>Sukuk</i>). 	<ul style="list-style-type: none"> • Courts of the relevant jurisdictions have discretionary powers to (un)authenticate the contract.

	<i>Sukuk</i> Returns	<ul style="list-style-type: none"> • Credit default risk 	<ul style="list-style-type: none"> • Guarantee/sureties are provided in <i>Nahkeel</i> case. 	<ul style="list-style-type: none"> • OCs promise the payment of the <i>sukuk</i> return without deducting any taxes. • In case of withholding taxes, the same would be paid by the originator.
	Residual Risk of Underlying Assets Borne by the Obligor/Originator	<ul style="list-style-type: none"> • Credit default risk 	<ul style="list-style-type: none"> • Guarantee/sureties are provided in <i>Nahkeel</i> case 	<ul style="list-style-type: none"> • The right is due to the purchase undertaking to buy the <i>sukuk</i> at face value at the end of <i>sukuk</i> period.
Investment Dar <i>Sukuk</i>	Credit Enhancement through Direct Recourse to the Investment Dar	<ul style="list-style-type: none"> • Only implicitly mentioned. • Direct recourse to the depends upon the recognition of trust by Kuwaiti courts. • No reserve account as the amount higher than the periodic distribution profit amount at aforesaid rate goes to manager TID as an "incentive fees" 	<ul style="list-style-type: none"> • No sureties are provided. 	<ul style="list-style-type: none"> • Kuwaiti courts have discretionary powers regarding this matter.
	Ownership of <i>Musharakah Sukuk</i>	<ul style="list-style-type: none"> • Financial accounts of originator show that <i>sukuk</i> are treated as liabilities in its balance sheet. • This show that underlying entire <i>sukuk</i> assets of <i>musharakah</i> may be treated as the TID assets, as <i>musharakah</i> assets are registered in the name of 'Investment Dar Company'. 	<ul style="list-style-type: none"> • Purchase undertaking of <i>musharakah</i> assets from the <i>sukuk</i> holders. 	<ul style="list-style-type: none"> • In default scenario, the courts needs to decide the actual ownership of the <i>sukuk</i> assets.

Saad's Golden Belt 1 <i>Sukuk</i>	Credit Enhancement through Payable Rental Promissory Note and Promissory Note against Purchase Undertaking	<ul style="list-style-type: none"> • Credit default risk • There is also <i>shariah</i> compliance risk as the courts may consider the rent relatively higher than the underlying assets' value and thus against the principle of equity. 	<ul style="list-style-type: none"> • OC clearly discloses these risks. 	<ul style="list-style-type: none"> • Promissory note make <i>sukuk</i> holders' claim <i>equal</i> to general creditors as it is governed by the Saudi laws.
<i>Nahkeel Sukuk</i>	Mortgages of the <i>Nahkeel</i> Holding 1 properties.	<ul style="list-style-type: none"> • Only recognized banks as lenders can become a registered mortgagee in government registers. Enforcement of security by the Dubai Islamic Bank (security agent) is untested in UAE courts (OC pp-132). • Court's order required to sell the mortgaged property. 	<ul style="list-style-type: none"> • OC explicitly discloses the risks. 	<ul style="list-style-type: none"> • The relevant courts have discretion on the issue.
	Credit Enhancement via Co-Obligor Guarantee and Parent Company Guarantee	<ul style="list-style-type: none"> • These agreements are governed by English law which may not be applied in related jurisdiction. • There are certain risks related to the co-obligors and parent company. 	<ul style="list-style-type: none"> • The OC clearly mentions all the risks related to the counterparties and the Dubai government does not guarantee the deal. 	<ul style="list-style-type: none"> • Dubai courts have discretionary powers regarding guarantees. • In case guarantees are consider valid <i>sukuk</i> would be subordinated to in the indebtedness of the guarantors.
	Shares Pledge by co-obligor <i>Nahkeel</i> Holding 1.	<ul style="list-style-type: none"> • Devaluation in share prices, especially when the company becomes insolvent. 	<ul style="list-style-type: none"> • Risks about the co-obligors are mentioned in OC general. 	<ul style="list-style-type: none"> • If the <i>Nahkeel</i> company is become insolvent it share's value must decrease as well.
	Right to Subscribe Shares of <i>Nahkeel</i> Company (equity convertibility)	<ul style="list-style-type: none"> • Of little worth if the originator is in financial distress and markets already perceived that. 	<ul style="list-style-type: none"> • Risks about the co-obligors are mentioned in general. 	<ul style="list-style-type: none"> • Also, <i>Nahkeel</i> company is the developer of the land parcels (underlying <i>sukuk</i> assets).

East Cameron <i>Sukuk</i>			
Underlying Asset, Oil and Gas Hydrocarbons (Claim on Reserves through Registered Ownership of ORRI)	<ul style="list-style-type: none"> • Legal risk. • The underlying assets' value may deplete. • Bad event (e.g. Hurricane) risk. 	<ul style="list-style-type: none"> • Mortgage over licenses. • ORRI can be sold in secondary market. • Insurance against physical damage. 	<ul style="list-style-type: none"> • The originator asked the court to consider the primary transaction contract as 'secured loans' and not as 'true sale' of assets. • The US courts recognized the ownership of the <i>sukuk</i> holders in underlying assets.
Credit Enhancement through USD9.5 million Reserve Account	<ul style="list-style-type: none"> • In case of continuous losses reserves may not be sufficient 	<ul style="list-style-type: none"> • Reserve covers 6 months cash to pay <i>sukuk</i> return. 	<ul style="list-style-type: none"> • Reserve account could not provide required liquidity in the event of actual default.
Periodical Redemption of <i>Sukuk</i>	<ul style="list-style-type: none"> • Counterparty risk 	<ul style="list-style-type: none"> • Reserve account is created for this facility. 	
Claim over Oil and Gas Production and its Sale	<ul style="list-style-type: none"> • Commodity Price Risk • Offtake risk 	<ul style="list-style-type: none"> • <i>Sukuk</i> structure use conservative commodity price projections. • Commodity price hedges in place to mitigate downside price risk. • Back up offtake agreement with Merrill Lynch to hedge the offtake risk. 	