

SUKUK – AN EVOLUTION

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Much controversy has recently arisen in determining the rights held by the investors of various *sukuk* structures in the event of default. In enforcing rights under *sukuk*, the challenge of the courts will be to determine the rights of investors in each of “asset-based” vs. “asset-backed” structures. In particular, the courts will need to resolve the ongoing legal debate on the rights of *sukuk* holders under transactional documents that incorporate a structure akin to a conventional bond that may not be consistent with *Shari’ah* principles. Invariably, these challenges will result in the evolution of *sukuk* that should strengthen the confidence of investors in Islamic finance structures.

Islamic law, or *Shari’ah*, principles must be applied when structuring *Shari’ah*-compliant financial products, including *sukuk*. These principles include the avoidance of *riba* (interest), *gharar* (uncertainty or speculation in contracts), unjust enrichment and prohibited activities or investments (such as gambling and alcohol related investments). The majority of recent *sukuk* structures have been *sukuk ijara* where the originator seeking financing transfers certain of its assets to a special purpose vehicle (SPV) that is often incorporated as a Cayman Islands offshore company. SPVs become the issuers/trustees of *sukuk ijara*. The SPV typically is owned by a charitable or a purpose trust (such as a Cayman STAR trust). The SPV will issue *sukuk* or trust certificates to investors (the certificate holders) and invest the proceeds in assets. Trust arrangements typically are governed by English law. The SPV holds the assets in trust for the benefit of the *sukuk* holders pursuant to a declaration of trust, using the income from the assets to make payments to the *sukuk* holders. There is typically a requirement that on maturity of the *sukuk* or upon an event of default, the originator has a purchase obligation to repurchase the assets enabling the SPV to redeem the outstanding certificates and repay the *sukuk* holders. In this regard, the rights of *sukuk* holders in the event of default will vary depending on whether the *sukuk* structure is an “asset-based” or an “asset-backed” structure. This is important since we recognise that if the originator is in default of its obligations to make payments to the trustee for use of the assets under a *sukuk ijara*, he may not be able to honor the purchase undertaking. Consequently, the SPV may not be in a position to repay the principal of the *sukuk* on maturity or default.

In an asset-based *sukuk*, the originator typically transfers only the beneficial ownership or equitable interest in the assets to the SPV issuer; therefore, there is no true sale. To maintain *Shari’ah* compliance there must be a transfer of assets, however, since investors have no recourse to the assets, the transaction does not focus on asset risk, but rather on the credit worthiness of the sponsors of the *sukuk*. If the originator fails to pay any amount payable pursuant to the transaction documents, the certificate holders normally have no recourse against the originator or the issuer/trustee. These types of *sukuk* do not grant the certificate holders the right to cause the sale or other disposition of any of the trust assets on default. Typically, they can cause the trustee to call a meeting of the certificate holders and exercise their rights under the transaction documents including issuing notice to the originator pursuant to its undertaking to repurchase the assets on maturity or default of the *sukuk*. In structuring the *sukuk*, additional security could also be granted by the originator including share charges, mortgages, and guarantees provided by related parties in the originator group. Alternatively, upon a default, the parties may agree to restructure the debt and related obligations including an agreement to reduce the principal sums outstanding or granting standstills on exercising any rights under the transaction documents. Ultimately, asset-based *sukuk* are based upon the credit of the issuer, guarantor or other co-obligors.

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Alternatively, in an “asset-backed” *sukuk*, legal title to the underlying assets will typically pass by way of a true sale from the originator to the issuer SPV. On default by the borrower, *sukuk* holders are able to exercise certain rights of ownership and control over such assets. The elements of true sale, fundamental to a securitization, must be present in an “asset-backed” *sukuk*. An asset-backed *sukuk* is similar to a securitisation in that it is a non-recourse obligation and credit risk performance is determined solely by the underlying asset.

To date, many *sukuk* issuers have been established as Cayman exempted companies. As a result, issues may well arise under Cayman Islands law as to how investors in a *sukuk* will be treated and what recourse they may have in the event of a default or in the course of a restructuring. The difficulty in this regard stems from the fact that investors and the courts may well struggle to make legal sense of finance structures that are designed primarily to comply with *Shari’ah*. Difficulties are sure to arise when transactional document remedies are at odds with *Shari’ah* and investors take the position that they must comply with *Shari’ah*, irrespective of the contractual terms agreed between the parties. Moreover, the questions of governing law, jurisdiction and enforcement authority may be entangled. As mentioned above, although a *sukuk* issuer is often incorporated as a Cayman Islands exempted company, the transaction documents, including the declaration of trust, are typically governed by English law and the courts of England will normally have exclusive jurisdiction to settle disputes under such documents.

The English courts have already considered the application of English law to *Shari’ah*. In the case of *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd. (No. 1)*¹ the court held that, irrespective of the election of the parties to subject English law to *Shari’ah*, English law applied because *Shari’ah* was not a governing body of law but merely embodied the Islamic religious principles to which Shamil Bank held itself out as doing business. The court cited that the Rome Convention 1980, scheduled to the Contracts (Applicable Law) Act 1990, only contemplated and sanctioned the choice of the law of a country, not a religious principle. This case will invariably assist lawyers in ensuring that *Shari’ah* principles (such as *riba*, *gharar*, etc.) must be specifically incorporated in the transaction documents.

Furthermore, since the underlying *sukuk* assets may be located outside of the Cayman Islands or the United Kingdom (in the Middle East for example), conflict of laws issues arise. Some foreign courts, for example, tend to guard their jurisdiction over a matter jealously and view the retention of jurisdiction as a matter of public policy. As a result, clauses purporting to grant exclusive jurisdiction to a Cayman Islands or United Kingdom court may be deemed to be contrary to public policy and not upheld. Furthermore, where there are no bilateral treaties for reciprocal enforcement of judgments between the Cayman Islands or the United Kingdom and foreign jurisdictions where the assets are located, even if judgment is obtained in the Cayman Islands or the United Kingdom against the borrower, there may be additional hurdles to be overcome to have those judgments enforced in those foreign jurisdictions.

A great deal of attention focused the East Cameron Gas Co. asset-backed \$165.6 million, 13-year *sukuk* issued in 2006. A unique feature of this *sukuk* was that it was the first ever asset-backed securitisation. The East Cameron *sukuk* originated from Houston-based East Cameron Partners, whose reserves are located in the shallow waters off the shores of the State of Louisiana. In October 2008, East Cameron Gas. Co. filed for bankruptcy protection under Chapter 11 in the U.S. Bankruptcy Court for the Western District of Louisiana after its offshore wells failed to yield the expected returns, partly because of hurricane damage. The ultimate question facing the court in the East Cameron case is whether the *sukuk* holders actually own a portion of the company’s oil and gas royalties. The company argued that there had been no transfer of ownership of royalties into the Cayman SPV formed to issue the *sukuk*. They submitted that the transaction was really a loan secured on those royalties suggesting that *sukuk* holders would have to share the royalties with other creditors in the event of liquidation. At this stage in the East Cameron proceedings, the bankruptcy court

¹ *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd (No. 1)*, [2003] EWHC 2118 (Comm), [2003] 2 All ER (Comm) 849, [2003] All ER (D) 25 (Aug) (Morison J), upheld on appeal [2004] EWCA Civ 19, [2004] 2 All ER (Comm) 312, [2004] 4 All ER 1072, [2004] 1 WLR 1784, [2004] 2 Lloyd’s Rep 1, [2004] 08 LS Gaz R 29, (2004) Times, 3 February, [2004] All ER (D) 280 (Jan) (Potter LJ)

appears to have rejected East Cameron's secured loan argument when it said that "holders invested in the *sukuk* certificates in reliance on the characterisation of the transfer of the royalty interest as a true sale". If East Cameron can not advance additional arguments favourable in support of its case, the *sukuk* holders' rights will obviously be strengthened and they may be entitled to the stream of royalties.

According to a recent Moody's report², most *sukuk* structures to date have been asset-based (rather than asset-backed), which equates them to conventional unsecured bonds. Scholars have raised issues with market *sukuk* structures that guarantee the return of capital of the *sukuk* holders and provide for credit enhancement purchase guarantees by related companies.

It should be noted that the Accounting & Auditing Organization for Islamic Financial Institutions ("AAOIFI") has recently approved new guidelines that will require investors to become the legal, rather than nominal, owners of *sukuk* assets. *Shari'ah* boards are to review all relevant contracts/documentation related to the transaction to ensure comprehensive compliance with *Shari'ah* and oversee that implementation and operation complies with *Shari'ah*.

AAOIFI's new guidelines have resulted in heightened investor awareness of *sukuk* structures. These guidelines appear to conclude that the *sukuk* must reflect an equity-type instrument that cannot represent a debt owed to the holder. We believe that this will likely result in increased investor preference for "asset-backed" *sukuk*. However, although asset-backed *sukuk* are more consistent with the ideal of granting the investor an ownership share of the asset, asset-based *sukuk* may be more suitable where legal title to assets can not be transferred investors (e.g., where there are restrictions on foreign ownership of certain asset classes such as real property). In addition, asset-backed *sukuk* may not be adequate in circumstances where the enforceability against the assets may be challenging (e.g., sovereign-related or owned assets).

Where *sukuk* are asset-backed or are structured as securitisations of a stream of revenue, the status of the transfer or sale to the issuer SPV is critical. As with other securitisations, if structured legally as a true sale, the *sukuk* holders will be better positioned to recover their investment through execution on the assets. A true sale will also be fundamental in determining that the assets of the issuer will not be consolidated with the assets of the originator in the event of the bankruptcy of the latter.

The Cayman Islands has been a beneficiary of the emergence of *sukuk* as a burgeoning source of business finance. The continuing success of Islamic finance will depend on structuring Islamic debt financing that strikes a balance between creditor and borrower rights while maintaining *Shari'ah* compliance. Invariably, the confidence of investors will increase with the evolution of *sukuk* in meeting these challenges.

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² Khalid Howladar, "The Future of Sukuk: Substance over Form: Understanding Islamic securitization, Asset-Backed and AAOIFI principles", Moody's Investor Services, 6 May 2009.

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Notes to Editors

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