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Regulatory and financial implications of Sukuk's legal challenges for sustainable Sukuk development in Islamic capital market

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This research paper does not represent the views of Maybank Syariah Indonesia towards the subject matter of this research.

Abstract - This discursive research paper is appraising issues pertaining to legal compatibility of sukuk, which is at the heart of Islamic finance. Sukuk serve a powerful tool for Islamic financial institutions to mobilise funds from the Islamic capital market, and to extend financing through Islamic capital market operations. In Shariah values, sukuk has to represent the ownership of either underlying assets or usufructs or services of the business entity based on asset securitisation concepts, where the return is justified by risk taking coupled with risk mitigation principles. Nevertheless, the present state of sukuk practises is detached from ideal values because, to some extent, a western legal framework is not supportive enough for sukuk operations in the Islamic capital market to comply with Shariah values. As a result, the structure of sukuk is heavily influenced by conventional bonds practises governed by the western legal framework. Due to that fact, in this research, sukuk structures are scrutinised to examine legal impediments inherent in sukuk contracts. This research portrays that the western legal system is not supportive enough for sukuk to protect the rights of sukuk holders in the event of sukuk defaults. Regulatory and financial implications are suggested as anticipations to any future sukuk defaults. The objective of this research paper is to sustain sukuk development in the Islamic capital market, where Shariah and western legal frameworks can be in harmony to govern sukuk operations.

Keywords: *sukuk*, Islamic capital market, legal challenges, *Sharia*, western legal framework

1. Introduction

Research background

The development of the Islamic capital market ('ICM') is crucial for the sustainable development of Islamic finance. ICM has a long-term objective to mobilise and allocate resources in an effective and efficient manner. This long-term objective can be achieved through real sector development financing. In another dimension, ICM is the avenue for liquidity management of the Islamic financial industry through Islamic money market operations. Liquidity management is a pivotal aspect for ICM in the short run because it is one of parameters for ensuring the long-run survival of Islamic financial institutions ('IFIs') in the financial market arena. Thus, the development of innovative, *Shariah* compliant ICM products is urgently needed for realising the existence of vibrant and efficient ICM. In this regard, *sukuk*, which is a term describing Islamic debt instruments in ICM, plays an important role for smoothing liquidity and resource mobilisation in ICM. Besides, *sukuk* are potential financing instruments for contributing to a country's economic growth through real sector development initiatives. *Sukuk* plural; singular *sak* are defined by the Accounting and Auditing Organisation for Islamic Financial Institutions ('AAOIFI') 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" (AAOIFI 2008, p. 307).

Sukuk are indeed promising as a *Shariah* compliant financing instrument. Total *sukuk* issuance amounts to US$ 236.75 billion as per June 2011 with Malaysia still champions the *sukuk* issuance[1]. This big number of *sukuk* issuance can be supported by the fact that western countries such as the United Kingdom and United States have jumped on the bandwagon for issuing *sukuk* as indicated by the UK's consideration of *sukuk* for government financing, and the issuance of *sukuk* by General Electric and East Cameron Gas in the US.

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Based on Islamic Finance Information Services ('IIFS') statistic database of *sukuk*, *sukuk* issuance experienced an impressive growth from 2005 to 2006, increasing by 134% with the total *sukuk* issuance amounting US$ 26 million. *Sukuk* issuance peaked at US$46 million in 2007 but substantially declined by 64% to US$17 million in 2008. There are several factors that can explain the substantial decline of *sukuk* issuance, including global financial crisis, dry liquidity, widening credit spreads, and investor's wait--and--see attitude (Damak *et al.*, 2009). Although *sukuk* were badly hit in 2008, they are indeed a promising ICM's instrument (IFIS, 2009). One reflection of this is the *sukuk* rebound throughout 2009 brought mainly by sovereign and quasi-sovereign *sukuk* issuances. These included the US$1.4 billion *sukuk* issuance of Terengganu Investment Authority in Malaysia, US$487.2 million retail *sukuk* issuance of government of Indonesia, plus *sukuk* from the Dubai government, the Islamic Development Bank (IDB), and so forth (Zawya *Sukuk* Intelligence, 2010).

Sukuk declined by 15% in 2010, which indicates that there was low confidence in *sukuk* market. This can be explained that there have been 21 *sukuk* defaults recently in Islamic capital market space as reported by Khnifer (2010), with Nakheel *sukuk* and East Cameron Gas *sukuk* are the most controversial one. These *sukuk* defaults pose severe legal risks of *sukuk* inherent in the *sukuk* contract. Specifically, the risk emanating from *sukuk* contract's enforceability whereby whether or not the *sukuk* can be enforced in order to protect the rights of *sukuk* holders in the event of *sukuk* defaults. As a matter of fact, legal conflicts are persistently occurring in the court due to *sukuk* defaults cases with the adverse impacts on legal rights, and even financial rights of the *sukuk* holders. Therefore, in this article, the issues surrounding enforceability of *sukuk* contract are discussed as an attempt to give possible legal and financial mitigations as solutions to the problem of *sukuk*'s legal challenges in Islamic capital market. At the end, it is expected that legal and financial rights of the *sukuk* holders can be fully protected.

Research objectives & questions

This research has four main objectives, which are as follows:

1. Appraising legal issues at stake in present *sukuk* structures,
2. As precautionary measures for Islamic finance key players regarding the importance of legal protection for *sukuk* structuring,
3. Presenting regulatory and financial implications for the ideal *sukuk* development in the ICM given the legal issues of present state of *sukuk* structures, and
4. As a way to obtain holistic approaches from academia and practitioners point of views to tackle unresolved legal challenges of *sukuk*.

In order to achieve the stated research objectives, there are three important questions that need to be answered in this research, which are as follows:

1. What is the present state of *sukuk* structures?
2. What are the salient legal issues that come to bear on *sukuk* structures?
3. What are the regulatory and financial implications for ideal future *sukuk* development in the ICM?

Significance and scope of research

There have not been much discussions going on to appraise legal aspects of *sukuk* with the fact that there are *sukuk* legal default cases in ICM. So far, the legal aspect of *sukuk*, which are heavily discussed in literatures and conferences, only pertains to *Shariah* compatibility of *sukuk* structures, but not taking consideration into *sukuk*'s legal issues. Amongst others, the research that discusses *Shariah* compatibility of *sukuk* structure are Rosly and Sanusi (1999) with critical evaluation of the application of *bay al-inah* and *bay al-dayn* contracts for *sukuk* issuance in Malaysia, Al-Amine (2001) with critics for the interest rate benchmarking and guarantee features in *sukuk* operation, and Usmani (2008) with critics over current *sukuk* mechanism on asset ownership, guarantee, and *sukuk's* pricing benchmarks. For the recent research, Dusuki & Mokhtar (2010) criticise asset ownership in current *sukuk* mechanisms, and Al-Jarhi & Abozaid (2010) discuss *Shariah* issues of current *sukuk* structure in a paper presented this year to the OIC *fiqh* academy conference.

However, in light of *sukuk* legal defaults occurring in ICM, so far there has been only one research paper discussed by Salah (2010) in reference to Nakheel's *sukuk* defaults. But, still more research paper is needed to find out solutions for *sukuk's* legal challenges since legal aspect is one of important ingredients in *sukuk* issuance packaging that makes *sukuk* attractive to the investors. Hence, this research paper will contribute by scrutinising legal problems inherent in current *sukuk* structures with the expectation that there will be significant efforts in improving the status quo of western legal systems to cater the needs of *sukuk* operations in ICM.

The scope of this research is limited to theoretical research with secondary source data from relevant literatures or journals. Field work research to collect primary data, such as interviews, or questionnaires, cannot be conducted for this research due to time and resources constraints.

Research outline

This research study is organised in a following manner. In the next section, the present state of *sukuk* will be scrutinised in light of recent debates and innovation of current *sukuk* structure. Section 3 is appraisal of the legal issues of *sukuk*. After appraising legal problems of *sukuk*, chapter 4 discusses regulatory and financial implications in the ICM arising from those legal issues. Finally, chapter 5 ends up this research paper with a conclusion.

2. *Sukuk* practises in Islamic capital market

Sukuk structures have evolved from their basic structures through attempts to innovate on *sukuk* so as to gain popularity in financial markets. Nevertheless, not all *sukuk* innovation is positive, as signified by the failure of *sukuk* to become a *Shariah* compliant financing instrument and alternative to conventional bonds after being tested by the Islamic financial industry.

Types of sukuk

Since *sukuk* can be structured in numerous ways, proper classification of *sukuk* is crucially important for issuers to determine the aim of *sukuk* structures, as well as the nature of *sukuk* structures. AAOIFI (2008) has classified

sukuk investments in its *Shariah* standards, which are *ijarah* certificates (leased assets), *ijarah* certificates (ownership of usufructs of existing assets, described future assets, specified party, and described future services), *salam* (purchasing goods to be delivered in the future) certificates, *istisna'* (manufacturing/production of goods) certificates, *murabaha* (purchasing goods) certificates, *musharakah* certificates (participation, *mudharaba*, and investment agency *sukuk*), *muzara'a* (sharecropping) certificates, *musaqa* (irrigation) certificates, and *mugharasa* (agricultural) certificates. *Ijarah* and *musharakah sukuk* are predominant *sukuk* structures prevalent in the Islamic capital market. Other than the *sukuk* classified by AAOIFI, Tariq & Dar (2007) have a list of the modified types of *sukuk*, which is as follows:

i. Hybrid/pooled certificates

These are certificates based on an underlying pool of assets, including *istisna'*, *murabahah* receivables, and *ijarah* with the condition that at least 51 percent of the pool comprises *ijarah* assets. The return on these certificates can only be a pre-determined fixed return.

ii. Variable rate redeemable certificate

This type of *sukuk* can be called alternative *sukuk* due to its seniority to issuer's equity, their redeeming nature and their relative stable rate as compared to dividend payouts. The return on these *sukuk* is benchmarked to market references, such as LIBOR.

iii. Fixed-rate-zero-coupon certificate

These certificates are non-tradable certificates based on an underlying pool of assets, primarily *istisna'* or *salam* that would create debt obligations.

Sukuk versus conventional bonds

It is imperative to differentiate between the basic tenets of bond and *sukuk* operations. Bonds are financial obligations, in form of certificates, issued by borrowers to creditors. Bonds have guarantee features in which creditors guarantee capital repayment with capital charge to the borrowers. The prime objective of bonds is to gear up the issuer's leverage through a loan relationship. That loan relationship implies a contract with the characteristic of earning money on money, which is the practise known as *riba* and prohibited in Islam (Adam & Thomas, 2004). Bonds are very liquid in nature, as they can be easily traded in secondary markets in case the bondholders need liquidity. Bond's risks are highly concentrated on credit risk of the issuer.

In contrast, *sukuk* represents asset ownership passed from the issuer to *sukuk* holders in form of *Shariah* compliant contracts such as lease, partnership, or sale contract, which originate from trade and business activities. The return can be either derived from profits of real underlying assets attached to *sukuk* or from sales, lease or partnership of business ventures, which characterises *sukuk* as an asset-backed financing instrument. It is important to note that *sukuk* are not always debt instruments, but sometimes equity instruments, depending on how they are structured. The risks of *sukuk* are broader than conventional fixed income instruments in that they involve not only credit risk, but also market risk, asset-quality risk, regulatory risk, and so forth (Zaidi, 2009).

Under current practises, *sukuk* are aimed at having structure similar to conventional bonds in spite of different characteristics and modus operandi between *sukuk* and conventional bonds. According to Miller *et al* (2007), *su*kuk ensure returns similar to conventional bonds, while the difference is that the return of *sukuk* is generated from the underlying real asset ownership, not interest payments obligation as found in conventional bonds. This is similar to Wilson's (2008) argument that replicating *sukuk* to be identical to conventional bonds has been attempted by financiers because the financiers' aim is simplifying risk assessment for this new asset class of investments.

In the Malaysian experience, asset-backed *sukuk* have been structured in such a way that the receivables attached in the *sukuk*'s underlying assets can be traded in the market, as with the Time Engineering *musharakah* asset-backed *sukuk*. In that case, *sukuk* is structured to acquire the receivables generated by Time System Integrator (Mokhtar & Thomas, 2009). Furthermore, the rating proxies' treatment of *sukuk* is exactly the same as conventional bonds as shown by the research conducted by Siswantoro (2006). He finds that revenue income of the coupon payments stream is attached to the whole company (obligor), not the specific project undertaken by the company. Hence, those facts indicate that the current structure of *sukuk* show indifference of economic outcomes of conventional bonds and adjusts well to modern western capital market technique, which characterises asset-based *sukuk*.

Asset backed sukuk versus asset based sukuk

According to IFSB guidelines (2005) No. 2, *sukuk* are ideally categorised as asset-based and equity-based instruments whereby the former offers fair and predictable return, such as in the case of *salam*, *istisna'*, and *ijarah* whilst the latter the return is derived from profit-loss sharing of joint venture business, which offers unpredictable return, based on *musharakah* or *mudharabah* contracts. Since there are deviations in the actual implementations of *sukuk* from ideal theoretical ground of *sukuk*, there has been a concern to categorise *sukuk* in order to differentiate genuine and non-genuine ones, particularly risk factors and sale execution. In this regard, the guidelines of *IFSB 7-Capital Adequacy Requirement for sukuk, Securitisations, and Real Estate Investments* (2009) distinguish three types of *sukuk* structures: Asset-Backed *sukuk* ('ABS') and two non-ABS structures, which are pay-through and pass-through structures.

According to these particular guidelines, ABS are "structures that meet the requirement for being an asset-backed structure as assessed by a recognised external credit assessment institution (i.e. rating bodies)" (p.3). Based on this guideline, there are two factors that constitute ABS. Firstly, in the case of any impairment of the *sukuk*'s assets, the *sukuk* holders have to face the loss. Secondly, the risk factor of ABS is the underlying assets of *sukuk*. Therefore, *sukuk* holders derive the risk and return from the cash flows of the *sukuk*'s underlying asset as well as have recourse to the *sukuk* asset, not the issuer, in case of default of *sukuk* issuer. True sale execution is another dimension of ABS in which there is a real transfer of assets from the originators to *sukuk* holders with the effect of releasing assets from the issuer's balance sheet to investors (Ahmed, 2010). Therefore, ABS issuance must be backed by real assets that

represent the *sukuk*'s ownership as well as risks attached to the assets.

In contrast, with asset-based *sukuk*, there is no true sale transaction taking place, rather one sees just transfer of financial rights to the asset and the income is derived from the financial rights to obligations attached to the debt (Aziz & Gintzburger, 2010, p.276). True sale transaction is absent since the *sukuk* holders have recourse to the originator instead of the underlying assets in the event of defaults. This is based on pay-through and pass-through as defined in IFSB-7 (2009) guidelines, in which the former constitutes recourse to the originator via purchase undertaking whilst the latter constitutes recourse to the issuer via guarantee. Therefore, the risk and return of asset-based *sukuk* are derived from the obligor instead of the *sukuk*'s underlying assets, so that in case of defaults, investors have recourse to the obligor and secured creditors cannot recourse the asset. The risks are measured solely on the issuer or obligor's creditworthiness to pay back the capital. Thus, it is not surprising that investors are mainly focused on sovereign/corporate credit quality and less concerned on the actual underlying asset performance when they buy sovereign *sukuk* (Hales, 2005). In this regard, *sukuk* holders are guaranteed to get the capital back in the event of bankruptcy. Furthermore, in asset-based *sukuk*, the structures are merely fulfilling the form of a contract with much more complexity, which ultimately leads to Islamic equivalent of unsecured conventional bond (Howladar, 2009). Hence, *sukuk* holders would only be able to dispose of the assets to the lessee and be treated as unsecured creditors or ranked *pari passu* with other unsecured creditors (Haneef, 2009).

Islamic securitisation vis-à-vis asset backed sukuk

In a conventional framework, asset securitisation refers to "the process and the result of issuing certificates of ownership as a pledge against cash flow streams of diversified pool of assets (assets portfolio) to investors" (Jobst, 2007, p.14). This asset securitisation proposes an alternative for capital market-based refinancing mechanism to diversify external sources of asset funding instead of intermediated debt finance based with a special emphasis on the risk assessment of securitised assets (Jobst, 2006). True sale, bankruptcy remoteness, and enforceability of assets are essential prerequisites for asset securitisation. Effective risk management and capital enhancement are great advantages of asset securitisation, since there are lower costs and risks emanating from asset securitisation than contractual loan relationships (Shaenker & Colletta, 1991; Dvorak, 2002). Asset securitisation is highly exposed towards interest rate risks, since receivables associated to securitised assets are valued by interest rate discounting. Mortgage Backed Securities ('MBS') is one of examples of asset backed security, in which a pool of receivables of home buyers is securitised through intermediary institutions, such as Fannie Mae or Freddy Mac in US, and Cagamas in Malaysia. The risks of asset securitisation can be commoditised in a way that the risks can be detached from the assets to trade the risks in the market through irresponsible derivatives instruments, such as Credit Default Swaps ('CDS') instrument. CDS transfers the risk of default from the fixed income security holder to the swap seller.

To a certain extent, conventional asset securitisation is in line with Islamic securitisation. Both of these types of securitisation have similar prerequisites, processes, and advantages. Nevertheless, due to *Shariah* restrictions, Islamic securitisation has distinctive features that distinguish it from asset securitisation. Following the spirit of *Shariah*, Islamic securitisation must be free from three prohibited practises, which are *riba*, *gharar*, and *maysir*. Thus, anything leading to these practises is not tolerated such as debt and financial assets trading (*bai al-dayn*), *haram* activities, interest bearing collateral, and so forth. Furthermore, Islamic securitisation must involve the funding or the production of real assets rather than financial securities, which causes irresponsible leverage as well as speculation, through derivatives lending (Wilson, 2004). Jobst (2007) points out four important conditions for Islamic securitisation to take, which are as follows:

1. Investor's asset ownership conferment through direct business participation,
2. Real purpose for securitisation through identification of productive securitised assets,
3. Unconditional and unsecured payment obligation (non-guarantee promissory notes),
4. Risk-pooling spirit whereby the risks and rewards are shared among market participants in the Islamic financial market

Thus, based on those four conditions, Islamic securitisation has the risk-reward sharing spirit and places a paramount importance on the real economy through undertaking real project activities.

Islamic securitisation is in line with asset-backed *sukuk* structures whereby the true sale transaction is taking place between the *sukuk* holders and the *sukuk* issuer. Besides, the return of securitised assets is derived from real activities, and the *sukuk* holders can legally enforce the securitised assets in the event of defaults. But, under current practises the *sukuk* structures, as asset-based *sukuk* is dominant structures in the ICM, unfortunately there is no such an Islamic securitisation in *sukuk* structuring. Thus, this poses major legal problems in the event of *sukuk*'s legal defaults where the *sukuk* holders cannot recourse to the securitised assets.

3. Legal challenges of *Sukuk* development in Islamic capital market

Legal infrastructure of Sukuk in various jurisdictions

Sukuk legal development is varied across countries operating Islamic finance, but the status of development is a major determinant of the success of *sukuk*. From an Indonesian perspective, the legal basis for *sukuk* development is not sufficient, because the legal basis for Islamic financial development as a whole still relies on conventional banking laws and regulations. With regard to *sukuk* development, the existence of the asset securitisation law in Indonesia is not in line with *Shariah* dictates, wherein the draft of the asset securitisation law clearly states that securitisation can only be structured through debt (Djojosugito, 2007). Meanwhile, in Malaysia, which is the most active Islamic capital market, has robust regulatory standards as framed by their Securities Commission ('SC').

From a British legal perspective, *sukuk* instruments apparently fall under the definition of a Collective Investment Scheme ('CIS') as pursuant to the Financial Services and Markets Act (FSMA 2000). If *sukuk* were treated in the same way as CIS, *sukuk* issuers would be subject to a wider range of controls, and may need to be authorised. Such authorisation would entail limits on the range of assets eligible for investments, gearing and marketing purposes. Hence, this would arguably put *sukuk* issuers at a disadvantage compared to issuers of conventional debt securities.

The legal perspective of the US, however, is very helpful for facilitating *sukuk* issuance by upholding its true value as project financing for real activities. *Sukuk* are regulated in such a way that *sukuk* are structured through U.S traditional private-placement.[2] The Securities Act, Section 4 (2) exempts "transactions by an issuer not involving any public offering," which indicates that the investors in the private placement market are not typical investors who need the protection of the registration provisions of the Securities Act, since the investors have the ability to make an informed decision and bear the economic risk of the specified investment (Khaleq & Young, 2007). This Securities Act is supported by Rule 144 A in which full due-diligence over the issuer must be conducted and receive disclosure on the prospectus from the US Securities Council within US disclosure standards and Management's Discussion and Analysis, Financial Condition Results of Operation ('MD&A').

Furthermore, Regulation S and Regulation D are interrelated to facilitate international secured financing through private placement in US (Shenker & Colletta, 1991). This can be seen in the *sukuk* issued by East Cameron Gas in the US through private placement, whereby there was a proper due-diligence conducted over the project – oil drilling – along with risk management mechanisms for project's anticipated risks. Hence, US federal securities law provides an impetus for *sukuk* development towards the true value, even though US federal securities law treats *sukuk* in similar fashion with conventional bonds.

Enforceability of Sukuk contracts

Dispute between Western law and *Shariah*

Before assessing issues surrounding the enforceability of *sukuk*, it is imperative to portray the kind of conflicts happening in the sphere of Islamic finance due to dual law system that governs transactions.

English common law and civil law each present distinctive problems when they collide with *Shariah*. The problem in using *Shariah* finance under common law jurisdiction is the conflict that emerges between *Shariah* law and common law; the national law/common law always prevails over *Shariah* law when there are disputes. As a consequence, the contract is interpreted solely based on what is written in the contract in respect to *Shariah* regulations. This can be seen in the case of Shamil Islamic Bank of Bahrain VS Pharmaceutical Company, as explained by Potter (2004). In that case, the defendant was not able to make payment for his financing to the bank, and the court judged based on English law instead of Islamic law. The defendants argued that the contract was so worded with *Shariah* principles as not to clash with English law. However, the judge ruled that there cannot be two separate law systems governing a contract, and that the national system is the valid law to govern the contract based on Roman conventions which have force in the British law system. The conflict between common law and *Shariah* leads to idiosyncrasies, such as that verdict which was decided based on sale contract law, while the substance of the contract was actually a conventional debt contract. Therefore, confusion emerged as to the legal basis of the verdict.

On the side of civil law, one sees a lack of predictability, transparency, and consistency. Full codification of law, which is needed for predictability, is not implemented in the countries under civil law regimes. The problems posed by civil law can be witnessed in the recent *Nakheel Sukuk* case, in which there was confusion over which law should be adopted when *Nakheel* declared itself in a state of default. Because the *Nakheel* offering circular was governed with English common law while the *sukuk* transactions took place in a civil law jurisdiction, there was a conflict when the investors sued *Nakheel* for capital repayment in Dubai's civil court. The investors could sue in English courts as well as in the United Arab Emirates, the seven-member federation that includes Dubai. Nevertheless, even if they win and the court orders seizure of the assets, the foreign law ownership as well as *sukuk* agreement cast doubts over whether the law is enforceable in the UAE (Kasolowsky & Abocar, December 2009). Consequently, the investors' rights are restricted from what was promised in the offering circular. Therefore, this indicates that civil law is not yet predictable and flexible enough to be enforced in governing jurisdiction.

With respect to *sukuk* structures in jurisdictions where *Shariah* concepts are followed, this is, to a certain degree, more straightforward from a legal perspective, although the process does compose more layers since it requires compliance with *Shariah* as well as local law (Khaleq & Richardson, 2007). Realising that in most of *sukuk* issuances that there are cross-border transactions, there is a problem with which law would be enforced. This enforceability issue causes legal impediments due to the inability to obtain satisfactory legal opinions, which emanate from the sales of assets between the originator and investors through the SPV, and also due to various bankruptcy law matters (McMillen, 2007). Hence, there is a confusion about which law can be enforced and to what extent that law can be enforced in *sukuk* issuance.

True sale execution

Executing a true sale is a crucial element in *sukuk* operation, as it constitutes a real transfer of ownership from the originator to the *sukuk* holders via the SPV. Nevertheless, some *sukuk* issuances do not execute a true sale, as with asset-based *sukuk* issuance, due to the absence of property law and bankruptcy law under civil law regimes. This again was reflected in the *Nakheel Sukuk* case wherein leasehold interests were not viewed as real rights or property rights under the relevant laws of the UAE as applicable in the Emirate of Dubai (Salah, 2010, p.10). Instead, the rights were viewed as unregistered personal contractual rights binding the parties as opposed to rights to the land in question (Silkenet *et al.,* 2009). Similarly, in Indonesia, the concept of beneficiary rights has not been recognised

for sovereign *sukuk* issuance, as state assets needed for government operational activities cannot be transferred to third parties and must be subject to the approval of a government body (Guritno & Oktavinanda, August, 2008). This indicates that the civil law indeed impedes the undertaking of true sales that would be enforceable in *sukuk* issuance.

Bankruptcy

Bankruptcy law is crucial for facilitating true sale transactions in which investors are protected and will receive payment on asset-backed securities, even in cases of the originator's bankruptcy (Schwarchz, 1995, p.151). So far in some countries under civil law regime, especially Middle East region, there has not yet emerged a proper bankruptcy law to protect *sukuk* holders from bankruptcy on the part of the *sukuk* originator. Taking example of the bankruptcy law of UAE, bankruptcy governed in Commercial Companies Law, Federal Law No.8 of 1994 does not have a specific definition of bankruptcy. The Law only shows the situation where a 'Trader' will be regarded as a bankrupt in the event of insolvency, as governed in Article 645 of the Law. In pursuant to Article 4 of the Law a trader is defined as being an individual or company that carries out commercial activities. The Law unfortunately does not have specific recognition of the term that describes the situation where shareholders have limited liability, as in the case of common law jurisdiction (Gulf News Report, January 2009). On the side of common law jurisdiction and some countries under civil law jurisdiction such as Indonesia and Netherlands, the bankruptcy law is codified in the specific law. Besides, the law has clearer administrative procedures to deal with bankruptcy entity.

Due to lack of codification of bankruptcy law under civil law regime in Middle East region, the transaction is not a true sale, but a secured disguised loan in a true sale. This originates from the suspicious type of financing occurring persistently between the originator and the trustee. Thus, in case of bankruptcy, the court follows the legal precedent that the financing is a transfer of collateral because of the presence of recourse to the originator (Lupica, 1998). Nakheel *sukuk* default is precisely the example of legal uncertainties in UAE where the *sukuk* holders' rights to claw back the assets are not protected when Nakheel declared its bankruptcy. Due to that fact, this is a warning for asset-based *sukuk* issuance in which the *sukuk* are issued in reflection of a secured collateralised loan. Hence, this means that the enforceability of the law in the court will be exactly the same between *sukuk* and secured collateralised loan.

SPV

An SPV is a bankruptcy remote firm, which is independent from the obligor. The SPV is established based on the trust law in which the *sukuk*'s originator as the transferor transfers the assets to the *sukuk* holders as beneficiaries via the SPV as a trustee with a good faith. Therefore, trust law plays an important role in governing the SPV's establishment. Trust law has been well incorporated into both common and civil law jurisdictions; Dubai and Bahrain have already incorporated trust law in their legal systems. This trust law recognises the equity for remedies and rights in which beneficiaries are provided with equitable treatment remedies against unfaithful acts. Within common law treatment, the legal rights of the trustee are bounded by the legal rights of beneficiaries. In contrast, under civil law treatment, the beneficiaries have no rights or control towards the assets managed by trustee (Hansmann & Mattei, 1998). Hence, civil law treatment entails a problem for *sukuk* issuance that originates from civil law jurisdiction countries. In those cases, in the event of default, the *sukuk* holders do not have recourse to the asset due to civil law restrictions, and therefore those *sukuk* are characterised as asset-based *sukuk*.

In *sukuk* issuance, usually the issuers do a cross-border securitisation in which the SPV is located outside the originator's country due to the absence of specific legislation on certain issues (e.g. tax law, securitisation law, etc.). This can be seen in the *Tamweel sukuk* issuance in which the SPV was located in the Cayman Islands – far from Dubai, the originator's country. However, this typical offshore SPV leads to a problem whereby there is no uniform law, insofar as the off-shore jurisdiction is very lax on specific law enforcement with the consequence of a fragmented legal governing process in order to accommodate the parties' needs (Frankell, 1998). Indeed, there is a significant legal unpredictability governing *sukuk* transactions if they are issued through an offshore SPV. Furthermore, even if legal judgments are obtained in the Cayman Islands or the United Kingdom, there can be additional impediments arising from those foreign judgements' enforceability in those foreign jurisdictions where there is an absence of bilateral treaties for reciprocal enforcement of judgments (Ryan & Elmalki, January, 2010). Therefore, this issue leads to weakness on the part of the local court or legislation as well as legal confusion with respect to certain laws' enforceability in case the issuer defaults.

4. Regulatory and financial implications of *Sukuk*'s legal challenges

Regulatory implications

Role of rating agency

It is an inevitable fact that when investors purchase *sukuk*, they are interested in the risk related to the issuer instead of the underlying assets or project undertaken due to prevalence of asset-based *sukuk*. This is happening because the methodology used by rating agencies for *sukuk* rating is similar with conventional bond ratings, since no independent *sukuk* rating agency has yet formed. In this regard, since the very essence of *sukuk* is project financing backed by real assets, rating agencies should shift the paradigm of *sukuk* rating whereby the risk's proxy is based on the feasibility and prudential evaluation of the assets instead of the originator's risks. Furthermore, compliance with *Shariah* as well as legal uncertainties are important proxies to be incorporated in *sukuk* rating methodology, particularly regarding how the *sukuk* issuance can protect the investors and also resolve the legal conflicts in the event of bankruptcy. It is important also for rating agencies to give assurances to investors through information notification regarding the underlying asset's quality, so that they can make informed decisions (Zaidi, 2009).

Standardisation of Sukuk

Since there are legal uncertainties and conflicts arising from *sukuk* transactions as well as *Shariah* divergences, *sukuk*

need to be standardised and streamlined in terms of legal documentation and *Shariah* standards. AAOIFI *Shariah* standards for *sukuk* have been set properly, but the problem is that the standards are not binding among key players in the Islamic financial industry. Therefore, enforcement of the standards is critical at the moment for having *Shariah* compliant *sukuk* in the market. Besides, there should be uniformity of law for offshore jurisdiction as well as the methods to resolve the conflict of legal systems that applies to all *sukuk* issuance across all jurisdictions. The goal would be that, in a case of default, the case could be resolved in pursuant to a standardised legal documentation. Hence, there would be predictability, certainties and *Shariah* convergence through *sukuk* standardisation.

Financial implications

Sukuk feasibility analysis

Since one must undertake a true sale undertaking as well as have full ownership of the assets, usufructs, or projects in a *sukuk* transaction, it is important that *sukuk* are structured in a manner backed by an identified of portfolio of high quality assets, which is in line with asset securitisation, and prospective projects (Dusuki & Mokhtar, 2010). Hence, the value of the identified portfolio of assets and project must represent the market value of the *sukuk* issuance in order to ensure that there are genuine interests over the portfolio of assets or a project. In this regard, at the initial *sukuk* structuring stage, it is vital for the *sukuk*'s lead arrangers, which are Islamic investment banks in most cases of *sukuk* issuance, to exercise careful due diligence over identified assets through scenario analysis (both best and worst scenarios), as well as stress-testing analysis where the asset performances in different financial situations over the *sukuk*'s tenure are evaluated. In addition, an on-site visit is required to look over the identified portfolio of assets and whether or not the assets are in existence and productive enough to generate positive cash flows. If, after thorough due diligence analysis over asset and an on-site visit, the identified of portfolio of assets are deemed to be high quality and productive assets, then the *sukuk* issuance can proceed. Consequently, positive cash flows are ensured for the investors along with the risks arising from a portfolio of underlying assets.

With regard to project identification, *sukuk* must be structured in a way that *sukuk* structures provide linkage of the identified project's risks to the *sukuk* holders. This can be seen in *Tamweel Sukuk* where there were risks borne by the *sukuk* holders over the property development project since the periodic rental payment is from a third party lessee. There must be a proper feasibility analysis over the investment project's plan, wherein the location of the project is identified. A scale model of project is also needed for conducting feasibility analysis. Realising that there are different sectors of industry, such as oil and gas, property development, pharmaceuticals, and so forth, industry analysis over the investment project plan is also required to assess the position of the sector in comparison with other sectors as well as the industry's risk assessment within current and projected economic conditions. If the project is deemed to have bright prospects in which the project would generate positive returns in the future, then the investment project should be undertaken. This project *sukuk* financing is actually a long-term investment asset class. Therefore, the investors are no longer interested in the issuers' risks rather than the asset's risks, with the consequence of no guarantee and the investors easily have recourse over the assets in the event of default since the investors have legal ownership. There must be a proper and simple disclosure of the risk assessment and the nature of assets and project risk profile to the investors at the first *sukuk* offering, so that investors can make an informed investment decision based on the underlying risks in the *sukuk* issuance.

This actually has a good implication for looking at alternatives for *sukuk* pricing, as *sukuk* are currently priced at LIBOR. Due to the fact that the *sukuk* holders bear the risks of the identified portfolio of assets and the projects, the periodic payment of *sukuk* to the *sukuk* holders is positive cash flow derived from the underlying assets in proportion with the number of *sukuk* holders. So, for *sukuk ijarah*, the cash flows are derived from rental payment of underlying assets leased to the third party lessee. For the project financing, the payment is from rental proceeds once the project is developed in a case of *sukuk ijarah mausuf bi al-zimmah*. Hence, the ideal pricing for a given *sukuk* is derived from the real underlying assets or projects rather than current interest rates, and this pricing mechanism is actually in line with Islamic economic objectives.

Shariah compliant financial innovations of Sukuk

Possible *Shariah* compliant financial innovations can be suggested in order to give the financial protection to the *sukuk* holders from the legal uncertainties. As suggested by Khnifer (2010), there are three ways for suggesting so. Firstly, *sukuk* maturity extension whereby the *sukuk* contract is extended until the issuer's legal dispute is resolved by imposing legal compensations in *sukuk* documentation, which can be reflected in higher rental payments to the *sukuk* holders in the case of *ijarah sukuk*, and higher agreed profit sharing ratio in the case of *musharakah sukuk*. Secondly, *sukuk* refinancing in which *sukuk* are refinanced with another *sukuk*, which have lower financing costs, in order to settle the *sukuk* holders' residual payments. These two suggestions can be done only if the *sukuk* position had a strong financial position. Lastly, convertible equity *sukuk* in which *sukuk*'s assets values are converted into the issuer's equity value based on pre-determined formula in the event of defaults. These innovations are expected to give assurances to the *sukuk* holders before the purchase undertaking is executed, and hence their financial rights are fully protected from legal uncertainties.

5. Conclusion

In this discursive research paper, current *sukuk* practises and legal compatibility issues of *sukuk* have been extensively discussed in the wake of *sukuk* defaults occurring in Islamic financing space. Regulatory treatments and also practical *Shariah* compliant financing innovations have been suggested to mitigate future *sukuk* defaults.

With the current structure of *sukuk,* the problems still revolve around form over substance of the *sukuk* structures whereby asset based *sukuk* structures are prevalent in the Islamic capital market. In line with Islamic securitisation concepts, asset-based *sukuk* do not fall under Islamic securitisation concepts because of the absence of a true sale in the operation, whilst asset-backed *sukuk* falls under

Islamic securitisation due to the presence of a true sale. The absence of true sales in current *sukuk* operations poses legal uncertainties to all *sukuk* parties, especially the *sukuk* holders. Based on an analysis of the legal issues discussed in this research, the legal infrastructure under various jurisdictions is not supportive enough for *sukuk* operations taking place. Each legal system entails different problems in governing *sukuk* operations as a true *Shariah* compliant financing. Due to that reason, at the bottom line, current *sukuk* structure fails to protect the legal rights of *sukuk* holders to the securitised assets. For the way forward, closer engagement between key players, regulators, Shariah advisers, and scholars in the industry are urgently needed to discuss and improve the feasibility of these regulatory and financial implications as discussed in this research paper.

This research paper only covers salient features of legal issues facing *sukuk* development. There are still rooms for improvements and more detailed analysis of this research topic, such as detailed legal analysis of trust law and bankruptcy law vis-à-vis SPVs, the regulatory issues pertaining to law development for *sukuk* issuance – just to name a few. It is expected that more works on this research topic will create awareness among regulators and key players in the Islamic financial industry, particularly the lawyers who do *sukuk* legal documentation. This is to ensure that *sukuk* can further progress through eliminating legal challenges with a step-by-step approach, which indeed requires concerted and synergised efforts from all key players in the Islamic financial industry.

Notes

1. The data is retrieved from combination 2 databases: Islamic Finance Information Services (IIFS) and Zawya Sukuk Monitor.
2. Private placement refers to secured long-term financing provided directly by a limited number of big investors such as big investment banks, insurance companies, and mutual funds (Ross et al., 2008).

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Overcoming the divergence gap between applicable state law and Shariah principles: Enhancing clarity, predictability and enforceability in Islamic finance transactions within secular jurisdictions

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Abstract - With the emergence of Islamic finance, legal precepts of Islam gained momentum through voluntary adherence by market participants. Transactions are not governed by Islamic law as such. Rather they are structured within the framework of freedom of contract in a way that is coherent with Shariah principles. In absence of an authoritative judicial institution deciding on the Shariah conformity of a commercial transaction, individual Shariah scholars fill this gap. They interpret Islamic legal principles and exercise oversight of the products and operations of the Islamic finance industry. In Islamic finance transactions, there is frequently a dichotomy and tension between Shariah principles and perceptions underlying contractual agreements and their de jure qualification and treatment in secular jurisdictions. This paper investigates the divergence gap between Shariah precepts and the contractual design of Sukuk transactions as well as transparency issues under the German legal regime. Sukuk is taken pars pro toto for Islamic finance products. German law is chosen as case example within the circle of European civil law systems. One of the problematic issues is ownership status of Sukuk holders in sale-and-lease-back based Sukuk. Although, asset linkage is a major characteristic that distinguishes Sukuk from conventional bonds, the transfer of ownership in some sale-based Sukuk structures is highly controversial not only from a Shariah perspective but also from a legal perspective. This is particularly the case when Sukuk transactions are structured in civil law legal systems where the common law concepts of trust and beneficial ownership are not recognized. The disengagement of Sukuk transactions from their underlying originating assets can be problematic for Sukuk holders in the event of a bankruptcy of the obligor. The asymmetrical risk allocation between Sukuk issuer/obligor on the one side and the investor on the other may not only be problematic from an inner-Islamic point of view. In some cases this situation may also cause legal liability issues. Besides the issue of ownership status, some other terms and conditions of widespread Sukuk issues appear to be problematic with respect to legal transparency requirements on national and EU level. This paper suggests solutions to bridge the gap.

Keywords: Sukuk, ownership issues, trust, insolvency, transparency, legal enforcement, conflict of laws

1. Introduction and overview of the issues

While Islamic law is applicable in most jurisdictions of the Arab world in the field of "statut personnel" (*akhwal al-shakhsiyya*) such as family law, it is generally not applied in commercial matters which are instead governed by codified civil law, even though many Arab constitutions declare Islamic Shariah to be a "main source of legislation". Similarly, civil codes of Arab jurisdictions refer to Islamic Shariah as interpretative rule (e.g., Art. 1(2) Qatari Civil Code 2004; Ballantyne, 1985, pp. 245–264; Al-Muhairi,

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1996, pp. 219–244). Islamic finance and banking is characterized by voluntary adherence to Islamic commercial principles such as the prohibition of interest (*riba*), gambling (*maisir*) and speculation (*gharar*) as well as the principle of profit-and-loss-participation. Despite the absence of an all-binding "Islamic lex mercatoria" and differences between the different schools of law on the admissibility of certain Islamic finance products, there is a high degree of consistency and consensus among Shariah scholars as to the core principles governing Islamic financial transactions. Moreover, standard setting organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have formulated principles pertaining to major Islamic finance transactions aiming inter alia to standardise rules and to avoid ambiguities. In recent legal disputes between parties to an Islamic finance transaction within a secular jurisdiction it had to be tested whether Islamic law is merely non-binding soft law or a set of rules that is also applicable and enforceable before secular state courts. The prevailing view in "Western" jurisprudence is that Shariah is "insufficiently determinate to be a governing law of a contract" (*Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd*, 1 WLR (CA 2004) (UK)).

Notwithstanding this finding, the parties to a Shariah compliant financial contract do have the freedom to "dress" their contracts in accordance with their belief. This can be achieved by formulating the principles of Islamic law in the form of contractual clauses.

This paper will consider contracts that *prima facie* seem to mirror and satisfy Shariah requirements but do not always stand up to further scrutiny. This problematic issue became apparent in some asset-based or "asset-light" Sukuk structures where doubts were voiced about their representation of ownership. These doubts do not only stem from Shariah law considerations (e.g., Dusuki and Mokthar, 2010; Haneef, 2009; Usmani 2007). With regard to current market practices, the validity of ownership transfers from the transfering obligor/orignator to the SPV who is the *alter ego* of Sukuk holders and is also contentious under applicable laws. This further provokes the question if there is a potential risk of a prospective "claw back" of the Sukuk assets by an insolvency practicioner in the event of the obligor's insolvency or the transfer's re-characterization as a loan (see also Thomas, 2009). These problematic issues emerge predominantly in civil law jurisdictions such as Germany or the UAE, which do not provide for the concept of trust or beneficial ownership, two of the main characteristics which mark the difference between common law legal systems and civil law jurisdictions.

Unlike in asset-backed structures, Sukuk holders generally do not have any security interest over assets underyling an asset-based Sukuk. The contractual agreements are designed in a way that ownership is reduced to a symbolic rather than enforceable status. This is because the perception under Shariah has generally no legal effect unless it is substantiated in the contract not by mere reference to Shariah but by virtue of material inclusion. However, Shariah positions may be taken into consideration in examining the will of the parties.

It must be remembered that asset-based structures were created due to market pressure and competition as well as legal constraints (Haneef, 2009, pp.108-110) such as the inalienability of property to foreigners in most Gulf jurisdictions. Asset-based Sukuk are a viable financing solution for corporations and banks who are unwilling to dispose of their physical assets by way of true sale to an SPV, inter alia due to risk management considerations. From an investor's perspective, asset-based Sukuk is a Shariah compliant alternative to bonds. The Sukuk holder generally has no asset risk but credit risk.

Besides the issue of ownership status of Sukuk holders, some other terms and conditions of widespread Sukuk issues appear to be problematic with respect to legal transparency requirements on national and EU level.

As will be discussed in this paper, Shariah issues ("lex internum") can strike through to the level of applicable state law ("lex externum") in various ways. Examining this scenario under (German and UAE) civil law, the paper will discuss the consequences of this divergence. It will then examine to what extent this "conflict of laws" can be resolved and the divergence gap be bridged.

2. The issue of transfer of ownership to the SPV

Basic characteristics of Ijara-Sukuk

The AAOIFI, in its Shariah Standard 17 (2), defines investment Sukuk as "*certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity*" (AAOIFI, 2008). Accordingly, asset linkage is a major characteristic that distinguishes Sukuk from conventional bonds and is required from a Shariah perspective. Asset ownership is also a condition for the tradability of Sukuk securities on secondary markets because the trading of debt (*bai al-dayn*) is not permitted (e.g., Ayub, 2007, p.146-147). Sukuk are based on a common Shariah contract such as *Murabaha*, *Salam*, *Istisna*, *Ijara*, *Mudaraba*, *Musharaka* and *Wakala* (for an overview of Sukuk see Ali, 2011; Adam/Thomas, 2004; Thomas, 2009; Sacarcelik, 2011). One of the most frequent types of Sukuk is the Ijara Sukuk. In a nutshell, in a typical Ijara-Sukuk transaction a capital seeking sovereign or corporate entity (obligor) incorporates a special purpose vehicle (SPV)—often in a tax efficient off-shore jurisdiction. The obligor sells and transfers (the beneficial ownership of) an asset or a class of assets to the SPV whose sole purpose is to participate in that specific Sukuk transaction. The SPV issues certificates (Sukuk) to the Sukuk holders (investors) to finance the purchase of the asset. In its capacity as trustee, the SPV holds the assets in trust for the Sukuk holders. The SPV then leases the asset back to the obligor for a period that corresponds with the term of the Sukuk certificates. According to prevailing definitions, the Sukuk certificates represent pro rata ownership in the asset. Hence, Sukuk holders are seen as (beneficial) owners of the asset. Often purchase undertakings, third party guarantees, liquidity facilities, profit reserve accounts as well as covenants ensure that the cash flow to the investors is maintained and the principal returned at term end or at the occurence of a dissolution event (e.g., default on payments). Other important elements of the Ijara Sukuk are the initial purchase and sale undertakings. The obligor undertakes

to purchase the underlying asset back from the SPV at face value on the maturity date (scheduled dissolution) or in case of a dissolution event. At the same time, the SPV undertakes to sell the asset back (sale undertaking) to the issuer. It is important to note for the present analysis that the SPV in its capacity as the trustee does not have the power to retain or sell the assets to any third party other than the obligor. The sale and purchase undertakings do not constitute offer and acceptance but a unilateral promise (*wa'd*) from both a classical Islamic legal and German civil law perspective. Whereas *wa'd* is not binding according to the majority view in classical Islamic legal literature and creates only a moral obligation, contemporary scholars declare it to be a binding promise if the promisee incurs liabilities and expenses on the basis of such a promise (e.g., Islamic Development Bank, 2000; for a discussion on the legal nature of *wa'd* and its application in Islamic financial transactions, Al-Masri, 2002; Mokhtar, 2011; Usmani, 2008, pp. 120). This is for example the case in *murabaha* financing and the repurchase agreement in Ijara-Sukuk structured as a sale-and-lease-back transaction. Accordingly, at the end of the lease term, the obligor (re-)purchases the underlying asset (e.g., real estate) from the SPV. The redemption price payable by the obligor equals the nominal amount of the outstanding certificates and is distributed to the investors through the SPV.

Ownership rights of Sukuk holders?

Common law trust and beneficial ownership

The vast majority of Sukuk issues are governed by English law. Legal certainty and familiarity demanded by investors explains the predominant use of English law. Another reason for this choice is that ownership rights can be split into legal and equitable or beneficial ownership in English law. This dualism of ownership is the fundament component in the concept of trust (Hayton, 2003) which is used both in conventional securitizations and Sukuk transactions. The obligor in a Sukuk transaction does not transfer legal title to the SPV but only the beneficial interest in the underyling assets (Thomas, 2009, pp. 95). Pursuant to a declaration of trust, the SPV acts as trustee and holds the (beneficial interest in the) assets upon trust in favor of the Sukuk holders who obtain (derivative) beneficial ownership. Among other qualities of a trust is that the assets do not form part of the estate of a trustee. The trustee can only act within the powers given to it by the trust deed or the statutes. As such it is not at liberty to sell on the sukuk assets or to keep the proceeds.

The concept of beneficial ownership as used in asset-based Sukuk is deemed sufficient by Shariah scholars (Thomas, Sukuk, pp. 97) to meet the requirements of Islamic property law (Habachy, 1962; Wohidul Islam, 1999; Ziadeh, 1993). And in fact, the legal position of a beneficial owner is similar to that of a legal owner in many respects. For example, the beneficial owners can enforce their right to the asset. They are also entitled to transfer their beneficial interest to third parties. Beneficial ownership can be obtained through inheritance. However, the protection against the legal owner who tranfers the asset to a bona fide third person is weaker (Baur and Stürner, 2009; § 64 mn. 31). In contrast to the transfer of legal title in real property (sec. 27(1), 3(a) Land Registration Act, 2002), the transfer of beneficial interest in real property does not require formal registration in English law. The concept of trust and the split of ownership facilitate the transfer of an asset without incurring tax or registration burdens.

The main structural weakness of beneficial ownership vis-à-vis full legal title, however, most notably comes up in the insolvency scenario under a legal regime (lex concursos) that does not recognize the concept of split ownership.

Despite the fact that, for example, English law is chosen as governing law in the Sukuk documentation (e.g., offering circular), according to the conflict of laws doctrine of *lex rei sitae* (e.g., sec. 43 German Introductory Law to the Civil Code (EGBGB)), the law governing the transfer of title to property is dependent upon, and varies with, "the law where the property is situated". Choice of law is not permitted in Germany for legal transactions involving property. The same applies most likely in UAE law which is far more protective when it comes to property ownership. This can be seen for instance in the ownership restrictions for Non-UAE and Non-GCC nationals in the Emirate of Dubai (Article 4 (1) of the Dubai Real Property Registration Law).

Conclusively, it is debatable whether ownership is effectively transferred to the SPV when real property underlying an Ijara-Sukuk or similar sale-based structures is situated for example in Germany or the UAE. This might also have an effect on the validity of the English law trust structure itself because one of the required certainties of a trust is the trust property.

Doubts about ownership transfer

In his recent criticism of some widespread asset-based Sukuk structures, *Sheikh Taqi Usmani* raised doubts about the transfer of ownership to Sukuk. His famous paper "Sukuk and Their Contemporary Application," which was circulated towards the end of 2007, caused quite a stir and led to turmoil in the Sukuk market during the global financial crisis. As a result of the controversies, the AAOIFI issued a Shariah resolution on Sukuk in 2008 to clarify the situation and restore calm. *Usmani's* main criticsm centered on the purchase undertaking in equity based Sukuk where the issuer undertakes to buy back the underlying assets from the issuer at face value and not prevailing market value or fair value on the expiry date of the Sukuk or in the event of a default. In fact, this stipulation moves Sukuk very close to a conventional debt security in terms of risk characteristics and performance. The risk is related to the credit worthiness of the provider of the purchase undertaking (obligor) and not the assets underlying the Sukuk. Whether recourse to the issuer or the asset (or a combination of both) is allowed, also affects the rating of a Sukuk, since rating agencies may evaluate a Sukuk either in terms of cash flow stability or default probability.

In his paper, however, Usmani did not deal with the issue of ownership directly or to any great depth (see already: Usmani, 2008, p.178), saying "*generally, Sukuk represent ownership shares in assets that bring profits or revenues, like leased assets, or commercial or industrial enterprises, or investment vehicles that may include a number of projects. This is the one characteristic that distinguishes Sukuk from conventional bonds. However, quite recently, the market has witnessed a number of Sukuk in which there is doubt regarding their representation of ownership*" (Usmani, 2007).

Acquisition of ownership under German law

As previously mentioned, the issue of ownership of assets underlying Sukuk becomes indeed apparent in Sukuk default scenarios where risk mitigating mechanisms cease to operate and both the distressed issuer and the obligor fail to fulfill their payment obligations. As a last resort, Sukuk holders seek recourse to the assets.

Protecting Sukuk holders from any prospective "claw back" of the assets by creditors of the obligor the SPV or the transfer's recharacterization as a loan requires that:

1. the SPV is insolvency remote
2. the transfer of ownership is valid and legally binding ("true sale" or off-balance sheet treatment)

Hence, in an inolvency of the obligor, it is decisive to identify the status of the SPV: Is it the owner of the Sukuk assets, a secured creditor or an unsecured creditor? This is crucial because according to s. 47 of the German Insolvency Code (Insolvenzordnung), for example, third party property does not belong to the debtor's bankruptcy estate. Owners have a right to segregate their property (*Aussonderungsrecht*) and enjoy a priority status over other creditors and equity holders who will only receive distributions after the higher priority claims are satisfied. Because of the disputed and unclear situation, the issue of proprietary rights and of Sukuk holders needs further examination from a civil law perspective.

Legal conditions for the transfer of moveable and immoveable property

In Sukuk transactions, the obligor and the SPV formally agree to conclude a contract of sale. The initial purchase agreement is also mentioned in the prospectus. Pursuant to this agreement, the Sukuk assets are sold to the SPV and leased to the obligor according to a lease agreement. The obligor undertakes to purchase the asset back on the maturity date or a dissolution event. The SPV is obliged to sell the assets back to the obligor and it is not at liberty to dispose of the assets. This arrangement shows structural similarities to the "Sicherungsübereignung" in German law where ownership in a *res* is transferred to a creditor for the security of a debt that is owed to them by the owner of the transferred res, or by another debtor. However, while the "Sicherungsübereignung" which resembles chattel mortgage is used for security purposes and is comparable to a lien on property, the agreements in a Sukuk transactions aim to ensure Shariah compliance.

Regardless of the purpose of the ownership transfer, the transfer is only valid if certain conditions are met.

In contrast to common law systems, in civil law systems, and particularly in the German one, there is a much greater differentiation between the "contract" (e.g., a contract of sale) (Verpflichtungsgeschäft), which creates the obligation to transfer, and the "conveyance" (Verfügungsgeschäft), the actual transfer of a proprietary right (especially ownership) in a *res* which effects the alienation of that res, i.e., the passing of the real right from transferor to transferee. The contract of sale does not effectuate the transfer of ownership *ipso iure*. Rather, the transfer of ownership in a *res* is a twofold process that requires first an agreement by the parties that ownership shall pass in respect of a specific *res*, and second the handing over of the res (delivery) as a factual act. If the *res* is immovable property, the conveyance must be approved by a notary (§ 311b German Civil Code) and the agreement on the transfer of ownership must be in the presence of a notary (§ 925 German Civil Code). Moreover, the transfer of ownership requires registration with the land registry (§ 873 German Civil Code). Similarly, in Dubai, it is compulsory to register real estate with the Dubai Land Department (Article 1277 UAE Federal Law No. 5 of 1985 (Civil Code) and Articles 6, 7 of the Dubai Real Property Registration Law – Federal Law No. 7 of 2006).

Despite the use of terms such as "sale" or "ownership" in the transaction documents, the initial transfer of ownership is often not perfected in asset-based Sukuk.

Characterisation of the transfer as a loan?

Because German law does not recognize the concept of trust or beneficial owner, the transfer of ownership in real property forming the underlying of a Sukuk and situated in Germany requires registration. It is expressively stated in the transaction documents of some Sukuk offerings that transfer of the ownership will not be perfected (see e.g., ADIB Sukuk, Offering Circular, Risk Factors, pp. 9–10). This provokes the question if this statement is merely of declaratory nature clarifying that the factual act of transfer, e.g., registration of real property did not take place. Assuming this is the will of the parties, one could argue that the registration of the property to perfect the transfer of the legal title could be made good at a later point in time, e.g., when investors fear the near default of the obligor. A counter-argument against this view could be that there is no convincing reason as to why the SPV representing the Sukuk holders should be given the right to pursue property registration although both parties willingly and knowingly did not act in conformity with their contractual sales agreement just until a critical stage is reached, i.e., payment problems of the obligor evolved. Sukuk holders who set themselves in contradiction to their previous conduct might forfeit their right to obtain ownership (*venire contra factum proprium*). However, this rigid sanction cannot be justified if there is a valid claim and only a relatively short of time elapsed after the conclusion of the contract of sale.

Taking into consideration that the intention of the parties of an asset-based Sukuk is to structure an instrument that replicates the economic features of an unsecured bond, one could also take the view that the obligor at no time intended to fulfill its obligation to transfer the assets to the SPV. One has to bear in mind that asset based Sukuk were created due to market pressure and competition (Haneef, 2009, pp. 108–110) as well as legal constraints such as the impossibility of true sales due to the inalienability of real property to foreigners in Gulf jurisdictions. Moreover, the SPV is not more than an "orphan shell company".

The assumption that the Sukuk holders generally are not quite interested in the underyling assets or structure of a Sukuk but rather the cash flow generated by them is supported by the fact that no asset due diligence or valuation is performed by a neutral third-party expert. This aspect is clearly indicated in certain prospectus: "*No investigation or enquiry will be made and no due diligence will be conducted in respect of any Sukuk assets. Only limited representations will be obtained from IDB in respect of the*

Sukuk assets of any series of trust certificates. In particular, the precise terms of the Sukuk assets or the nature of the assets leased or sold will not be known (including whether there are any restrictions on transfer or any further obligations required to be performed by IDB to give effect to the transfer of the relevant Sukuk assets). No steps will be taken to perfect any transfer of the relevant Sukuk Assets or otherwise give notice of the transfer to any lessee or obligor in respect thereof. Obligors and lessees may have rights of set off or counterclaim against IDB in respect of such Sukuk assets" (IDB Sukuk 2005 Offering Circular, Risk Factors, pp. 69–70). Thus, in most cases it will also not be possible to asses whether the face value of the Sukuk certificates truly reflects the real market value of the underlying assets. Similar to the "disclaimer" mentioned above, one can also find the clarification in some prospectuses that Sukuk holders will not have interest in the assets from a legal perspective. This is indicated for example in the DP World offering circular: "*Each of the Mudaraba Agreement, the Purchase Undertaking and the Sale Undertaking are governed by English law under which the interest under Shariah in the Mudaraba Assets of either the Issuer and/or the Trustee may not be recognized. Neither the Issuer nor the Trustee has any interest in the Mudaraba assets under English law*" (DP World Offering Circular, Risk Factors, p. 22).

The lack of interest of Sukuk holders in the assets—at least so long they receive payments—may not be a sufficient evidence to negate ownership. Similarly, the (fiduciary) restrictions on the transferability of the assets to third parties by the SPV is legally permissible in German civil law (sec. 137 German Civil Code) and serves the interests of the Sukuk holders. However, the fact that payment obligations of the issuer rank *pari passu* with the claims of all its other unsecured and unsubordinated creditors possibly can be taken as an argument against ownership of Sukuk holders.

On the basis of the statements in the sales contract or the prospectus stating that "no steps will be taken to perfect any transfer of the relevant Sukuk assets" one could argue that the claim of the SPV for procuration or transfer of the assets as promulgated in sec. 433 subsec. 1 German Civil Code is waived. In view of these circumstances, one would perhaps not go to the length of holding the transfer of property or the sales contract as fictitious and thus null and void (e.g., sec. 117 German Civil Code). If, however, the sales contract is "deformed" to such a degree that the most fundamental obligation of a sales transaction, i.e., the transfer of the subject matter, is excluded bilaterally on the basis of a (side) agreement, one will usually tend to take a substance over form approach and classify the transaction as sale and not a loan—irrespective of the designation by the contracting parties. The financing character of the described structures dominates the transactions. Thus, there is little room to classify the transaction as a contract of sale. Rather, the contract would be classified as a loan according to sec. 488 German Civil Code.

In recent judgments in the UAE or Saudi Arabia, courts took a substance over form approach when they had to consider Islamic finance transactions. In a decision dated 24 March 2010, the Dubai Court qualified an Ijara Contract as a sales contract taking a substance over form approach (personal communication). The Saudi Board of Grievances declared that "the circuit is concerned about the substance, not the title" (Khalid Bin Abdulaziz Alanzan v. Saudi American Bank (Samba Financial Group), 17.1.1429 A.H./26 January 2008, Personal communication). Accordingly, taking a substance over form approach, the courts in the GCC could declare the Sukuk construction with the aforementioned features to be a disguised form of an interest bearing bond.

Similarly, in the recent case *Blom Development Bank vs. The Investment Dar Company* ([2009] EWHC 3545 (Ch)), the English High Court moved away from the previous view taken in *Shamil Bank of Bahrain vs. Beximco* ([2004] EWCA Civ. 99) and held that TID's legal counsel had made an arguable case that a *Wakala* agreement entered into between TID and Blom was not compliant with Shariah and, therefore, that the agreement was beyond the corporate powers of TID and void.

The classification of the underyling contract not as a sales transaction but a loan could also trigger unpredictable international enforceability issues (e.g., Salah, 2010). If, for example the Sukuk transaction is structured under German law but the assets are in Doha or Dubai, the local court could accept the German judicial assessment and commence with the enforcement procedure. In this case the court could ignore the limited recourse or insolvency remote structure of the Sukuk transaction, pierce through this veil and realise the assets of the obligor. However, the local court might also revisit the merits of the case and could make Shariah considerations fully or partially effective. Hence, the court could give effect to the sale contract and acknowledge the proprietry rights of Sukuk holders. It would first urge the parties to register the underyling real estate with the Land Department. In this scenario, Sukuk holders would only have recourse to the assets taking the risk that the asset value is not sufficient to cover the invested capital.

One possible way to avoid these problems would be to use the concept of German "custody" or "fiduciary agency" (*Treuhand*) which is very close to the Common Law Trust. Whereas the opinions in legal literature are "liberal" as to the conditions of an insolvency remote *Treuhand*, the German Federal Court (Bundesgerichtshof) requires an immediate transfer of the *Treuhand* asset from the Beneficiary (*Treugeber*, here: SPV) to the Trustee (*Treuhänder*, here: Obligor). According to this restrictive view, a declaration by the Obligor that it holds the assets on trust for the SPV is not sufficient. Furthermore, in case the Treuhand asset is a real estate, the Federal Court takes the view that the registration of a priority notice (*Vormerkung*, sec. 883 German Civil Code) is compulsory. In light of this judicature it is recommendable to register the real estate with the land registry in order to grant Sukuk holders recourse to the assets in case of insolvency of the Obligor and to avoid a "claw back" by an insolvency practitioner.

Legal concequences of deficient transparency in sukuk documents

Sukuk structures, as described above, may be particularly problematic if they are publicly offered to retail customers. Despite the disclaimers and statements in the prospectuses, confusions on the side of average retail customers about the *de facto* characteristics of an asset based Sukuk cannot be entirely dispersed. Especially the terms "sale", "lease",

or "repurchase" used in Sukuk prospetuses may be misleading. Market participants who, without access to (or interest in) the legal detail, could sincerely believe there is asset security and that the investment/financing provided is collateralized (see Moody's, 2009, p. 5).

Poor transparency in the terms and condition of Sukuk offerings can violate the transparency requirement promulgated in sec. 3 Bond Act (Schuldverschreibungsgesetz) or the unfair terms provisions, most notably sec. 307 of the of the German Civil Code, rendering the relevant clause void. Moreover, prospectus liability may arise, e.g. when the formulations in the prospectus are misleading. Prospectus liability can be triggered also in case of explicit violation of fundamental Shariah rules (Casper, 2011; Sacarcelik, 2010).

3. Shifting ownership risks to the lessee

Another major concern in Ijara Sukuk is that Sukuk holders who are owners (i.e., lessors) from the Shariah point of view are responsible for major maintenance or insurance expenses of the subject matter of the sale and lease agreement. In practice, the obligor is frequently appointed as servicing agent for the asset. In this capacity, the lessee manages the maintenance on behalf of the Sukuk holders. The lessee usually receives a servicing fee and can claim reimbursement if any additional expenses incurred. However, the ownership responsibilities and costs are passed on to the lessee through charging a supplemental rental in the amount equal to the expenses claimed by the lessee. The lessee's obligation to pay supplemental rent is then set off against the lessor's (SPV/Sukuk holders) obligation to reimburse expenses. Passing on maintenance responsibilities can be agreed under German law between the lessor and the lessee within certain statutory limits. In conventional finance lease contracts, the lessee usually bears this responsibility. Since Sukuk holders economically benefit from this arrangement there is generally no legal objection; e.g., with respect to unfair terms rules. However, this risk shifting might be problematic from a Shariah perspective because it disburdens Sukuk holders from genuine ownership obligations. Moreover, German tenancy law sets limits to the rent increase both for residential and commercial real estate. Consequently, charging supplemental rent to absorb expensive maintenance costs might be barred when it exceeds a certain level.

4. Conclusion

This article has shown that Shariah considerations underlying Islamic finance transactions and legal structuring can fall appart and create a gap. This divergence gap can be seen, for example, when it comes to ownership issues in asset-based Sukuk. The compexity of the issues increase due to the international scope of these transactions involving different jurisdictions. The disengagement of Sukuk transactions from their underlying assets leads to a risk structure that is not always reflecting the stipulations of Shariah compliant finance.

This paper suggests that in absence of the trust structure in German law or comparable civil law legal systems, a true sale has to be effectuated to grant Sukuk holders ownership rights. Formal registration is mandatory where the underyling asset of a Sukuk is immovable property. The valid transfer of the assets can eliminate the risk of a "claw back" of the assets or the characterization of the transfer as loan. Alternatively, the concept of Treuhand can be used to approximate the relevant Sukuk under German law to transactions utilizing an English law trust.

Legal issues in Sukuk transactions structured in civil law jurisdictions are not limited to Ijara Sukuk. Equity-based Sukuk such as Mudaraba and Musharaka also show features that might conflict with existing legal provisions of German law. Moreover, the Mudaraba or Musharaka arrangement could qualify as civil or commercial company. However, complying with Shariah requirements usually does not cause legal frictions as long as the relevant statutory rules are observed. Despite challenges and some problematic issues reagarding current Sukuk market practices, German law provides a liberal and secure legal environment for Islamic finance transactions including Sukuk. This has been already proven by various Islamic funds, certificates and the prominent Saxony Anhalt Sukuk being the only "European" Sukuk to date.

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