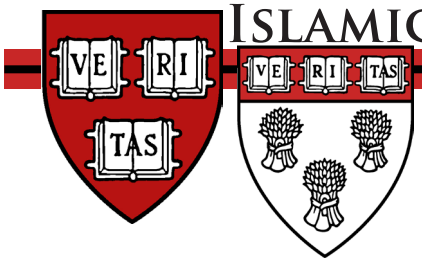

ISLAMIC FINANCE PROJECT

HARVARD LAW SCHOOL
ISLAMIC LEGAL STUDIES PROGRAM

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INSOLVENCY & DEBT RESTRUCTURING IN ISLAMIC FINANCE: A SHORT REPORT

The global financial crisis that started in 2008 did not only affect mainstream finance but also niche segments such as Islamic finance. Many prominent institutions in the Islamic financial sector experienced difficulties meeting their obligations and some faced bankruptcy. In this context, the Islamic Finance Project (IFP) of the Islamic Legal Studies Program (ILSP) of Harvard Law School (HLS), along with the London School of Economics and Political Science (LSE), co-hosted their seventh annual workshop to discuss the issues of insolvency and bankruptcy under shari'a and their possible consequences on Islamic financial institutions working under different legal jurisdictions.

Harvard-LSE Annual Workshops on Islamic Finance

These annual workshops are a forum for in-depth and multidisciplinary discussion on some of the most pressing issues facing the Islamic financial sector. They are not meant to prescribe a particular course of action or reach definitive conclusions but to provide an open environment for discussion. The topic of each workshop is chosen based on a survey of the participants. Participants are then provided background information on the topic and requested to submit their comments. The comments received are compiled and distributed to all participants prior to the workshop. The workshop spans an entire day with several issues discussed in multiple sessions. To facilitate free and open discussion, the views expressed are not attributed to any participant.

Shari'a scholars, legal experts, bankers, and economists from different countries first submitted written responses, then gathered at the LSE campus in London on February 28, 2013 to discuss various aspects of Islamic law related to insolvency and debt restructuring.

The theme of the workshop, "Insolvency & Debt Restructuring in Islamic Finance" was examined from the following angles:

a) Defaulting individuals;
b) Defaulting corporate transactions (insolvent corporate borrowers; sukuk issuers);
c) Distressed financial institutions;
d) National and cross-border bankruptcy and insolvency legislation, rules and regulation; and
e) Islamic finance industry bodies (e.g. standards, model laws).

Objectives

The objectives of the workshop were as follows:

1. Reviewing the understanding of the Islamic insolvency and debt restructuring with respect to creditors' and debtors' rights;
2. Understanding how modern regulatory regimes have handled financial defaults and how they have applied Islamic legal concepts and principles;
3. Discussing and applying Islamic financial insolvency concepts;
4. Discussing potential economic, legal, and regulatory reforms required to better deal with the complexities involved in defaults of contemporary Islamic finance products and institutions; and
5. Exploring any new guiding principles or processes that might help the Islamic finance industry in its quest for a more sustainable future.

Introduction

The workshop benefited from 25 written responses submitted before the in-person discussion. Later 29 experts (including some special invitees) participated in the day-long deliberations on February 28, 2013.

Dr. Nazim Ali, IFP Director and Acting Executive Director of ILSP, at Harvard Law School emphasized the importance of academic cooperation between Harvard and LSE and welcomed the participants who came from various countries to participate in the academic discourse.

Professor David Kershaw from LSE welcomed the participants on behalf of LSE and highlighted the importance of Harvard's and LSE's joint efforts in conducting programs on novel subjects like this. Prof. Kershaw termed this workshop as a capacity-building effort for LSE in the field of Islamic banking and finance. He also underscored the importance of ethics in the current financial world.

Professor Frank Vogel, while setting the ground rules for the workshop, reemphasized the importance of gathering thought leaders of the Islamic banking and finance industry and conducting off-the-record discussions for more frank and fruitful discussion. He noted that while in most respects modern bankruptcy and insolvency regimes seem compatible with the rules of the Islamic fiqh, there are a few spheres of challenge and potential conflict. These include issues of final discharge of the bankrupt without creditor consent, the liquidator's power to void any transaction prior to commencement of bankruptcy, bankruptcy requested by a debtor, acceleration of claims and discounting present value, inclusion of debts yet to mature, the shari'a status of goods that haven't been paid for, the possibility of assigning preference to government or workers, and the status of creditors who appear after the bankruptcy begins. On the implementation side, he highlighted questions of choosing the best means and resources available to deal with such issues.

Approach to Insolvency and Bankruptcy under Shari'a

The discussion formally started with the presentation of a summary of the comments received from the participants. Two distinct approaches could be gleaned from the summary:

1. Create a new model insolvency legal regime for the Islamic finance industry; or
2. Use the existing legal regimes with modifications for Islamic finance.

Challenges and benefits associated with the respective approaches were also highlighted. For example, the benefits highlighted in favor of a new model insolvency law included overcoming constraints of the current legal system, procedural flexibility, reducing legal arbitrage, stress rehabilitation (*sulh*) over liquidation or bankruptcy, avoiding strategic defaults, and uniform implementation of AAOIFI Shari'a Standard 43.

Islamic concepts of *ibra'* (cancellation of debt), hawala (transfer of debt liability to third party), and voluntary deferment of debt were the tools highlighted for achieving the new regime.

On the other hand, major challenges for the proposed new regime were found to be related to the cost of development, lack of enforceability powers and conflict with existing rules, regulations, and mechanisms.

Some of the pertinent shari'a issues related to a new regime concerned carrying of debt and whether the bankrupt could be finally discharged of his obligation. Should individuals and corporations be treated similarly? Is there possibility of nullifying certain transactions to protect the interest of creditors? It was also pointed out that acceleration of debt is another important issue where the shari'a and conventional points of view are quite different.

Continuing with the existing mechanism would have certain distinct advantages. Among them, the most important was lesser uncertainty and greater integration with the existing global financial system, leading to higher confidence of investors and institutions alike. It was further argued that shari'a-compliant products have already become a part of secular jurisdictions and are providing good interface with secular courts of law. The most important challenge found in this case was lack of infrastructure to deal with Islamic finance and the opportunity of legal arbitrage. Enforceability of shari'a guidance and lack of alternative mechanisms to resolve bankruptcy related matters faced by Islamic finance were other important issues associated with the existing mechanism. It was observed that Chapter 11 is too lenient and biased in favor of debtors, which conflicts with the Islamic ethos of debt.

Bankruptcy in Shari'a: Nature and Scope

Participants had a long discussion regarding what constitutes insolvency (*iflas*) and bankruptcy (*al-i`sar al-madani*). It was concluded that insolvency is a debtor's inability to clear his debt at the time of maturity but without necessarily implicating his ability to clear his debt. Bankruptcy was described as a situation in which the liability of the borrower exceeds his assets. It was noted that shari'a has a provision only for insolvency.

Another notable aspect on this topic was related to the *mudaraba* (investment management) deposit of Islamic banks. It was highlighted that an Islamic bank may become insolvent on *mudaraba* accounts but remains a going concern with regard to its other activities. Some participants highlighted a new term (*ta'athur*, i.e., financial distress) being used for restructuring on the principle of *sulh waqi min al-iflas* (a settlement that prevents insolvency) though many others believed that rescheduling and debt restructuring could attract serious shari'a objections.

Some participants pointed out that the rules of the game are clearly different today from what might be envisaged in an ideal shari'a environment. For example, debt in shari'a-compliant business is not a policy decision, but in today's business environment it has become a matter of conscious policy. In this context it was also suggested that it is important to look at legal and real personalities where an individual may be averse to borrowing but a legal entity may not have the same reservation. Some participants also sought to draw the link between economic and legal perspectives. They referred to the exploitation of existing bankruptcy laws by corporations

to their advantage. Issues of fairness and justice and economic expediency which weigh heavily in the current bankruptcy regulations were also discussed in the light of shari'a, and it was found that there are certain points of conflict with shari'a. For example, what is fair to a debtor may not be in the best interest of the business enterprise and consequently may affect economic development and poverty alleviation efforts of government. Many participants agreed that a flexible bankruptcy regime is good for the economy but comes at the cost of moral values. The main concern in this regard is how to strike a balance between disciplining debtors, protecting creditors, and encouraging entrepreneurship.

Major Challenges Confronting Insolvency and Restructuring

A great number of the transactions in Islamic finance are actually based on sale and lease-back types of contracts; according to many participants this leads to confusion among parties with regard to their rights. For instance, what are the options available when a bank goes bankrupt and has financed or leased out an asset to a customer? Can the asset be taken back because the bank has yet to receive its full payment or holds the title? Or will the asset remain with the customer and he will continue to make payment as per his agreement with the bank? Or will renegotiation happen to close the deal earlier than its original schedule?

Another related issue in the case of an early closing is whether the customer is required to pay as per the original agreement or if he is entitled to a rebate for making early payment? What is the shari'a view on these issues and how much discretion do judges have to enforce a settlement? Most importantly, how can these types of situations be resolved keeping in view justice and fairness and without prejudice to other claimants' rights and status?

According to participants, the AAOIFI Shari'a Standard is clear on this subject: the bank has the right to a full claim. On the other hand, it was pointed out that claiming full profit (as against accrued) will be unfair to the customer in case of early termination and may prejudice other unsecured creditors—which the court will not accept. It was submitted that Malaysian courts have not yet resolved this issue. It was also brought to the attention of the participants that the Saudi Central Bank has made it obligatory for banks to accept early termination by charging a maximum of 1% of the remaining profit.

Participants elaborated the shari'a view on this by stating that in *iflas,* all deferred payment will be accelerated. All four major schools of Sunni thought are of the view that rebate is not allowed—though OIC has permitted this practice by the banks. On practical side, it was highlighted that judges should use their discretion on this matter rather than making rebate statutory, which may harm the creditor.

Participants then moved on to discuss following possible scenarios:

- How to adopt an Islamic insolvency law or existing insolvency law to make it better for Islamic insolvencies?
- How to achieve it?
- How to distinguish between insolvencies of Islamic banks and insolvencies of sukuk and insolvency of customers?
- How to resolve issues of collateral and *pari passu* when a combination of conventional and Islamic finance is used to finance a project?

During the discussion on the above, AAOIFI's Shari'a Standard on *sukuk* underwent critical scrutiny of some of the participants. One participant noted that the AAOIFI standard defines sukuk such that holders have ownership; however, in practice, the dominant majority of sukuk are not structured that way. He called it a contradiction between theory and practice. Another participant clarified that AAOIFI's standards are minimal in nature as far shari'a compliance is concerned and that scholars have allowed some liberty to achieve tax efficiency in the transaction. He further explained that there is no shari'a issue if the *sukuk* holders (being owners) agree to forego their rights and become *pari passu* with other creditors. Another scholar contended that any condition which violates the spirit of the contract is unacceptable; it is only post-closing that one may agree to such conditions but not at the time of signing the agreement.

Future Course

Considering the enormity of challenges in both the options (creating a new model or working with the existing legal system), another path was discussed among participants as a better alternative. This called for educating stakeholders by clarifying to them shari'a principles, making specific recommendations to Islamic finance institutions on how to manage within existing laws, preparing a master agreement on bankruptcy (like that of tahawwut), and preplanning insolvency. To avoid instances of bankruptcy it was suggested that preparing model guidelines based on work done by the International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL) would help and guide legislators, practitioners, and possibly courts.

It was noted that some Muslim states are in the process of revising their insolvency laws, so this may be an opportune time to work with them. But the major challenge in this connection was the actual shari'a-related changes required for existing regimes and whether *fiqh* level issues can be overcome through government legislation as has been the case in recent past. How far legislative compulsion can be justified under shari'a? For example, can creditors be forced to accept reorganization? Can a stay be imposed on secured creditors? How can the rehabilitation option be strengthened? How can the handling of *ta`aththur* be strengthened? How can one jurisdiction or arbitration entity be developed into a recourse for insolvencies?

With regard to the above, major challenges discussed among participants focused on the following: the differences among scholars on fiqh issues; the different philosophical approaches (pro-debtor, pro-creditor); the complexity of fact situations; and the divergent treatment of these issues across laws and jurisdictions. Some complex issues like the limits of f*iqh*, what is subject to pre-agreement, what is subject to the discretion of financial institutions as a grace, what is up to the discretion of judges, and what is achievable only through regulation were also discussed among participants to identify and set priorities among institutions, markets, and participants.

Suggestions

It was suggested to conduct a review of the rules and institutions existing world-wide insolvency and bankruptcy systems as to their susceptibility to harmonization or not with shari'a—a "World-Wide Legislative Review" (WWLR)—and then recommend which solutions would be best from the viewpoint of shari'a compliance, along with any further ideas. It was thought to have the following benefits: it would be worthwhile even for revisions of a general insolvency law (Islamic and not); it would be useful for legislative bodies with a significant Islamic sector; legislation could then be adjusted to local historical, legislative, and cultural contexts; and it could be useful to judges and insolvency practitioners, as well as stakeholders.

Participants also discussed the possibility of producing a tool-kit of restructuring methods and approaches that will be acceptable in shari'a. These would be designed primarily to prevent bankruptcy through voluntary workouts and amicable settlements among parties. And in the event of the involvement of courts, these tools would guide in matters of reorganization, rescue, and liquidation.

At the end of the workshop, participants provided specific suggestions on how to deal with the issue. Some of the key suggestions are: first, look at preventive measures to help avoid insolvency and bankruptcy; review the existing *fiqh* literature on the subject in the light of current experiences; conduct a survey of Western jurisdictions with a focus on the issues of importance to shari'a; produce a model law of insolvency using international best practices; and improve AAOIFI's current Shari'a Standard 43 to bring it up to requirements of the time.