### Harvard Law School Islamic Finance Panel
### September 26, 2011

# Islamic Finance: Bankruptcy, Financial Distress and Debt Restructuring: A Short Report

The Islamic Finance Project and Islamic Legal Studies Program of Harvard Law School organized a panel discus¬sion in Pound Hall on September 26, 2011 entitled "Islamic Finance: Bankruptcy, Financial Distress and Debt Restructuring". The goal of the seminar was to create an understanding of recently reported cases of bankruptcy and debt restructuring of Islamic finance products. The discussion paper was prepared and presented by Ibrahim Warde, Adjunct Professor, The Fletcher School, Tufts University, Medford, Massachusetts, and there were four panelists: Chibli Mallat, Custodian of the Two Holy Mosques Visiting Professor of Islamic Legal Studies, Harvard Law School, Presidential Professor of Law and Professor of Middle Eastern Law and Politics, S.J. Quinney College of Law, University of Utah; Umar F. Moghul, Partner, Murtha Cullina LLP, Hartford;  Muddassir Siddiqui, Partner and Head of Islamic Finance, SNR Denton & Co., Dubai, United Arab Emirates and; Kristen Stilt, Custodian of the Two Holy Mosques Visiting Associate Professor of Islamic Legal Studies, Harvard Law School.

## IBRAHIM WARDE PRESENTATION

Issues of debt and default are both timely and timeless. We are currently going through an unprecedented debt crisis, the impact of which is felt all over the world and at every level of society. Major government rescues have allowed the largest global financial institutions to remain solvent, at a high cost to taxpayers. In the past few months, Greece and other countries have been teetering on the brink of default, and as a result the entire European banking system is at risk. All over the world we have seen protests against the austerity measures imposed by governments on behalf of creditors. In the United States there is widespread anger against the financial system, the bailout, the generous bonuses bankers award themselves and the foreclosures that have devastated entire communities. Indeed, it is said that about a third of American homeowners are "underwater," meaning that the value of their home is less than the debt they took out to purchase it. All those examples raise important practical, moral and religious issues: Who should be held responsible for unpaid debts? Who should pay the price of bad business decisions? Is it moral for a generation to pass on a significant debt to the next generation, or for solvent "underwater homeowners" to walk out on their debt?

Most religions, and indeed most political orders and secular philosophical systems, hold a moral view on debt, punishment for default, and debt forbearance and relief. In traditional societies, delinquent debtors were subjected to some form of bondage, ranging from prison time to outright enslavement. Debtors' prisons, which existed in the United States until the 1840s, typically served in different times and places different functions: a punishment imposed by society, or more pragmatically a way of forcing debtors to reveal the whereabouts of their hidden assets, or to perform hard labor to pay off their debt. Many societies also provided for periodic debt relief. The Hammurabi Code recommended debt relief every three years. In the Jewish tradition, a Sabbatical year is decreed every seven years, during which all the debts owed by members of the community, but not those of foreigners, are released; and the seventh Sabbatical year, or forty-ninth year, is then followed by a Year of the Jubilee, during which the release of all debts (for fellow community members and foreigners alike) and the release of all debt-slaves are mandated.

In the late Middle Ages, modern finance started taking shape in Italian city-states, and later spread to Northern Europe and elsewhere. In those days, major cases of insolvency involved kings and feudal lords; defaults were often resolved in a political and military way, and creditors could be at risk of imprisonment or expulsion. But with the rise of commercial society and the growing clout of merchants, more systematic mechanisms were devised to deal with insolvency in an orderly and predictable fashion. Economic historians tell us that the first modern bankruptcy law appeared in England with the 1542 Statute of Bankruptcy. Over time, comparable legislations appeared elsewhere. One notable fact is that such bankruptcy laws were often modified and sometimes reversed to reflect changing circumstances and new priorities—favoring risk-taking vs. protecting the status quo, or punishing delinquent

debtors vs. encouraging fresh starts following economic failure—resulting from shifting balances of power between creditors and debtors. Especially significant for our purpose was the gradual development throughout the Western world of joint-stock limited-liability corporations, which enjoyed a legal personality separate from that of their owners. As a result, the worlds of business and finance were durably transformed.

What about the Islamic world? In the pre-Islamic era (*jahiliyya*), a draconian system known as riba al-jahiliyya, which strongly favored creditors, prevailed. If the debtor sought a reprieve, it came at the price of a doubling of the debt. The process would be repeated and non-payment typically resulted, in the end, in the enslavement of the borrower. With the advent of Islam came the prohibition of riba and a new approach toward debt and debtors. In addition to the importance of honoring one's pledges and safeguarding against disputes through proper documentation and witnesses, the Qur'an expresses the desirability of conciliation and forbearance. In a clean break with pre-Islamic practices, the Qur'an states: "If the debtor is in difficulty, grant him time till it is easy for him to repay, if ye remit by way of charity, that is best for you if ye only knew." (2:280). In the Hadith, there are more specific injunctions addressed to both creditors and debtors. Depending on the repayment ability of debtors, creditors should remit at least part of their loan. At the same time, failure to pay debts, especially by debtors who are able to pay, is roundly condemned, as is leaving after death a debt that no one could reimburse.

Islamic jurisprudence took a special interest in matters of insolvency (*iflas*), and brought more specifics to debt restructuring. The judge (*qadi*) was the central figure in finding an appropriate resolution to the cases brought before him. What resulted was an ad hoc attempt at compromise as opposed to systematic receivership. Assuming good faith, both sides were expected to make concessions. Typically there would be a reduction of debt and a change in terms based on the debtor's ability to pay. The judge was expected to be fair to both sides, though at times a clear bias could be found toward the rights of creditors. By the same token, the religious stress on forbearance was not always heeded. Indeed, non-payment or even delays in reimbursement could bring forth lashing and imprisonment, which were common in Islamic societies.

The central difference with Western approaches to insolvency lay in the absence, in classical Islamic law, of the notion of a separate corporate personality. In the West, as we saw, the joint-stock limited-liability corporations slowly developed and became dominant economic actors. The corporations, in addition to enjoying legal personality, were usually established for an unlimited period of time, and could in their own corporate name contract debt, be placed in receivership, be liquidated, etc. In contrast, with only a few exceptions (*awqaf*, *bayt al-mal*), Islamic law did not recognize partnerships as separate corporate entities. Thus in the Islamic world until the mid-nineteenth century, the principal form of business remained the partnership, which consisted of individuals who were personally responsible for the debts incurred. If the individual is the bearer of commercial duties and rights, then the underlying intent of his actions is essential, which is irrelevant in the case of the impersonal corporation. Forbearance by creditors was also a matter of individual judgment. The Islamic approach in contrast concentrated on individual partners, their circumstances and motivations: was the debtor trying to conceal assets or cheat the creditor, or did he fail because of circumstances beyond his control? In the latter case, the creditor was supposed to show forbearance. *Qard Hasan*, the benevolent (and interest-free) loan, which is also the only form of loan provided for by the shari'a, was often extended to distressed borrowers. Incidentally, debtors are among the proper recipients of zakat. Economic historian Timur Kuran has focused on the difference between the partnership-based system of Islam and the joint-stock limited-liability corporation that slowly took shape in the West, as well as on the difference in inheritance laws to explain "the long divergence" between Islam and the West. According to Kuran, the short life of partnerships (since a partnership was dissolved whenever a partner died) and the constant dispersion of ownership due to Islamic inheritance laws made it difficult to achieve the accumulation of capital that made the industrial revolution possible.

Starting in the 19th century however, Islamic traditions on matters of commerce and finance were overtaken by Western influences. In 1850, the Ottoman Commercial Code appeared, based on the French Napoleonic code, and introduced hitherto unknown forms of limited liability corporations, such as the "Société Anonyme" and the "Société à Responsabilité Limitée." Especially significant were the events of 1875—the bankruptcy of the Ottoman Empire and the Egyptian default. In both instances the debtors were Islamic governments, whereas the creditors were Westerners. Debtors' responsibilities and bondholders' rights took center stage. The political and military consequences in the Ottoman Empire and Egypt reflected the new balance of military and economic power. In both cases, the management of debt and finances was essentially delegated to the bondholders and more specifically to Western (mostly British) powers. In the case of Egypt, this soon evolved into direct British political control.

With Islamic law generally confined to personal status and family law, most Islamic countries adopted commercial codes – including bankruptcy laws – borrowed from European (mostly French) law. The trend persisted throughout the era of decolonization. Even in Saudi Arabia, a country that was not colonized and where the shari'a is the law of the land, a bankruptcy system was established as part of the 1930 Commercial Court Law, and later updated with the 1996 Bankruptcy Preventive Settlement Law. The system was based on Western-based norms of receivership and liquidation, with an overlay of Islamic principles, based on the ideals of justice, fairness, and profit-and-loss sharing. The 1996 law thus sought to encourage debt relief by inviting debtors to seek settlements with creditors through the intermediation of a bankruptcy-avoidance ombudsman. Still, the resolution of insolvency cases, especially the significant ones, whether in Saudi Arabia or elsewhere, often took place outside the bankruptcy

system. This can be explained by political and cultural factors, ranging from face saving when leading political figures and prominent citizens are involved, to limiting the damage to a country's economy and reputation. Indeed, a strong stigma is still attached to the notion of iflas. One such example is the Kuwaiti Souk Al-Manakh crash in 1982, which still reverberates today. Following frenzied speculation in the unofficial Kuwaiti stock market using postdated checks valued at the time at $100 billion, the government stepped in with an ad hoc legislation intended to contain the damage. The legislation, known as the Difficult Credit Facilities Resettlement Program essentially bailed out a large chunk of the insolvent investors.

When modern Islamic Finance appeared in the mid-1970s, scant attention was paid to the questions of insolvency and debt restructuring. In its original form, Islamic Finance was supposed to be based on equity, through partnerships such as mudaraba or *musharaka*, as opposed to debt. The mudaraba (commenda partnership) involves two parties: the financier or *rabb al-mal* who brings the money, and the agent or mudarib who actually runs the partnership. In early Islam, trading caravans were financed according to that principle: a rich merchant would provide financing for a younger, poorer, more energetic person who would be willing to go on a long trading voyage and make business decisions as agent for the rabb al-maal. In this partnership of funding and effort, the two parties would share profits and losses according to a pre-agreed ratio. The founding fathers of Islamic finance envisioned a system based on the double mudaraba principle, which would have extended the partnership ideal to both sides of the balance sheet. On the liability side, the depositor is the financier and the bank is the agent; on the asset side of the balance sheet, the bank is the financier and the entrepreneur (the borrower in conventional finance) is the agent. Under such an equity-based system, the bank is essentially a venture capitalist. When ventures fail, both parties lose all or part of their contribution to the partnership: the financier loses all or part of his investment, and the agent receives little or no compensation for his effort.

But in practice Islamic finance did not really function that way. More accurately, on the liability side of the balance sheet, Islamic banks still operate by and large on the basis of a mudaraba logic, but the foray into profit-and-loss sharing on the asset side was a failure from the start. It is easy to understand why. Most new ventures fail, and by linking its fate to such new ventures, the bank puts itself, and its depositors, at great risk. Banking is significantly different from venture capitalism. The banker wants his loan repaid (and for that reason he will ask for a collateral that is unrelated to the venture being funded), whereas the venture capitalist, starting from the assumption that most of his investments will fail, wants as many of them as possible to be successful, so as to turn a profit. The different logics of the two businesses explain why successful venture capitalists are seldom former bankers—they are more likely to be former entrepreneurs. With the relative failure of the equity-based model, Islamic banks moved to a different model of banking, based on replicating much of what conventional banks do, albeit via Islamic contracts. *Murabaha* became the dominant activity of Islamic banks, and debt therefore came to assume a greater role than was initially anticipated. Still, for most of its short history, modern Islamic finance paid scant attention to insolvency and its consequences.

Some ten years ago, the *sukuk* phenomenon started in earnest. The word *sukuk* is the plural of sakk, a promissory note from early Islam, which is at the origin of the word "check." It is usually translated as "Islamic bonds" or more correctly "Shari'a compliant investment certificates." In the past decade, the market experienced a spectacular rise, although a slowdown occurred in recent years as a result of two factors: one was the decline in demand by global investors as a result of the 2008 global financial meltdown; the other was the statement by leading Islamic scholar Sheikh Taqi Usmani to the effect that most *sukuk* may not after all be shari'a compliant, which raised new worries among issuers and investors.

There were also instances of *sukuk* failures and quasi-failures, which brought to the fore matters of insolvency, bankruptcy and restructuring. On November 25, 2009, the financial community was stunned when the government of Dubai asked the creditors of Dubai World (a major government-owned conglomerate) for a 6-month standstill. The focus was specifically on the Nakheel *sukuk*, the largest ever issued, which were due to mature on December 14 of that year. Default was narrowly averted as Abu Dhabi came to the rescue in the last minute. During that three-week period, the value of those *sukuk* fluctuated wildly, and the uncertainty attracted a new class of investors, particularly global hedge funds. While the spotlight was on Dubai, much smaller *sukuk* defaulted elsewhere – in Saudi Arabia (Saad group *sukuk*), Kuwait (Investment Dar *sukuk*) and Houston (East Cameron Partners).

The rapid growth of *sukuk* coincided with the recent oil boom, at a time when the possibility of default was not foremost in the minds of issuers and investors. The failures and other difficulties brought to light underlying ambiguities that had been ignored. Little thought was given to the substance of those *sukuk* and to what would happen in the case of default. The prevailing assumption was that the *sukuk* were "asset-backed," meaning that their holders had claims to specific assets. In reality, the nature of the collateralization was different: *sukuk* holders had claims only on the cash flows generated by the assets, not to assets themselves. In other words, the *sukuk* were "asset-based" and not "asset-backed."

The enforcement of *sukuk* contracts and their liquidation in the case of default were shrouded in ambiguity. The 237-page Nakheel prospectus, rather than clarifying matters, added to the uncertainty. It stated for example that "judicial precedents in Dubai have no binding effect on subsequent decisions." The *sukuk* were by definition shari'a compliant but *sukuk* issuers, and Dubai in particular, targeted two groups of investors: those looking for Islamic in-

struments, but also the community of global investors. To reach the latter, they positioned themselves at the cutting edge of global finance, and adopted most features of conventional bonds. Indeed, reading the *sukuk* prospectuses, one gets the feeling of hasty cut-and-paste jobs. As I mentioned, certain shari'a scholars, included those who had initially approved the *sukuk*, had second thoughts once they realized the implications of the fine print.

Here are some examples of the confusion related to potential claims. First was the assumption that Dubai as an Emirate would be responsible for the debts of companies it owned, such as Dubai World. Statements following the request for a standstill showed that this was not the case. Then there was the matter of the physical asset underlying the *Nakheel sukuk*, a strip of undeveloped waterfront property belonging to the emirate and valued, in 2006, at $4 billion. Some creditors now say that the property actually consists of a seabed, worth considerably less. Another question is that of enforceability. Under Dubai law, no debt owed by the ruler or the government can be recovered by taking possession of the government's assets. Not surprisingly, the prospectus notes, usefully, that bondholders have no guarantee of "repayment of their claims in full or at all."

There are also a number of jurisdictional matters. Despite their Islamic character, the Nakheel *sukuk* are governed by English law. Within the emirate itself, there are multiple jurisdictions (the United Arab Emirates, the Dubai Emirate and the Dubai International Financial Center). Decree No. 57 whose purpose was to restructure the debts of Dubai World, added to a confusing patchwork of laws, institutions and jurisdictions. Legal battles are thus being fought on multiple fronts.

It is easy in this context to lose sight of the ways in which the Islamic logic on subjects such as financial distress, insolvency and debt restructuring differ from prevailing practices in global finance. The outcome-oriented, conciliatory approach advocated in the Islamic tradition stands in sharp contrast to the process-oriented, winner-take-all approach of global finance where "gaming the system" is the principal objective. Consider for instance the notion of "strategic bankruptcy" where companies seek bankruptcy protection not because they are insolvent but because it would reduce their debt and strengthen their position vis-à-vis creditors. The best-known practitioner of that art may be Donald Trump who in some subsidiaries bearing his name has used the bankruptcy weapon against creditors. This would fly in the face of Islamic principles considering that it is a great sin not to pay one's debt when one can afford to. There are also countless differences on matters of punitive damages, hierarchies of claims and claimants, and many other matters. Fully understanding those differences and structuring *sukuk* accordingly will be the next major challenge of the Islamic finance industry.

## DISCUSSION

Chibli Mallat Comments

There is a huge divergence about what Islamic law has to say about bankruptcy and how the modern world, both the Muslim world and the West, organize bankruptcy. There was no concept of bankruptcy in *fiqh*/classical Islamic law, merely insolvency (*iflas*). The absence of a distinction between commercial and non-commercial entities, the absence of joint-stock companies, and then the complicated dimension of Islamic finance which started with *mudaraba* and was then waywarded into *musharaka*; all of these categories are being displaced and it has resulted in three big bankruptcy cases involving billions of dollars and lawsuits being filed by investors globally. I have been involved in the Saad case. I found it very interesting that British courts were asking very pointed questions about classical bankruptcy law in Islamic law, whereas it is dealt with in Saudi Arabia in a very different way. Thus we have a situation where Islamic law is more sought after in its classical dimension elsewhere than in the countries where it is supposed to be. I asked the governor of the Lebanese central bank, which comparatively had done better than banks in the West, how he managed to avoid the crisis. He said, "If things go wrong, who do you sue?" I think this is a good question across the board. Unfortunately, it is also a very good question considering what is going on now in the Islamic *sukuk* world, which is that these arrangements are so complicated, overblown, and tortured that the fine print tends to be the dominant dimension. There is very little collateral to rely on so the good faith lender and investors are finding themselves on the wrong side of the law. At the same time, creativity in loans its quite dangerous because it never corresponds to what you expect. There is a very interesting decision of the UAE Supreme Court based on the *hadith* that when there is intentional delaying by one person who is capable of repaying a debt, there is no reason why a penalty like interest or a late fee cannot be imposed. The court used this idea to actually support the request for interest by saying that when someone can pay and is being willfully late in paying, there is no particular reason why he or she shouldn't be penalized in the form of interest. There are interesting discrepancies looking at the tradition and the use of it by modern courts.

Umar F. Moghul Comments

My perspective comes as a practitioner thinking about the shari'a as a body of principles creating and promoting justice or fairness broadly. I am also coming from the perspective that Islamic transactional law and New York or Delaware transactional law are not all that different. I actually see quite a bit of parallel and very little contradiction between them, besides the critical preference for debt under US laws, particularly tax laws.

To study this subject of bankruptcy and insolvency, both in the shorter term and longer term, it would be worthwhile to take a look at Islamic law and its legislative jurisprudence. That is, how law is enacted and derived by the jurists, how it is made, if there are outright contradictions that are irresolvable between the two systems (US laws and Islamic law), and if we can implement some of Islamic law by relying on local law to create more predictable outcomes in dispute resolution – and outcomes more in line with shari'a-based dispute resolution. I don't think it is reasonable to put an entire law into a contract or even a dozen contracts that would dictate how a dispute within the transaction would be resolved, or a bankruptcy or insolvency issue within the transaction would be resolved, but certainly the parties are hoping when they transact in the U.S. that their instruments will simply be enforced as written. That is the goal. As lawyers, that is what you want to see happen. We can talk about whether or not the goals are appropriate or the transaction structure is appropriate from an economic point of view (in light of Islamic law) and maybe we can get into *fiqh* debates based on that as well. We now have defaults in the Islamic residential mortgages in the US as well, which has some positive consequences; across the board we see courts deciding the disputes or foreclosure matters as if the transactions were secured, conventional financing. From the financiers' perspective, that's what they want to see happening, but at the same time we see the "underwater" problem among the *musharaka* (Islamic) mortgages, which is a particular oddity.

We worked on a transaction a few years ago on the outset of the credit crisis that was interesting. It was a leveraged acquisition by an Islamic bank based in the gulf of a Silicon Valley based technology company. As the transaction was moving forward, the crisis was beginning and worsening, so we kept hitting obstacles along the way when the client was short of money. At one point, the conventional bank providing an Islamic facility was unwilling to provide a certain decently sized amount so an Islamic bank stepped in to provide debt on an Islamic basis and became a second lien holder. Those of you familiar with finance know that then comes the inter-creditor agreement, which is a phenomenal problem given what Islamic legal-financial jurisprudence expects and what U.S. banks expect. What I think is happening in Islamic finance vis-à-vis conventional finance is, if we say that conventional finance is about the identification and transfer of risk, that the Islamic parties are perhaps not able in some cases or willing in others to take on and share the sort of risk that classical jurisprudence requires of them in order to be entitled to a profit, namely a market or asset risk, what can we ask or expect? Can we expect, for example, an Islamic provider of real estate mortgage financing to have a pool of talents to evaluate the sort of required risk across hundreds of local markets? Will shari'a boards continue to be so pragmatic, flexible, and accommodating on issues of risk sharing and ownership - all of which have an effect on the downside of transactions? Will Islamic finance be willing to take on more substantive ownership as we saw in the East Cameron case with the true sale?

To say more on East Cameron case, this is probably a junk *sukuk* offering out of an oil field producer in Louisiana. Going into bankruptcy, what is interesting for at least the lawyer in me is that the issuer says we did all this structuring and made it Islamic just to say it is Islamic when it isn't actually—the *sukuk* holders do not have recourse to the assets or an ownership interest in the assets. The judge then said that there was a true sale opinion that there was a sale of the assets and that the court would hold that there was a transfer of the assets to the *sukuk* holders. Here you have the issuer relying on the Islamic finance market to obtain capital and now turning around and saying it is not really Islamic, and this is not something that is unique to the East Cameron case. A US judge then is resolving the dispute in a manner, at least in this respect, where the result is consistent with Islamic law. This is then structured and adjudicated as an asset-backed and not merely an asset-based *sukuk*. That is a victory in many respects for certain proponents of asset-backed financing.

Muddassir Siddiqui Comments

As Professor Warde mentioned, Islamic finance is new. During the late 60s and early 70s, Muslim economists and scholars were searching for Islamic alternatives to interest-based financing and banking. Their main focus was on *mudaraba* and *musharaka*, which were among the better known Islamic financing tools in the books of *fiqh*. Initially, banks experimented with two-tiered mudaraba, in which the Islamic bank and depositors served alternatively as the mudarib and the *rabb al-maal*.

This experiment did not work for several reasons. Firstly, all banks were licensed to operate under central banking laws and regulations. They had to strictly follow the limits on the type of activities permitted to banks. Engaging in a full-fledged *mudaraba* or *musharaka* was not the type of activity permitted to banks. Secondly, tax laws also created an uneven playing field in some jurisdictions. Thirdly, banks were not equipped to micromanage and control the numerous SMEs which they financed as *rabb al-maal*. As a result, most clients who received financing from banks under the *mudaraba* reported losses. In the absence and negligence of the mudarib, the IFI, as *rabb al-*

*maal*, had to bear those losses. Since IFIs did not receive any profits from borrowers (*mudaribs*) there was no profit to distribute to depositors (*rabb al-maal*). For these reasons and others, two-tiered mudaraba proved to be commercially unsustainable model for Islamic banking.

The practical solution came in the form of *bay' bi-thaman aji*l (BBA) with a mark-up over the spot price. BBA allowed a merchant to charge more than the cash price by allowing the buyer to pay the purchase price at a later date. This mode of financing was adopted as the *murabaha* contract around 1976 and subsequently became very popular in the Islamic banking world. The BBA was accepted by the majority of scholars, many holding the view that a BBA sale was not an ordinary cash sale but a deferred payment sale with a premium for time allowed for the payment of the purchase price. All in all, the *murabaha* model provided a shari'a-compliant mode of financing which could be used by Islamic banks at a level playing field with the competing conventional market. The basic *murabaha* framework was then replicated in other contracts such as Islamic forward leases, finance leases, diminishing partnerships, *Salam*, various parallel contracts, *sukuk* and so on. These contracts were developed to meet a variety of financing needs of the shari'a-compliant investors and consumers.

Many reservations and disappointments are expressed by observers of the short history of the development of Islamic finance products due to their apparent functional equivalency with conventional financing. One of the sources of confusion is in the way in which the time value of money (TVM) Principle has been incorporated and integrated into modern Islamic financing contracts. Modern Islamic financing turns every financing arrangement into a trade contract. The Islamic finance investor (IFI or *rabb al-maal*) and its customer are made to act like buyers, sellers, lessees, lessors, builders, partners, principal, agents and so on. The contracts they sign are not financing contracts. The financing is always a by-product of two or more trade relationships. In all these contracts the difference between the lower cost of acquiring the item and the higher price realized by passing it on to the customer represents the return of the IFI. However, unlike the real merchants in the original BBA (*bay' bi-thaman ajil*) contracts, the IFIs, who are not merchants, make only one profit – the profit from financing. The IFI has neither the margin nor the setup to meet the obligations which are imposed by law on sellers, lessors and builders, etc. To mitigate their risks, IFIs either disclaim or assign these obligations and warranties to the original source from where the item was acquired. However, there are other liabilities that may fall into the category of strict liabilities that cannot be disclaimed by the IFI under local laws or the shari'a principles.

Through reading many cases that have so far been litigated in courts around the world, I have found that in almost all cases, the courts have struggled to reconcile the substance and form of the contract. Was it a sale, lease, construction or partnership contract or a financing arrangement between the parties?

In one case involving a *murabaha* contract in a U.K. court, the customer tried to avoid his obligation to pay his *murabaha* debt, alleged that the diamonds sold by the IFI to the customer were defective. The question whether the IFI was a seller and thereby responsible for the quality of the diamonds sold or a financial intermediary determined whether the IFI was entitled to receive the *murabaha* debt. In numerous BBA cases in Malaysian courts, the determination of the amount due to IFI in a 20 or 25 year *murabaha* financing, which ended earlier as a result of the default of the customer within a short period of signing the *murabaha* contract, depended on whether the contract was literally a deferred payment sale contract or a financing arrangement. If it were a sale contract, the total unpaid *murabaha* debt (including the IFI's cost as well as unearned profit from financing) would be owed by the customer to the IFI. If it were a financing arrangement, the IFI would be entitled to the unpaid *murabaha* cost (the unpaid principal) only. In Dubai, the determination by the court whether a lease-to-own contract was an operating lease or an installment sale contract, determined the identity of the actual owner of the property (the IFI or its customer). This in turn determined the equitable distribution of the proceeds of the house between the IFI and its customer. If the court held the contract as the operating lease contract, the IFI would have held to be the owner of the whole house despite the fact the customer has paid substantial numbers of installments leading up to his ownership, leaving only few unpaid installments as a result of the financial distress. The court, despite the title of lease-to-own, re-characterized the contract as an installment sale. In Saudi Arabia, the determination of the proper venue (the Board of Grievances or Saudi Arabian Monetary Agency Committee for the Settlement of Banking Disputes) depended whether a dispute arising from a commodity *murabaha* contract was a commercial dispute or banking dispute. In the UAE, many financial institutions that have financed the purchase of apartments and villas under forward lease contracts are asked by their customers to return the down payments they have paid due to the failure of the IFI in delivering the property on promised date. IFIs have financed the partial construction in the form of progress payments made to unscrupulous builder who have abandoned the projects. However, the contracts which the IFIs have signed with their customers are construction contract (the IFI being the builder) and have failed to deliver the property on the agreed time. The customers on the other hand are under the constant threat of going to jail because the IFIs have received from them post-dated checks for the payment of rents. The IFI would want to recover the amount of financing they have already made to an unreliable and un-reputable builder chosen by their customers. As financiers, they feel they are owed these money notwithstanding the builders chosen by their customers have abandoned the project.

The confusion that exists today results from the way the mandate of the verse 275 of Chapter 2 of the Quran was imbedded and integrated in the Islamic finance contracts by financial intermediaries. There were two possible

means to comply with the shari'a mandate of TVM Principle: "Time value of money is permissible if it is an integral part of trade but not when it arises from a loan". One means was to turn every financing arrangement into multiple buy and sell contracts by requiring the IFIs to act as merchants, sellers, lessors and builders and their customers to act as buyers, lessees and partners, etc. The other possible way was to write contracts in which the TVM Principle is fully observed without distorting or dressing up the true nature of relationship between all parties to an Islamic financing. A sale contract between the seller and the customer and a financing contract between the IFI and the customer tied together in such a way that the financing and trade will go together from the inception to the end of the financing relationship. This would have preserved the shari'a principle of financing as well as gotten rid of the confusion, dissatisfaction, cost and risks associated with the use of synthetic contracts. Those shari'a scholars, who accepted the TVM Principle, must have been concerned that it would easily lead to the adoption of the conventional financing methods. Those who did not believe in the TVM Principle resorted to preserve the original form and turned the IFIs into traders and merchants.

With the experience and knowledge gained during the last two decades, we should now revisit whether the approach adopted earlier has led us to a path that would be hard to sustain. In addition to the credibility concerns, which are at the heart of an ethical system premised on divine values, we will face additional challenges, as the industry needs a rational and logical system which will not conflict with other laws required to fulfill maqasid al-shari'a. Islamic finance is only a segment of many laws needed for the well-being of human community, local or international. The harmony and standardization between various laws can only exist if they are consistent with the reality and meet the natural expectations of all parties to a contract. There is a need for the development of a sound basis which meets these concerns. With the benefit of knowledge and experience gained during the last two decades, the full participation of shari'a scholars, economists, lawyers, bankers and accountants would allow for the development of a system which will fulfill the maqasid al-shari'a (objectives) without distorting the true nature of the relations of parties to a trade financing agreement. These rational solutions are urgently needed for the long term, credible and healthy growth of the Islamic finance industry.

Kristen Stilt Comments

The East Cameron Partners (ECP) *sukuk* is extremely interesting. It has attracted attention as the first *sukuk* issuance to come from a U.S.-based entity, but this turned out to be an unfortunate first due to the company's bankruptcy. Interestingly, this was not an entity that sought to issue an Islamic bond. Rather, ECP, a father-and-son partnership with significant oil and gas leasehold assets, wanted to raise funds to buy out an equity partner and did not like the terms available on the conventional market. An investment banker based in Lebanon proposed the idea of an Islamic bond and ECP was amenable because it would look like traditional debt on ECP's accounts while offering the terms it was seeking, which were to avoid the lenders taking an equity stake in the partnership. The rating from S&P took two and a half months in part because it had never rated a *sukuk* before; the product ended up with a CCC+ rating. Some of the investors were not seeking a sharia-compliant investment, but rather merely found the economics of the transaction suitable for their investment portfolios.

What did ECP's bankruptcy and the related treatment of the *sukuk* holders teach us? First, there is now far greater attention to what a *sukuk* actually is. Is it a bond or something different? Many are asset-based and not asset-backed, for example. There is now a greater awareness that *sukuks* have many permutations. Second, what are the applicable laws for Islamic financial transactions and what are their sources? Conventional bankruptcy and other laws apply and Islamic transactions are never isolated from the rest of a country's legal system. In the ECP case, a major issue in the bankruptcy proceedings was figuring out how to treat the interests of the bondholders under U.S. law. Islamic bankruptcy laws have not been developed. The third issue this raises is how an Islamic bankruptcy law might develop, and who would use it? We could develop a modern Islamic bankruptcy law as an academic exercise, but that doesn't mean that it will be applied in practice in any jurisdiction. We also want to be cognizant of the fact, as has been pointed out, that classical Islamic insolvency dealt with individuals, not corporations, so any law we might develop would have to make a leap from individuals to corporate entities. There is nothing obvious about what a modern Islamic corporate bankruptcy law would look like. The fourth issue is what tribunals are appropriate for the resolution of bankruptcy cases when the company has either issued Islamic instruments or purports to operate according to notions of Islamic law? Regular courts are not always knowledgeable, but efforts to develop Islamic arbitration tribunals have not been very successful. Thus, even if we come up with an Islamic bankruptcy law, we do not know which tribunals would be competent—or willing—to apply it. To conclude, I want to suggest that we think about the issue of bankruptcy, and *sukuk* defaults in particular, in the larger context of the meaning and role of Islamic law in the contemporary world. The debates are actually very similar across subject areas, even as scholars of Islamic finance typically see their own issues as unique.

## BACKGROUND INFORMATION OF THREE DEFAULT CASES

East Cameron Partners is an American independent gas and oil production and exploration company based in Houston, Texas with significant gas reserves in East Cameron, Louisiana. East Cameron Partners had received financing from Macquarie Bank to buy a lease on the EC71 and EC72 oilfields from Conocophilips in 1992. After repaying their 50% equity in the asset, East Cameron Partners sought to buy back Macquarie Bank's equity in the lease. Bemo Securitization (BSEC) in Beirut, Lebanon suggested *sukuk* as an alternative mode of financing a buyout of the bank without the interest typically required. In 2006, East Cameron Partners became the first U.S. company to issue a *sukuk*. The arrangement involved the East Cameron Partners and the issuer SPV as the two parties to the *musharaka sukuk*, with quarterly repayments based on volume produced. In 2008, East Cameron Partners filed for bankruptcy. The issue then became whether the *sukuk*-holders actually owned a portion of the company's oil and gas royalties. East Cameron argued that there had been no real transfer of ownership of royalties and that the transaction was a loan secured on those royalties, implying that *sukuk*-holders would have to share royalties with other creditors in the event of liquidation. However, the judge ruled that *sukuk*-holders had invested in the *sukuk* certificates in reliance of their characterization as a true sale, though the case was left open for East Cameron to advance more arguments in support of its position

For further information:
http://www.failaka.com/downloads/SukukInsider001.pdf
http://www.cpifinancial.net/v2/print.aspx?pg=magazine&aid=1942
http://hbr.org/product/east-cameron-partners-the-sukuk-bond/an/910N14-PDF ENG?Ntt=East%2520Cameron%2520Partners
http://www.islamicfinancenews.com/HanbookPDF/32.East.pdf

Investment Dar (http://www.inv-dar.com/homeclient.aspxis) is a financial services company in Kuwait. In 2007, Investment Dar bought the majority shares of Aston Martin, the British sports-car producer. The arrangement involved a *murabaha* agreement between Bidco and WestLB as investment agents and a mudaraba agreement between WestLB and the syndicate banks, with an eight-year final maturity and five-year put option. In 2009, Investment Dar defaulted on a $100 million debt repayment and became the first company in the region to default on Islamic bonds. Afterwards, they agreed to change shari'a-compliant debt terms to revive *sukuk* sales. Interestingly, the issuance took place despite the fact that Kuwait has no *sukuk* or trust laws in place.

For further information:
http://www.cpifinancial.net/v2/print.aspx?pg=magazine&aid=2053
http://www.privateequityonline.com/Article.aspx?article=13569&hashID=8817E854DAC861C223F70CFA1E036CFB73FAD345
http://www.thenational.ae/business/banking/defaults-to-bring-sukuk-shake-up
http://www.ameinfo.com/96918.html
http://www.islamicfinancenews.com/pdf/doty07.pdf (page 63 and 64)

Saad Group (http://www.saadgroup.net/home/index.aspx) is a privately owned conglomerate in Saudi Arabia. To help finance property purchases and investments in London and Saudi Arabia, the Saad Group sold a five-year *sukuk* in 2007. The *sukuk* was structured around land leased in Saudi Arabia to Golden Belt 1 *Sukuk* Co., a special-purpose vehicle registered in Bahrain. Saad Group defaulted on a repayment of $650 million to Citicorp Trustee Co. Ltd, who agreed to dissolve the trust. The dissolution may allow investors to claim assets used to back the securities sold in 2007.

For further information:
http://www.bnpparibas.com/en/news/press-releases.asp?Code=BDEV-4QD3X&Key=BNP%20Paribas%20Completes%20Sukuk%20Bond%20issue%20in%20Saudi%20Arabia%20for%20Saad http://www.ft.com/intl/cms/s/0/b5b4ee7c-eedb-11db-8f38-000b5df10621.html#axzz1YVZ8sykl
http://archive.arabnews.com/?page=6§ion=0&article=97557&d=16&m=6&y=2007
http://www.zawya.com/Story.cfm?id=ZAWYA20070612054449&pagename=sukukmonitor&l=054400070612


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