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"Transaction of Sukuk in Dubai: Issues and Challenges"

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Transaction of Sukuk in Dubai: Issues and Challenges

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Abstract

Dubai has advanced development of laws governing the Islamic financial system, and specifically, the law governing *sukuk*. The Dubai Financial Services Authority (DFSA) was established as an 'integrated regulator for the Dubai International Financial Centre (DIFC), a financial free zone in the Emirate of Dubai'. As an international Islamic financial centre, Dubai is active in structuring the legal framework to facilitate the growth of the *sukuk* market. This paper addresses the legal system governing *sukuk* in Dubai. It mainly examines the adequacy of these laws through discussing a case study on several types of *sukuk*, including Nakheel Sukuk and Tamweel Sukuk. The discussion analyses the extent to which the nominate or innominate *sukuk* contracts actually comply with the substance of the contracts according to Islamic legal treaties. The structure of *sukuk* in Dubai faces the risk of re-characterisation due to the similarity of these structures with non-*shari'ah*-compliant contracts or controversial contracts in *shari'ah*. Analysis of cases and models of *sukuk* in Dubai evidences legal pluralism, legal uncertainties, and re-characterisation problems. Despite the technical, legal, and *shari'ah* issues, the solution to be provided must comply with the higher purpose of Islamic law. Ultimately, an approach towards the resolution of the issues evidently points to the pluralist approach in order to recognise the differences and to apply them as unity in diversity.

Keywords: *Sukuk, shari'ah*-compliant contracts, nominate contracts, re-characterisation, legal pluralism

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1.2 The Definition of *Sukuk* and Related Terms

The etymology of *sukuk* carries a diversity of meanings.[3] Hence, it is important to highlight several terms considered relevant to *sukuk*, and discussed in this paper.

1.2.1 *Sukuk*

Literally, *sukuk* (plural of *sakk*) is derived from the Arabic word '*sakka*', which means 'to strike violently'.[4] It is also known as '*sakkun*', which refers to a contract, deed, legal instrument, document, investment certificates, [5] or the book containing information on business transactions between contracting parties.[6] '*Sakk*' is also used as a document to prove the validity in marriage, or the report that contains the confession of the guilty party in court and/or as a transaction instrument in the market.[7] Based on the definition, the applicability of this instrument is wide. However, the growth in the Islamic Capital Market as one of the structures in the Islamic financial system has observed the use of this term in a more specific yet diversified context. The diversity of the applicability of *sukuk* in modern days can be traced through the definition adopted by various institutions.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines investment *sukuk* (*sukuk istithmar*) as:

> the certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services (in the ownership of), the assets of particular projects or special investment activity, however, this is true after

[3] Wizarah al-Awqaf wa-al-Shu' un al-Islamiyyah *Al-Mausu'ah al-Fiqhiyyah*, vol 27 (Wizarah al-Awqaf wa-al-Shu' un al-Islamiyyah 1992) 46-47.
[4] Deeb Al-Khudrawi, *A Dictionary of Islamic Terms* (2nd edn, al-Yamamah 2002) 241.
[5] R Wilson, 'Overview of the Sukuk Market' in Nathif J Adam and Abdulkader Thomas (eds), *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (Euromoney Books 2004) 3; Al-Khudrawi (n 4); Rohi Baalbaki, *Al-Mawrid* (Dar El-'Ilm Lil-Malayin 1995) 698.
[6] *Al-Mausu'ah al-Fiqhiyyah* (n 3).
[7] ibid.

> receipt of the value of the sukuk, the closing of subscription and the employment of funds received for the purpose for which the sukuk were issued.[8]

The AAOIFI Standards' definition of investment *sukuk* differs from the definition of shares and bonds related to debt.[9] This is evident in the last part of the definition. In fact, there are differences between *sukuk*, shares, and bonds.[10] However, critics claim that the transaction of *sukuk* has similarities with conventional bonds.[11] Hence, the International Council of Islamic Fiqh Academy ('the Council') in its 19th session held in Sharjah, proposed that *shari'ah*-compliant *sukuk*:

> is defined as a document or monetary certificate that is issued, in which it represents a common share in the ownership of property (real property, benefit from property, rights or a mix of real property, money and debts) that is in existence or founded on the return of subscription, and that is issued according in a Shariah-compliant manner *[sic]*[12]

This definition suggests the existence of an element of certainty in the transaction, whereby the certificate represents common shares in the ownership of various types of properties. If debt is included, it is ruled to be combined with real property to avoid the element of uncertainty.[13] This prohibition is aimed at avoiding conflict and dispute between the parties.[14] This definition shows similar the element of *sukuk*, as defined by AAOIFI and the Council, and excludes some types of instruments from being recognised as *sukuk*.

6.2 Legal and Regulatory Framework Governing *Sukuk* in Dubai

The Constitution of United Arab Emirates (the UAE) states that the Union shall have exclusive legislative jurisdiction in matters including ' … banks … civil and commercial transactions

[8] Standard 17(2) of the Accounting and Auditing Organization for Islamic Financial Institutions (2004/5) *Shariah Standards* (AAOIFI 2010) 298.
[9] ibid.
[10] The differences will be highlighted in section 1.2.5.
[11] For example, Saiful Azhar Rosly and Mahmood Sanusi, 'Some Issues of *Bay' al-'Inah* in Malaysian Islamic Financial Markets' (2001) 16(3) Arab Law Quarterly 273; MT Usmani, 'Sukuk and Their Contemporary Application' <http//www.failaka.com/downloads/Usmani_sukukApplications.pdf> accessed 23 February 2008.
[12] Decision Number 178 (19/4) <http://www.isra.my/index.php?option=com.content&view=article&id=357&itemid=195> accessed 11 October 2009.
[13] The mixed asset has raised some criticism that will be dealt in the next chapter.
[14] Ibn Qudamah, *Al-Kafi*, vol 3 (Al-Taba'ah wal-Nashr wa-Tawzi'wal-I'lan 1997) 23.

and company law … '.[15] The UAE Provisional Constitution provides *shari'ah* as a principal source of legislation.[16] However, in facilitating transactions in Islamic finance, Duabi International Finance Centre (DIFC) has its own legal and regulatory system based on common law, civil and commercial courts, and the financial services regulator, the Dubai Financial Services Authority (DFSA).[17] The law governing Islamic financial business is always reviewed and developed in accordance with the needs in the market. The issuance of *sukuk* is 'subject to the relevant Markets Law and it is associated to DFSA Rulebooks, including the DFSA Offered Securities Rules (OSR) Module, as well as NASDAQ Dubai requirements'.[18] The issuance of these laws suggests that Dubai is preparing a comprehensive legal infrastructure to facilitate the Islamic financial activities in its region. The extent to which the laws are adequate to facilitate *sukuk* transactions are discussed below.

6.2.1 The DFSA Rulebook: Islamic Finance Rules (IFR)

The DFSA Rulebook, called Islamic Finance Rules (IFR), applies to every person who carries on, or holds itself out as carrying on: (a) a financial service in or from the DIFC as in accordance with *shari'ah*;[19] (b) a domestic fund, which is operated or held out as being operated as an Islamic fund;[20] and (c) it also applies to a person making an offer in or from DIFC relating to an investment, which is held out as Islamic- or *shari'ah*-compliant.[21] The IFR also states several Rules on Islamic financial instruments and products.[22] The Rules explicitly states that the DFSA takes a 'substance over form' approach in the treatment of Islamic financial business.[23] This ruling suggests that DIFC looks at the purpose of the transaction instead of the form. This is in line with the approach by the classical jurists and the majority of contemporary

[15] Constitutional Amendment No 1 of 2003, art 121.
[16] WM Ballantyne, 'The States of the GCC: Sources of Law, the Shari'a and the Extent to which it Applies' (November 1985) 1(1) Arab Law Quarterly 11.
[17] DFSA, 'The DFSA's Approach to Regulating Islamic Finance in the DIFC' <http://www.dfsa.ae/Documents/Islamic%20finance%20docs%20for%20upload/DFSA%27s%20approach%20to%20regulating%20Islamic%20finance2.pdf> accessed 29 August 2011; Bhambra (n **Error! Bookmark not defined.**); N Al-Shaali, 'Developing Islamic Capital Markets: New Challenges and Opportunities for International and Islamic Financial Centers' (Paper presented in London Sukuk Summit 2008, 25 June 2008).
[18] Thani (n **Error! Bookmark not defined.**) 18, 7-24; 'NASDAQ Dubai is the region's international exchange and operates according to the highest of international regulatory standards, and provides a first-class listing and trading environment': 'A Fast Track Guide to Listing Sukuk on NASDAQ Dubai' <http://www.nasdaqdubai.com/products/docs/Guide%20to%20Listing%20Sukuk.pdf> accessed 20 December 2011.
[19] IFR, s 1.1.1(a).
[20] IFR, s 1.1.1(b).
[21] IFR, s 1.1.1(c).
[22] IFR, s 2.4.
[23] IFR, s 2.4(2).

scholars.[24] However, are there any specific provisions or laws that govern the substance of the contract? This aspect is analysed in the discussion of the prevalent Dubai *sukuk* laws.

DIFC Law No 13 of 2004 was enacted on 16 September 2004 and was subsequently amended by DIFC Laws Amendment Law 2005, DIFC Law No 2 of 2005 on 19 April 2005, DIFC Laws Amendment Law 2007, DIFC Law No 2 of 2007 on 15 February 2007, DIFC Laws Amendment Law DIFC Law No.1 of 2010 on 2 May 2010; DIFC Laws Amendment Law, DIFC Law No. 7 of 2012 on 23 December 2012; and DIFC Laws Amendment Law, DIFC Law No. 1 of 2014 on 21 August 2014. This Law is an addition to the provisions of the Regulatory Law 2004 and the Markets Law 2004.[25]

The governance clause available to comply with Shariah is the requirement to appoint *Shari'ah* Supervisory Boards:

> An Authorised Firm or Authorised Market Institution with an endorsed Licence authorizing it to conduct Islamic Financial Business shall appoint a Shari'a Supervisory Board. The DFSA Board of Directors may make Rules prescribing the appointment, formation, conduct and operation of a Shari'a Supervisory Board.'

These clauses explicitly mention that the *shari'ah* compliancy aspect is to be decided by the *Shari'ah* Supervisory Board. Therefore, this Law is presumed silent on the substance of the *shari'ah* nominate and innominate contracts. Thus, to what extent the presumption is true is discussed next.

6.2.2 Markets Law

Markets Law 2012, previously Markets Law 2004. hereinafter the 'Markets Law', does not expressly deal with the substance of the nominate contract. However, the clauses generally state the principles that form the basis of Islamic and ethical transactions. For example, the prohibition against being involved in a fraudulent transaction provides:

[24] See the discussion in Chapter 2.
[25] DIFC Law No 13 of 2004, art 8.

> A person[26] shall not, in the DIFC or elsewhere, directly or indirectly, engage or participate in any act, practice or course of conduct relating to Investments that the person knows or reasonably ought to know:
>
> results in or contributes to, or may result in or contribute to, a misleading appearance of trading activity in, or an artificial price for, Investments; or perpetrates a fraud on any person.[27]

Furthermore, the Markets Law also prohibits misleading or untrue statements,[28] deceptive conduct, [29] or statements. [30] it only provides the general principles of Islamic business transactions without specifically stating the types of nominate or innominate contracts, or the characteristics of these contracts. There is no clear provision governing the substance of the contracts, save for several clauses that indicate the ethical investment and general clauses, which state that the transaction should be looking at in the substance of the transaction and not merely at the form or the name of the contract.[31] If the guidelines on the offer made are taken as the substance of the contract, this Law still only provides the general rule on the purchase and sale contract, but not the underlying contract in *sukuk*. For example, the offer made should comply with the Offered Securities Rules (OSR), and the information should assist the investors in making their decisions. The provision requires the Prospectus to contain information relating to the assets and liabilities, financial position, profits and losses, and prospects of the offeror or issuer or both, as well as the nature of the securities, and the rights attached thereto.[32]

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[26] 'A person in this Law interpreted as a person includes any natural person, body corporate or body unincorporated, including a company, partnership, unincorporated association, government or state' Schedule No 1 in Rules of Interpretation in the Markets Law.

[27] Markets Law , art 36.

[28] Markets Law , art 37..

[29] Markets Law, art 38.

[30] Markets Law, art 39.

[31] This view is originally based on the views of majority jurists who interpret the contract by looking into the meaning instead of the form of the contract itself as discussed in Chapter 2.. Therefore, this view needs to be expressed in a proper law if 'tidy and satisfactory organization of the judiciary' is desired to be implemented, as suggested by Schacht – that is, through the approach of 'the states of modernist orientation'. This approach is through 'enacting codes derived from Western models and organizing tribunals capable of administering them': J Schacht,'Islamic Law in Contemporary States' (Spring 1959) 8(2) The American Journal of Comparative Law 134, 133-147. This approach also provides what is called 'certainty' in the laws as preferred by many investors and market players to ensure the confidence in dealing in certain transactions in a particular region; H Bhambra,'Supervisory Implications of Islamic Finance in the Current Regulatory Environment' in S Archer and RAA Karim (eds), *Islamic Finance: The Regulatory Challenge* (Willey Finance 2007) 198, 198-212.

[32] Markets Law, art 15(2).

Further analysis of the OSR indicates that it is to resume the purpose of the Markets Law.[33] The Rules specify the procedures for offering securities. There are flexibilities in the OSR regarding how the offers are to be made. For example, the OSR allows either the offer or acceptance to be made by the offeror or offeree.[34] This is in line with the Markets Law, which provides that a party is regarded as making an offer of securities if he:

(a) makes an offer which, if accepted, would give rise to a contract for the issue of securities by him or by another person with whom he has made arrangements for the issue of securities; or;

(b) makes an offer or invitation in relation to an issue or sale of Securities in circumstances prescribed by the OSR.

However, there is no ruling related to other forms of contract. Given this gap, the issue arises as to whether the UAE Civil Code, as the base law of the UAE, is applied. Brendel, Barrette and El-Riachi assert that the application of the law is only made where there is no specific legislation, or if the specific legislation is silent on that issue. However, they further argued that the review of the Civil Code must be made in connection with UAE Federal Law No 18 of 1993, issuing the Commercial Code.[35]

However, to what extent this claim is true. The International Finance Law Review (IFLR) reported that DIFC has its own jurisdiction, separate from the civil and the commercial laws of Dubai and the UAE.[36] This is affirmed by Tarbuck and Lester, whereby DIFC is 'independent of the civil and the commercial laws of the UAE'.[37] Therefore, the UAE Civil and Commercial Codes do not apply to DIFC. This premise suggests that there are loopholes in the DIFC laws since these laws do not have provision for the substance of the contract. Therefore, this gap in

[33] OSR, r 1.1.1.
[34] OSR, r 2.2.1(1).
[35] 'The Civil Code provisions apply where there is no specific legislation to the contrary and where specific legislation is silent on a point in issue'. ' … the Civil Code must be reviewed in connection with the UAE Federal Law No. 18 of 1993, issuing the Commercial Transactions Code of the UAE, as amended (the 'Commercial Code'), which applies to certain contract that meet the requirements of a "commercial contract". Procedurally speaking, the UAE courts are governed by the UAE Federal Law No 11 of 1992, issuing the Code of Civil Procedure of the UAE, as amended (the 'Civil Procedure Code')': NR Brendel, AL Barrette and W El-Riachi, 'The Availability in the UAE of Liens to Secure Payment under Construction Contracts' [2010] Arab Law Quarterly 24, 311.
[36] P Bourke and others, 'Watch and Learn: The First Steps of a New Common Law Jurisdiction in Dubai' (*IFLR* August 2007) 48, 48-49.
[37] A Tarbuck and C Lester, *Dubai's Legal System: Creating a Legal and Regulatory Framework for a Modern Society* (Motivate Publishing 2009) 11.

the law governing the substance of the contract needs to be remedied by appropriate available laws and/or regulations to facilitate transactions.

The current laws governing sukuk in Dubai

The new amendment to this law governing sukuk in Dubai stated in the DFSA Rulebook on Islamic Finance Rules (IFR/VER13/12-18). The relevant rules stated in Rules 7 related to Offers of Islamic Securities as below:

7. OFFERS OF ISLAMIC SECURITIES

7.1 Application

7.1.1 (1) Subject to

(2), this chapter applies to any Person who Offers Islamic Securities in or from the DIFC.
(2) A Person making Offers of Islamic Securities in or from the DIFC must comply with the requirements in the Markets Law 2012 and the MKT module except to the extent otherwise provided in this chapter.

(3) Islamic Securities, for the purposes of this chapter, do not include Units of an Islamic Fund.

Guidance

1. The issue of Securities is not an activity that constitutes a Financial Service. Therefore, the activities such as the issue of Shares, Debentures (Sukuks) or Warrants do not attract the Financial Services prohibitions in the Regulatory Law 2004. However, the Offer of Securities is an activity to which the Markets Law 2012 and the MKT module apply. Under the Markets Law 2012, a Person making an Offer of Securities in or from the DIFC is subject to numerous disclosure requirements, unless exempt.

2. Offers of Islamic Securities which are Units of a Fund are not subject to the requirements in this section because the Collective Investment Law 2010 and CIR module provide for such activities to be regulated.

Chapter 6 of this module sets out additional requirements that apply to the Fund Manager when Offering Units of an Islamic Fund.

3. The definition of the term Islamic Securities is in the GLO module.

7.2 Contents of a Prospectus for Islamic Securities

7.2.1 Deleted.

7.2.2 Deleted.

7.2.3 Where the relevant Securities are held out as being in accordance with Shari'a, the Prospectus relating to those Securities must include:
(a) details of the members of the Shari'a Supervisory Board appointed by the Issuer who have undertaken the review of the relevant Securities;
(b) details of the qualifications and experience of each of those Shari'a Supervisory Board members;
(c) in the case of issuance of Sukuks:
(i) the opinion of the Shari'a Supervisory Board in respect of whether the Securities are Shari'a compliant;
(ii) a description of the structure of the underlying transaction and an explanation of the flow of funds; and
(iii) where applicable, the disclosures required by the Shari'a Standards published from time to time by AAOIFI in respect of investment Sukuks; and
(d) instead of the statement required under MKT Rule 2.5.1(3)(d), a prominent disclaimer in bold, on the front page of this Prospectus as follows:

"The DFSA does not accept any responsibility for the content of the information included in the Prospectus, including the accuracy or completeness of such information. The liability for the content of the Prospectus lies with the issuer of the Prospectus and

other Persons, such as Experts, whose opinions are included in the Prospectus with their consent. The DFSA has also not assessed the suitability of the Securities to which the Prospectus relates to any particular investor or type of investor and has not determined whether they are Shari'a compliant. If you do not understand the contents of this Prospectus or are unsure whether the Securities to which the Prospectus relates are suitable for your individual investment objectives and circumstances, you should consult an authorised financial advisor."

7.3 Continuing disclosure relating to Islamic Securities

7.3.1 The Reporting Entity responsible for Islamic Securities must, without delay, disclose to the markets and the DFSA details of any changes to the membership of its Shari'a Supervisory Board, the identity, qualifications and experience of any new Shari'a Supervisory Board members and the identity of any Shari'a Supervisory Board members who resign or are dismissed.

7.3.2 A Listed Entity with Islamic Securities admitted to the Official List of Securities must make the required market disclosures in accordance with the requirements under section A2.1 and comply with the other continuing obligations under section A2.2.

6.2.3 International Standards and Guidelines

An issue that needs to be addressed relates to the incorporation or adoption of the international standards in DIFC. The DFSA has been regarded as a world-class regulator based on the international's best practice and experience.[38] Dubai also is an active member of the IFSB and the AAOIFI.[39] However, the application of IFSB and AAOIFI standards in Dubai depends on the extent of their suitability.[40] This statement suggests that the application of the international standards is not mandatory in Dubai. The extent to which the standards are suitable in Dubai's jurisdiction were analysed in the prospectus and the terms and conditions of *sukuk* issued in Dubai.

[38] DFSA (n 17).
[39] ibid.
[40] ibid.

6.3 Types of *Sukuk* in Dubai

Dubai is one of the leading jurisdictions in the issuance of *sukuk*. Thani observes that the market for *sukuk* will grow further due to the increase in the 'infrastructure projects and plans across the region'.[41] There are various types of *sukuk* that have been issued in Dubai.[42] Among the *sukuk* issued are claimed to be *ijarah sukuk,*[43] *mudarabah sukuk,* [44] and *musharakah sukuk.*[45] However, those *sukuk* issued are not actually named after these contracts; rather they are named after the issuing companies.

A major risk of legal uncertainty is the re-characterisation of *sukuk* contracts into other forms of contacts, which to a certain extent, may lead to issues of *shari'ah* compliance. Re-characterisation issues impacting *sukuk shari'ah* compliance depend on the extent to which there is non-compliance and contradiction of the characteristics of the original Islamic contractual rules and principles. This matter is further studied in Nakheel *sukuk* case study.

Nakheel *sukuk* are one of the controversial *sukuk*, which are claimed to be structured according to the Islamic nominate contract of *ijarah.*[46] However, some scholars tend to re-characterise these *sukuk*. For example, Salah claimed this structure as comparable to a conventional lease contract.[47] However, he also assertes that the underlying structure basically implements the AAOIFI Standard, that is *sukuk manfa'a-ijarah.*[48] This assertion and the structure of these *sukuk*, as depicted in the figure below, is critically analysed in this paper. The principal activities of these *sukuk* are to develop infrastructural companies based in Dubai, UAE. Their portfolio includes waterfront developments, such as the Palm, the World, and Dubai

[41] Thani (n **Error! Bookmark not defined.**) 18.

[42] IIFM, *Sukuk Report 1st Edition: A Comprehensive Study of the International Sukuk Market* (*IIFM* 2011) <http://www.iifm.net/customer/MailDocument .aspx?DocID=14> accessed 27 July 2011; Tabreed Sukuk (*CPI Financial Tuesday, April 15 2008* <http://www.cpifinancial.net/v2/print.aspx?pg=news&aid=161> accessed 10 October 2011; 'Deal of the Year' (*Sorouh Real Estate Company*, *Islamic Finance News*) <http://www.islamicfinancenews.com/pdf/doty08.pdf> accessed 10 October 2011; Nakheel *Sukuk* (*Islamic Finance News* <http://www.islamicfinancenews.com/HanbookPDF/5.Nakheel.pdf> accessed 11 August 2011; DEWA Sukuk (*AME info*) <http://www.ameinfo.com/137178.html> accessed 10 October 2011.

[43] For example Nakheel *Sukuk* issued by Nakheeel Group, DEWA Sukuk, Tabreed *Sukuk* issued by The National Central Cooling Company (Tabreed); and Tamweel *Sukuk* issued by Tamweel PJSC; IIFM, *Sukuk Report* (n 42).

[44] Aldar *Sukuk* issued by Aldar Properties PJSC and Sorouh Sukuk Deal of the Year (Sorouh Real Estate Company) (n 43); .

[45] DMCE Sukuk; Rafe Hanef, 'From "Asset-Backed" to "Asset-Light" Structures: The Intricate History of Sukuk' (2009) 1(10) ISRA International Journal of Islamic Finance 115.

[46] O Salah, 'Dubai Debt Crisis: A Legal Analysis of the Nakheel Sukuk' (2010) 4 Berkeley J Intl L Publicist 21, 19-32.

[47] ibid.

[48] ibid; AAOIFI Standard No 17/3/2.

Waterfront. The assets comprise leasehold rights for a term of 50 years over certain land, buildings, and other properties at Dubai Waterfront. The recognition of leasehold rights of the assets suggested the adoption of *ijarah,* according to *Shafi'i* and *Hanbali* jurists.

The parties in the contract of *ijarah* are different from the traditional *ijarah* practice. The 10 parties of these *sukuk* comprised Nakheel Development 2 Limited as the issuer, Nakheel World LLC as the seller, Nakheel as the lessee and the purchase undertaking obligor and servicing agent, Dubai Islamic Bank PJSC as the security agent. The issuer also acted as the trustee and agent. In addition, Deutsche Bank AG, London Branch acted as the transaction administrator, principal paying and exchange agent, transfer agent, replacement agent, and calculation agent. Lastly, the Deutsche Bank Luxembourg SA acted as the registrar. The involvement of these parties suggests some differences with the original *ijarah* contract. In this situation, the structure of the *sukuk* meant that a party had to play the various roles aforementioned. It is these various roles of the parties that caused differences to the original *ijarah* contract. One entity, such as a lessee, may also represent another entity, depending on its role. The existence of these parties and their various roles suggest a change in the market needs of modern transactions.[49] These circumstances indicate that modern practice is at variance with traditional practice. Thus, it needs different treatment to ensure that the involvement of the parties in the contract is not jeopardised and that their rights are preserved. However, the remedy to this situation is yet to be widely prevalent. In reality, Nakheel *sukuk* experienced several problems, especially with regards to guarantee.

[49] M Korotona, 'Conflict of Interests in the Conventional and Islamic Securitisation' (2012) 8 J Islamic St Prac Intl L 67, 68.

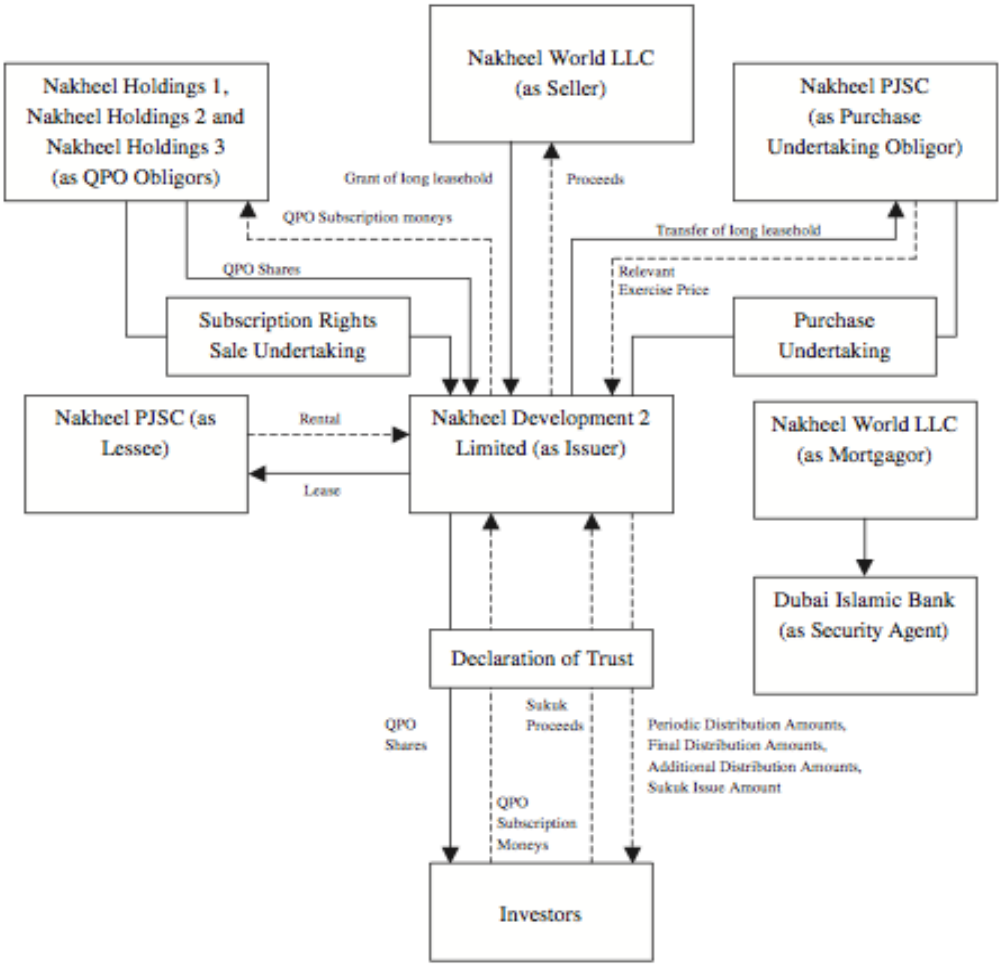

Figure 6.3.1.1.1: The *Ijarah* Model of Nakheel *Sukuk*[50]

6.3.1.2 The Legal and Shari'ah Issues in Nakheel Sukuk

According to Salah, the transaction in Nakheel *sukuk* raised several legal problems in Dubai. He classified these problems as relating to internal conflict concerning the issues of guarantee,

[50] Offering Circular Nakheel Sukuk 2008, (*NASDAQ*) 7 <http://www.nasdaqdubai.com/resources/2008/3/11/be8190d7-76fc-4f58-bf31-669116537ca4/Offering%20Circular.pdf> accessed 5 December 2011.

recognition of property rights, and recognition of the law of trust in Dubai.[51] Even though Salah claims that the problems are rooted in the law governing financial transactions in Dubai, intensive analysis highlights some *shari'ah* issues.[52] This is because, to a certain extent, the non-satisfaction of the requirement of substance of contract in the formal legal system and in Islamic *Shari'ah* impedes the recognition of these contracts, and could therefore affect the dispute resolution process.[53] The judge adjudicating a case of this nature will have no reference and will tend to decide according to the law with which he is familiar, such as the governing English law stated in the contract. This situation could lead to the issue of re-characterisation as in previously decided cases.[54]

6.3.1.2.1 The Problems of Re-Characterisation in Nakheel Sukuk

In this structure, the problems of re-characterisation involved the real transfer of the assets or sale and the transfer of the leasehold right.[55] To constitute true securitisation, the asset should be transferred and should acquire the status of a true sale.[56] In the structuring of Nakheel *Sukuk*, the transfer of the underlying assets from Nakheel Holdings 1 to Nakheel SPV was not proven to have taken place.[57] The *sukuk* assets were leased to Nakheel Holdings 2, as stated in the lease agreement. [58] This is because the transfer in these *sukuk* was not the transfer of proprietary rights, but the transfer of leasehold rights to the underlying tangible assets for a period of 50 years.[59] The proprietary right was still with Nakheel Holdings 1, while the leasehold right to the underlying tangible assets was leased back to Nakheel Holdings 2. According to Salah, this structure is *sukuk manfaah-ijarah* from an Islamic perspective.[60] In fact, the structure suggests similarity with the AAOIFI Shariah Standard because of the recognition of the selling of usufruct of a future asset. This structure recognised the certificate holders as the joint owners

[51] Salah (n 46) 28.
[52] Rashid Khalid Alkhan, *Islamic Securitization: A Revolution in the Banking Industry* (Miracle: Kuwait Finance House 2006) 25; AK Hassan and M Kholid, 'Bankruptcy Resolution and Investor Protection in Sukuk Markets' <http://www.qfinance.com/regulation-best-practice/bankruptcy-resolution-and-investor-protection-in-sukuk-markets?page=1> accessed 10 January 2012.
[53] ibid.
[54] For example, the case of *Beximco Pharmaceuticals Ltd & ors v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19; *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd and others* [2004] 4 All ER 1072; *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Germs NV & Ors* [2008] EWCA Civ 389.
[55] Salah (n 46) 28.
[56] See the discussion in Chapter 2.
[57] Salah (n 46) 28.
[58] Salah (n 46) 28.
[59] ibid.
[60] ibid.

of the undivided usufructs to share the risk and the benefit.[61] However, this structure could also be re-characterised as lease and leaseback.[62] This dilemma is rightly described by Alkhan when he stated:

> The problem that arises with the securitization of *Ijarah* is the misconception of what is being securitized specifically and what the certificate should represent a proportionate ownership in the specific asset with all its rights and obligations rather than just representing the holder's right to claim a certain amount of rental only. The laws of Shariah prohibit securitization when the certificate only represents the right to claim money without being assigned to any kind of ownership, risk and reward of the asset must lie with the owners. This is due to the fact that rent is actually a debt payable by the lessee to the lessor. Trading with such a certificate is similar to trading with money, which is prohibited in Islam. Actually, monetary obligation can be traded but only for an equal amount which, in turn, defeats the purpose of securitization and the creation of a secondary market. Therefore, one must not confuse or misconstrue the purpose of *Ijarah* certificates which are solely to represent the holder's proportionate ownership in the leased asset rather than only having the right to enjoy a part of rent.[63]

Salah argued that this transaction is clear evidence of the differences between a sale, that involves real transfer of assets to the other party, and lease. However, Salah, and Hassan and Kholid observed that 'leasehold interest is not perceived as real right under the relevant laws of the UAE as applicable in the Emirates of Dubai'.[64] Based on this observation, the structure is open to 'proprietary risk' because leasehold right is not seen as a real right or property right under UAE law as applicable in Dubai. This limitation affects the right of the investors to claim and enforce the law.[65] However, Termini and Vogel were of the view that property in Dubai can be owned and registered.[66] Even for a lease, either registered or not, the contract is valid

[61] AAOIFI Standard 17/5/1/5/2(a).
[62] ibid.
[63] Alkhan (n 52).
[64] Salah (n 46) 28; Hassan and Kholid (n 52).
[65] Hassan and Kholid (n 52).
[66] RJ Termini and JH Vogel, 'Property Law in the UAE' (2007) <http://www.pattonboggs.com/ViewpointFiles/290b522b-c728-400a-ac39-11ff72715596/AmericanLawyer_PropertyLawintheUAE_Vogel.Termni.10.07.pdf> accessed 14 March 2014.

and enforceable by the parties.[67] This view is similar to that of Abraham, Long, and Henderson when they observed the status of the laws regarding the proprietary right in Dubai.[68] In fact, it is evidenced in the Law of Real Property DIFC Law No 4 of 2007, which sets out the right for other GCC countries or foreigners to own land in Dubai. However, the right is only in respect of designated land;even if a lease is considered as valid and enforceable.[69]

In the Nakheel *sukuk* case, the assets involved in the transactions were certain land, buildings, and other properties at Dubai Waterfront.[70] Therefore, whether these properties were covered as designated areas is another issue that needs to be identified. In the case of *Tamweel Ijarah Sukuk*, the properties were located in designated areas, and therefore the foreigners may be granted 'the right to freehold ownership or usufruct/leasehold rights over real property for a period not exceeding 99 years'.[71]

Re-characterisation of these *sukuk* inadvertently turn them into conventional instruments of leasehold rights. This re-characterisation also brings elements of a controversial contract in the Islamic law, including the risks that need to be foreseen in the event of default of these *sukuk.* The structuring of these *sukuk* to lease and leaseback suggests similarity with the controversial contract of *bay' 'inah.*[72] Therefore, there are possibilities that these *sukuk* also might face a *shari'ah* compliance issues.

6.3.1.2.2 The Issue of Uncertainty in the Governing Laws in the Prospectus (Offering Circular)

There are also issues of uncertainty in the governing laws in the Prospectus (also termed the 'Offering Circular'). The Prospectus stated:

> The Declaration of Trust, the Transaction Administration Deed, the Agency Agreement and the Certificates will be governed by English law and subject to the non-exclusive jurisdiction of the English Courts. The Purchase Agreement,

[67] Real Property DIFC Law No 4 of 2007.
[68] R Abraham, S Long and S Henderson, 'Real Estate Finance in Dubai' (*IFLR*, 2008) <http://www.iflr.com/Article/1984124/Real-estate-finance-in-Dubai.html> accessed 15 March 2014.
[69] Real Property DIFC Law No 4 of 2007.
[70] Offering Circular of Nakheel Sukuk, 10.
[71] Tamweel Prospectus 157 (*ISE*) <http://www.ise.ie/debtdocuments/Tamweel10264.pdf> accessed 17 April 2012 ('Tamweel *Ijarah* Prospectus 2007').
[72] This part has been discussed in Chapter 5 and the same justification given when the opponent of *bay' 'inah* justified the similarities of *Ijarah* structure of lease and leaseback to this contract.

> the Lease Agreement, the Service Agency Agreement … will be governed by the laws of the UAE as applied by the Dubai courts. The courts of Dubai have non-exclusive jurisdiction to hear all disputes relating to each of those documents.

However, this Prospectus further stated:

> The Conditions and certain of the *[sic]*Transaction Documents are governed by English law. Certain transaction documents are governed by UAE law. No assurance can be given as to the impact of any possible judicial decision or change to English or UAE law after the date of this Offering Circular, nor can any assurance be given as to whether any such change could adversely affect the ability of the issuer to make payments under the Certificates.[73]

Thus, Hassan and Kholid criticised this prospectus, stating that it 'contains ambiguous provisions'.[74] They suggested that 'the issuers should provide a clear and definitive provision in their prospectus and agreement'.[75] The ambiguity is due to the indication in the Prospectus that: ' … once an English court had given judgment, executing it in Dubai might be difficult because it is not possible to enforce measures on property owned by the government or the ruling family'.[76]

However, one may ask whether the certainty provision in the Prospectus is an accurate representation of the legal system. For example, if the Prospectus provides false assurance by hiding the real problem, this may amount to deception, which is clearly prohibited. Therefore, by highlighting the risks indicated in the clause in a prospectus, the buyer will be able to make an informed choice whether to subscribe to the *sukuk* or not.[77] This will also create a problem related to *shari'ah* compliance as English Law may not be compliant with *shari'ah* and English courts are not qualified to check for *shari'ah* compliance.

[73] Offering Circular of Nakheel Sukuk, 47.
[74] ibid; Hassan and Kholid (n 52).
[75] ibid.
[76] ibid.
[77] The importance of disclosure was highlighted by IOSCO to ensure the investors are given material information in order for them to make an informed decision: 'Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products by Executive Committee of the IOSCO' (*SC*, September 2008) http://www.sc.com.my/main%20asp?pageid=6288&menuid=3147newsid=&linkid=7type= accessed 24 July 2009.

McMillen corroborated these problems when he observed several legal uncertainties in the process of structuring and issuing *sukuk* in Dubai.[78] The legal uncertainties include:

(a) the conditions in the UAE mortgage market 'with limited historical performance'. (There are laws governing mortgages and some scholars view them as untested applications.[79]);

(b) the problem with interpretation, application, and enforcement of relevant laws in the UAE, which is described by McMillen as having 'significant uncertainties', especially regarding the recent issue of bankruptcy and collateral securities laws that have not been the subject of judicial proceedings;

(c) the *shari'ah* requirement for the seller-lessor to retain structural maintenance during the term of *ijarah*, which was considered an economic issue that is required to be addressed;

(d) the risk of bankruptcy to the title holders of the properties;

(e) 'incomplete title registrations issues with respect to the properties due to a new title registration process implemented in the new registration authority (Dubai Land Development)';[80]

(f) 'geographic concentration of the properties';

(g) the issue of variable rate adjustment, which is not in harmony with *ijarah* and *sukuk*;

(h) the usage of a post-dated cheque for payment and the transfer of this cheque;

(i) the lack of control to limit rental increase in the new legislation because of the 'high rates of inflation' in Dubai economy; and

(j) consent issues re assignment of rent payments.

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[78] JT McMillen (n 55) 754.
[79] ibid.
[80] 'This issue happened in the case of Golden Belt Sukuk or Saad Sukuk, whereby the *sukuk* documents stipulated that following a dissolution or default event, the *sukuk* holders would have recourse to so-called trust assets only. However, the ownership is clear under the Chairman of Saad … Even the prospectus declared a purchase agreement between originator and SPV about sukuk asset (leasehold interest) against the price equivalent to the total amount of *sukuk*. However, there are no regulations in UAE regarding the registration of these rights with Dubai Land Department': S Wijnbergen and S Zaheer, *Sukuk Defaults: On Distress Resolution in Islamic Finance* (Duisenberg School of Finance,Tinbergen Institute Discussion Paper TI 13-087/VI/DSF 57, 2013) 35 <http://www.tinbergen.nl> accessed 20 December 2014.

These issues are some examples of cases that indicated the instances of overruling by the higher legal system, namely, the federal structure in the UAE, when the federal law may supersede Dubai law.[81] The 'multi-jurisdictional structure' of the transaction further raises the issue of enforcement of foreign judgments and awards.[82] However, this issue might be resolved through the application of the governing laws enforced in DIFC. Despite the critics ascribing the terms 'uncertainties and unpredictability' to Islamic law, Islamic law itself has in fact been providing many solutions to unprecedented and specific cases given its ability to fulfil human legal needs and its pragmatic nature. There are also several Dubai asset-backed *sukuk* 'designed to minimize significant legal uncertainties'.[83] The issue of uncertainty arose due to the untested security structure in the Dubai courts – for example, in the case of Tamweel *Sukuk*, which is discussed in section 6.3.3 below.

McMillen highlighted the legal issues by making an analogy with the conventional transaction.[84] The legal consequences of transacting with conventional instruments are more or less the same.[85] Therefore, the legal risk that is faced by the conventional instrument could become a lesson to the *sukuk* market players and drafters to equip the legal framework in order to mitigate the legal impediments. Moreover, *sukuk* may have significant risk in terms of

[81] For example, Ballantyne, on the sources of law in the GCC: 'In Dubai the Sharia Courts have residuary jurisdiction in all but the few specific matters in which jurisdiction has been granted by Decree to the Civil Courts; in particular, the latter has jurisdiction in banking matters and any financial transactions in which a bank is involved, so that any consideration of the legality of interest would come within their province. Article 14 of the Dubai Courts Law 1970 provides that the Civil Court shall exercise its power in accordance with (i) the laws in force in the Emirate; (2) the provisions of the Sharia; (3) the rules of custom and usage, provided the same be not in conflict with the laws, or public order or morals; and (4) the rules of natural justice, law and equity. Thus we again find the admission of general principles of law. In the absence of any Dubai legislation on banking, the Civil Judge finds himself directed towards the Sharia by this Article, yet in practice, the Dubai Courts have in the past taken the view that interest is not illegal. The extent to which Dubai may be affected by trends emanating from Abu Dhabi is difficult to assess, but it is worth restating that Dubai as recently as 1979 reinforced its own autonomous system of courts by establishing a Dubai Supreme Court of Appeal (Law 2/1979) to replace the old Appeal Court'(Ballantyne (n 16) 14, 3-18.

[82] 'The expansion of international commerce transactions in recent years has brought about in all countries an increase in disputes involving foreign elements. Some disputes are settled amicably. Many, however, are resolved in courts or arbitral tribunals. In both cases the judgment or award rendered needs to be executed. If the judgment debtor has assets within the jurisdiction of the country in which the judgment has been rendered, it can be executed therein. However, a problem exists where the assets of the judgment debtor are located in a country other than one in which judgment was rendered. In this case, the issue of enforcing the judgment in a foreign jurisdiction arises. As a result, an increasing importance has been attached by practitioners and scholars to the mechanisms by which judgments are recognised and enforced beyond the boundaries of the State in whose courts a matter is for adjudication'.': HMS Al-Mulla, 'Conventions of Enforcement of Foreign Judgments in the Arab States' [1999] Arab Law Quarterly 33.

[83] McMillen (n 55) 754.

[84] ibid.

[85] The issues in conventional law, such as proprietary issue and enforcement of laws and awards, are also highlighted by JD Dalhuisen, *Dalhuisen on Transnational and Comparative Commercial, Finance and Trade Law* (3rd edn, Hart Publishing 2007).

shari'ah recognition, given the variance in the interpretations of the jurists in various schools of thought. Therefore, the pluralist approach is one possible approach to address this issue, as will be discussed later.[86]

6.3.2 Tamweel *Istisna' Sukuk*[87]

Tamweel *Sukuk* 2008 were claimed to be structured according to the underlying contract of *istisna'*. These *sukuk* were issued on 12 May 2008 by Tamweel *Sukuk* Limited, a firm incorporated in the Cayman Islands. The structure of these *sukuk* can be seen in the figure below.

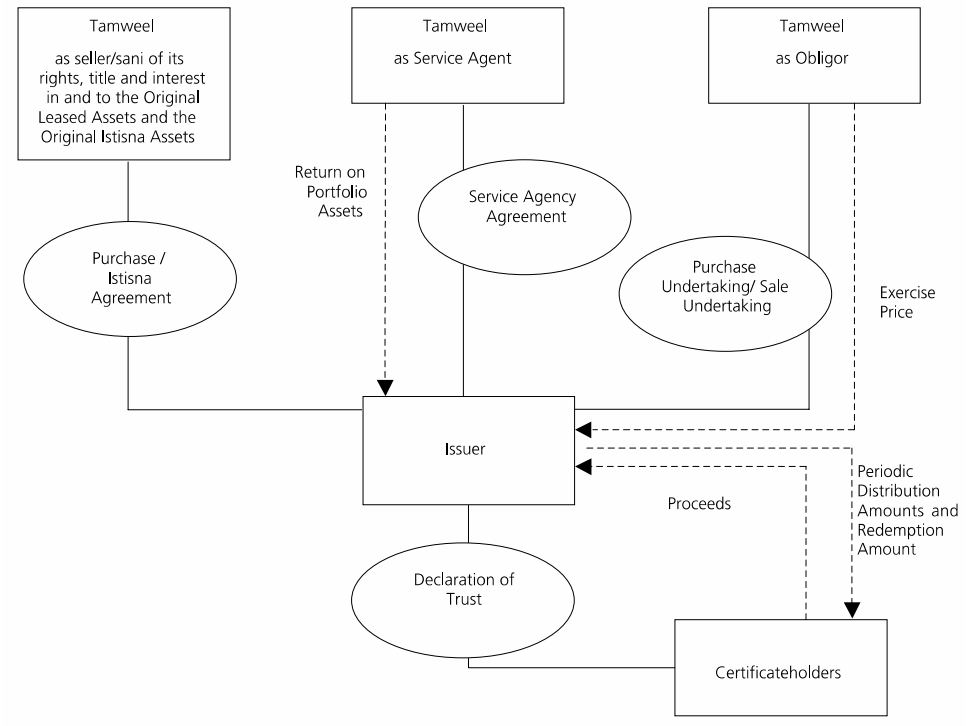

Figure 6.3.2: The *Istisna'* Model of Tamweel *Sukuk*[88]

[86] AH Ab Halim, M Zahraa and MA Ab Halim, 'Legal, Regulatory and Shariah Issues on Sukuk: A Pluralist Approach' (Proceeding International Seminar on Muamalat, Islamic Economics and Finance 2009 (SMEKI '09), organised by Universiti Kebangsaan Malaysia (UKM), 20-21 October 2009) 553-572.
[87] Tamweel Prospectus (*ISE*) <http://www.ise.ie/debtdocuments/Tamweel10264.pdf> accessed 17 April 2012 ('Tamweel *Istisna'* Prospectus 2008').
[88] Tamweel *Istisna'* Prospectus 2008.

There were 10 parties in this contract: Tamweel PJSC, Tamweel *Sukuk* Ltd, the certificate holders, the joint lead managers and bookrunners, the delegates, the principal paying agent, the calculating and replacement agents, the registrar, and the transfer agents.[89] Tamweel *Sukuk* Ltd acts as the issuer, and the trustee of the trust assets acts as certificate holders. The trustee was to delegate certain powers, duties, and authorities in order to enforce the trust assets.

In these *sukuk*, Tamweel PJSC acted as the seller, the service agent, and the obligor. As the seller, Tamweel PJSC was to sell its rights, title, and interest in a portfolio of *istisna'* assets to the trustee according to the terms of the *istisna'* agreement. The selling price was 'equal to no less than one third of the proceeds of the issue of the certificates'. Tamweel PJSC was also to be appointed as service agent to provide certain services to the trustee according to the service agency agreement. The purchase undertaking was to be executed by Tamweel PJSC in favour of the trustee in fulfilling its role as the obligor. Tamweel PJSC was to undertake the purchase of all of the trustee's rights, title, and interest in relation to the portfolio assets.

The trustee was then to purchase Tamweel PJSC's rights, title, and interest in the original leased assets in accordance with the purchase agreement dated on or about the closing date. The trustee was also to purchase Tamweel PJSC's rights, title, and interest in the original *istisna'* assets in accordance with the *istisna'* agreement.[90] The assets in this transaction were called 'portfolio assets', and they comprised the original leased assets and the original *istisna'* assets and any assets at any time, replacing the portfolio assets in accordance with the service agency agreement, including *shari'ah*-compliant income-generating assets.[91] The trust assets consisted of the trustee's rights, title, interest, and present and future benefit, in, to, and under, the portfolio assets, and the transaction documents. These also included all monies for the transaction and all proceeds of the foregoing.[92]

Tamweel PJSC, as the service agent, was to provide services to the trustee with respect to the portfolio assets.[93] Its role was to create a UAE dirham denominated account and to record the crediting of any reserve amounts in respect of the portfolio profit,[94] and if applicable, to re-

[89] ibid.
[90] Tamweel *Istisna'* Prospectus 2008' 4.
[91] ibid.
[92] ibid.
[93] Tamweel *Istisna'* Prospectus 2008.
[94] 'Portfolio profits means the amount by which all rental, sale proceeds or other income or consideration, damages, insurance proceeds, compensation, or other sums received by the Service Agent in connection with the Portfolio Assets (the Portfolio Revenues) exceed the aggregate of (i) Portfolio Revenues required to be reinvested in accordance with the terms of the Service Agency Agreement and (ii) any claims, losses, costs and

credit any advance incentive fee in accordance with the terms of the service agency agreement.[95] This amount was used to pay for the periodic distribution in the event that there was insufficient portfolio profit for such payment. The amount was to be paid into a profit reserve account to facilitate payment to the service agent as an incentive fee.

The purchase undertaking was to be executed by the obligor in these situations; (i) when the trustee delivers an exercise notice to the obligor specifying the dissolution redemption date; (ii) when the trustee delivers an exercise notice to the obligor specifying a rating downgrade redemption date; and (iii) when the trustee delivers any exercise notice to the obligor, and the notice must be delivered not later than 3 and no earlier than 30 business days prior to the maturity date. Upon the delivering of the notice by the trustee, all of the trustees' rights, title, and interest in and to the portfolio assets will be valued at the exercise price, according to the terms and conditions of the purchase undertaking. This situation suggests an uncertainty concerning portfolio assets since the term of the agreement stated:

> All of the Trustee's rights, title and interest in and to the Portfolio Assets on an 'as is' basis (without any warranty express or implied as to condition, fitness for purpose, suitability for use or otherwise and if any warranty is implied by law) at the Exercise Price, on the terms and subject to the conditions of the Purchase Undertaking.[96]

It was further provided that the trustee shall sell all of its rights, title, and interest in and to the portfolio assets on 'as is' basis at the exercise price subject to the conditions of sale undertaking. The execution of sale was undertaken by the trustee in favour of Tamweel dated on or about the closing date. Pursuant to this sale undertaking, the trustee was to sell all of its rights, title, and interest to the portfolio assets to Tamweel.

6.3.2.1 The Legal and Shari'ah Issues in Tamweel Istisna' Sukuk

There are several legal and *shari'ah* issues in these *sukuk*, including the issues of uncertainties in the assets, and uncertainties in the laws governing the transaction. For these *sukuk*, the parties were not only the manufacturer (*sani')* and the customer (*mustasni')* but various other parties

expenses properly incurred by the Service Agent in providing the services under the Service Agency Agreement ('Portfolio Liabilities'): Tamweel *Istisna'* Prospectus 2008 (n 87) 4.

[95] ibid.

[96] Tamweel *Istisna'* Prospectus 2008 (n 87).

were involved, such as the trustee, the issuer, the obligor, the service agent, and the certificate holders. The link between these parties is more like an agency relationship than an *istisna'*. This is evident in the terms and conditions of these *sukuk*, which stated:

> Payments and any delivery relating to the certificates will be made in accordance with a paying agency agreement dated the Closing Date (as amended or supplemented from time to time, the 'Agency Agreement' made between the Issuer, the delegate and the Bank of New York Mellon, acting through its London Branch as principal paying agent (in such capacity, the 'Principal Paying Agent' and, together with any further or other paying agents appointed from time to time in respect of the Certificates, the 'Paying Agents',) as replacement agent (in such capacity, the 'Replacement Agent' and, together with any further or other replacement agents appointed from time to time in respect of the certificates, the 'Replacement Agents') and as calculation agent (in such capacity, the 'Calculation Agent') and the Bank of New York (Luxembourg) S.A. as registrar (in such capacity, the 'Registrar') and as transfer agent (in such capacity, the 'Transfer Agent' and, together with any further or other transfer agents appointed from time to time in respect of the Certificates, the 'Transfer Agents'). References to the Delegate, the Principal Paying Agent, the Paying Agents, the Transfer Agents, the Replacement Agents, the Calculation Agent and the Registrar shall include any successor thereto in each case in such capacity.[97]

The contract is therefore, an agency contract that involves many parties. While these forms of contracts have been approved by Tamweel Fatwa & Sharia Supervisory Board as in compliance with the *shari'ah,*[98] there are several issues identified in these *sukuk.*

6.3.2.1.1 The Issue of Uncertainty of the Assets of Tamweel Istisna' Sukuk

[97] Term and Conditions of Tamweel *Istisna'* Prospectus 2008 (n 87) 20.

[98] The Tamweel's Fatwa & Sharia Supervisory Board consists of Dr Hussain Hamid Hassan, Sheikh Dr Mohammed Abdul Hakaim Zuair, and Sheikh Mohammed Abdul Razak El-Sedeiq: Tamweel *Istisna'* Prospectus 2008 (n 87) 17.

Meanwhile, the major issues are in terms of the assets concerning uncertainty of status and the transfer of the assets. The composition of the assets suggests that the types of asset could not be ascertained. This is evidenced in the Prospectus, which stated:

> In particular, the precise terms of the Portfolio Assets or the nature of the assets sold will not be known (including whether there are any restrictions on transfer or any further obligations required to be performed by Tamweel to give effect to the transfer of the rights, title and interest in and to the Portfolio Assets).[99]

This situation raises the issue of uncertainty regarding the subject matter of the contract. It suggests that there is a contradiction with the condition of *istisna'* contract. Even the transfer of these assets could not be ascertained. This Prospectus, in relation to the risk related to the transfer of assets, stated:

> No steps will be taken to perfect any transfer of such rights, title and interest or otherwise give notice to any lessee or obligor in respect thereof. Obligors and lessees may have rights of set-off or counterclaim against Tamweel in respect of such Portfolio Assets.[100]

This paragraph indicates uncertainty even in terms of the delivery of the subject matter of the contract. This matter is further exacerbated when the law itself is uncertain with regard to the transfer of the assets, as highlighted in the Prospectus:

> No investigation has been or will be made as to whether any interest in any Portfolio Assets may be transferred as a matter of the law governing the contracts, the law of the jurisdiction where such assets are located or any relevant law. No investigation will be made to determine if the Purchase Agreement or Istisna' Agreement will have the effect of transferring an interest in the Portfolio Assets. Accordingly, no assurance is given that any rights, title and interest in and to the Portfolio Assets has been or will be transferred to the Trustee.[101]

[99] ibid 18.
[100] Tamweel *Istisna'* Prospectus 2008 (n 87) 18.
[101] Tamweel *Istisna'* Prospectus 2008'.

This paragraph suggests the inclusion of the element of excessive uncertainty, as viewed by *Maliki* jurists,[102] and therefore it amounts to a contract that is not permissible according to Islamic law. This paragraph is also not in line with the AAOIFI Standard related to *istisna'* contract, which provides:

> A contract of *istisna'* is binding on the contracting parties provided that certain conditions are fulfilled, which include specification of the type, kind, quality and quantity of the subject matter to be produced. Moreover, the price of the subject matter must be known and, if necessary, the delivery date must be determined.[103]

6.3.2.1.2 The Uncertainties of the Laws Governing Tamweel Istisna' Sukuk

Legal uncertainty is the situation where there is uncertainty in the outcome of the law due to either the uncertainty of the legal system or the enforcement of the law itself in that particular region.[104] The Tamweel *sukuk* were concluded through many agreements. The paragraph in the Prospectus stated: 'the governing law for the declaration of trust, the agency agreement and the certificates are governed by, and will be construed in accordance with English law'.[105] However, the Prospectus also states: 'the purchase agreement and the *istisna'* agreement will be governed by the laws of the Emirate of Dubai and applicable Federal laws of the United Arab Emirates and subject to the jurisdiction of the courts of Dubai'.[106] The Prospectus also includes rulings on disputes of services as follows:

> … the Service Agency Agreement, the declaration of trust, the agency agreement, the cost undertaking and the purchase undertaking, Tamweel has consented to arbitration in accordance with the Rules of the International Chamber of Commerce if the Trustee so requires.[107]

Based on these provisions, the various governing laws could lead to the issue of conflict of laws. The Nakheel Prospectus provides that that under the current Dubai law, the courts

[102] See the discussion in Chapter 2.
[103] Shariah Standard No 11/2/2/1.
[104] For example, Thani (n **Error! Bookmark not defined.**) 26; SV Wijnbergen and S Zaheer, 'Sukuk Defaults: On Distress Resolution in Islamic Finance' (Duisenberg School of Finance, Tinbergen Institute Discussion Paper TI 13-087/VI/DSF 57) <http://www.tinbergen.nl> accessed 20 December 2014.
[105] Tamweel *Istisna'* Prospectus 2008 (n 87) 34.
[106] ibid 10.
[107] ibid 10.

examine the merits of the claim before enforcing the English judgment.[108] The court also may not observe the parties' choice of English law as the governing law of the transaction. Hence, there is risk of non-enforcement of the English judgment.[109]

This is evidenced in Federal Law No 11 of 1992, as amended (the Civil Procedure Code), article 235:

> (1) An order may be made for the enforcement in the UAE of judgments and orders made in a foreign country on the same conditions laid down in the law of that country for the execution of judgments and orders issued in the state.
> (2) An order for enforcement shall be applied for before the court of first instance within the jurisdiction of which it is sought to enforce, under the usual procedures for bringing a claim, and an enforcement order may not be made until after the following matters have been verified:
>
> (a) That the courts of the UAE had no jurisdiction to try the dispute in which the order or judgment was made, and that the foreign courts which issued it did have jurisdiction thereover in accordance with the rules governing international judicial jurisdiction laid down in their law,
>
> (b) That the judgment or order was issued by a court having jurisdiction in accordance with the law of the country in which it was issued,
>
> (c) That the parties to the action in which the foreign judgment was issued were summoned to attend, and were validly represented,
>
> (d) That the judgment or order has acquired the force of res judicata in accordance with the law of the court which issued it, and
>
> (e) It does not conflict with a judgment or order already made by a court in the State, and contains nothing to conflict with morals or public order therein.

This provision suggests that the judgment issued by the courts of England will not be enforceable in Dubai if the court in Dubai has the jurisdiction over the subject matter of that

[108] ibid.
[109] Offering Circular Nakheel (January 2008)

judgment.[110] Moreover, judicial precedent in Dubai has no binding effect upon the subsequent decision, which leads to more uncertainty during the dispute settlement process.[111] Therefore, to ensure the certainty of the law, the court should recognise the parties' choice of governing law in order to preserve the sanctity of the contract to the extent that justice is seen to be done.

Furthermore, English law is adopted as the governing law to the extent it is compatible with the Emirate of Dubai's law and public policy.[112] However, the Tamweel Prospectus stated that DFSA has no responsibility to determine whether the *sukuk* are *shari'ah*-compliant.[113] The Prospectus states:

> … in their view, the proposed issue of the certificates and the related structure and mechanism described in the Transaction documents are in compliance with Sharia principles. However, there can be no assurance as to the Sharia permissibility of the structure or the issue and the trading of the certificates and none of the Issuer, Tamweel nor the Joint Lead Managers make any representation as to the same. Investors are reminded that, as with any Shariah views, differences of opinion are possible. Investors should obtain their own independent Sharia advice as to the Sharia permissibility of the structure and the issue and the trading of the certificates.[114]

How about the treatment of *shari'ah* in English law? Based on previous decided cases, the English court does not recognise *shari'ah* laws in commercial practice.[115] The only way is to strengthen the contractual document in order to ensure that the court will preserve the sanctity of the contract between the parties.[116] However, the risk of re-characterisation should be anticipated because in the event of default, one party might intend to outwit the other and the

[110] Tamweel *Ijarah* Prospectus 2007 (n 71).
[111] Offering Circular Nakheel, 51.
[112] ibid 7.
[113] Tamweel *Istisna'* Prospectus 2008 (n 87) 17.
[114] Term and Conditions of Tamweel *Istisna'* Prospectus 2008 (n 87) 17.
[115] For example the case of *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd* 1 WLR 1784 (CA 2004) (UK). In this case, the Court held that there can be only one law governing enforceability of the provisions of the contract at issue and the law is the law of England and not both English and Shariah. Some cases were recognised by the court (for example, cases related to Muslim matrimonial cases); JR Bowen, 'How Could English Courts Recognize Shariah' (2010 7(3) University of St Thomas Law Journal 412-434.
[116] Laldin (n **Error! Bookmark not defined.**.

court will need to determine the intentions of the parties through proper legal documentation.[117] Indeed, these uncertainties could affect the rights of the parties in the contract.

6.3.3 Tamweel *Ijarah Sukuk*

Tamweel *Ijarah Sukuk* were issued on 25 July 2007. The figure below depicts the structure of the *sukuk*.

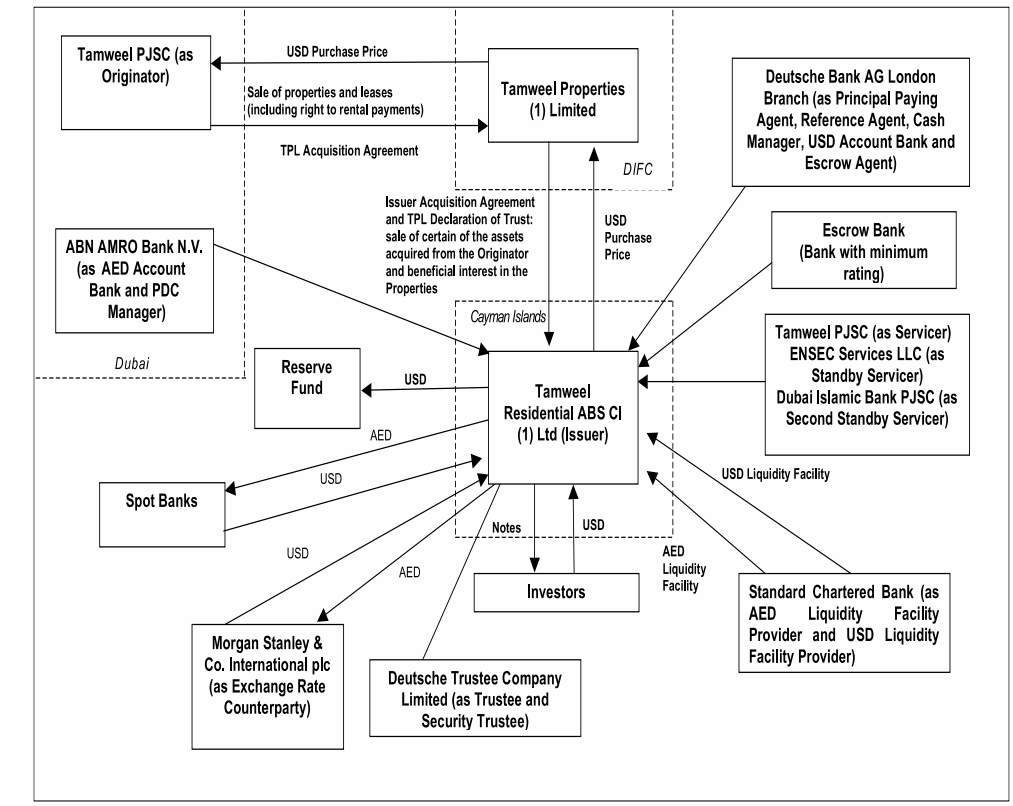

Figure 6.3.3: The *Ijarah* Model of Tamweel *Sukuk*[118]

There were numerous parties in these contracts.[119] The involvement of these parties suggests differences from the original *ijarah* contract, as *ijarah* basically involves only two parties: the

[117] See the example in the case of *The Investment Dar v Bloom Bank* [2009] EWHC 3545 (Ch), the case of *East Cameron Partners* 2008 Bankr LEXIS 3918, and the case of *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV and others* [2002] All ER (D) 171 (Feb).

[118] Tamweel *Ijarah* Prospectus 2007 (n 71).

[119] (1)Tamweel Residential ABS CI (1) Ltd as the Issuer; (2) Tamweel Properties (1) Limited (TPL) as the special purpose company; (3) Tamweel as the Originator and Servicer; (4) eNSEC Services as the Standby Servicer; (5) Dubai Islamic Bank PJSC as the Second Standby Servicer; (6) ABN Amro Bank as the Post Dated Cheque (PDC) Manager; (7) Deutsche Trustee Company Ltd acts as Trustee and Security Trustee; (8) Deutsche Bank

lessor and the lessee. However, in this transaction, the involvement of various parties suggests that the practice is not the same. In the Tamweel *ijarah sukuk* transaction, the originator was to sell the legal ownership title to the anticipated properties to Tamweel Property Limited (TPL)[120] pursuant to the TPL acquisition agreement.[121] Anticipated properties were the properties listed in Schedule 1 to the TPL acquisition agreement.[122] These properties were listed in the TPL initial request to purchase. Tamweel, considering TPL as its successor, was to assign and transfer its title in the anticipated properties and the leases. The transfer of these properties was also related to the transfer of its rights and obligations in the leases.[123] In each subsequent purchase date, the originator was to sell the legal ownership title to the anticipated properties listed in TPL's subsequent request to purchase. This was to be done if the terms and conditions were fulfilled with regard to the registration of the properties in the name of the originator, and pursuant to the TPL acquisition agreement and escrow agreement.[124] The titles to the anticipated properties and the leases related to the assets, the rights, and obligations were assigned and transferred to TPL. The assignment also was to be made to TPL for subsequent acquired assets, as defined in the acquisition agreement.[125] Consequently, TPL was to be legally entitled to the properties.

In addition, TPL was to become subject to the rights and obligations under and related to such leases and properties. The entitlement included the usufruct-related rights and rental payments under the leases. After entering into the TPL acquisition agreement, TPL was to enter the declaration of trust in favour of the issuer over the legal ownership title to the initial properties and the subsequent properties.[126] The dates of declaration of trust for each asset were made on

AG, London Branch as Principal Paying Agent and Deutsche International Corporate Services (Ireland) Limited as the Irish Paying Agent; (9) Deutsche Bank AG, London branch as the reference agent; (10) Standard Chartered Bank as the liquidity facility provider; (11) Morgan Stanley & Co. International plc as the Exchange Rate Counterparty Guarantor.

[120] 'Tamweel Properties (1) Limited is a private company with limited liability incorporated in the DIFC. This company is a special purpose company whose primary purpose is to acquire the legal ownership title to the Properties and other assets and rights it will purchase under the TPL Acquisition Agreement (including usufructory related rights including the rental payments under the leases relating to such properties) and to enter into the Transaction Documents to which it will be a party'.: Tamweel *Ijarah* Prospectus (n 71) 8.

[121] 'TPL Acquisition Agreement means the agreement so named dated on or about the Issue Date between Tamweel, TPL, the Issuer and the Security Trustee': Tamweel *Ijarah* Prospectus 2007 (n 71) 79.

[122] ibid 65.

[123] Ibid 7

[124] Escrow Agreement means the agreement so named dated on or about the Issue Date between the Issuer, TPL, the Originator, the Servicer, the Trustee, the Security Trustee, the Cash Manager, the Escrow Agent and the Escrow Bank ibid 68.

[125] ibid 65.

[126] 'Subsequent Properties means, in respect of each Subsequent Purchase Date, those Anticipated Properties that are listed in the TPL Subsequent Request to Purchase issued in connection with that Subsequent Purchase Date and are acquired by TPL on or about that Subsequent Purchase Date.': ibid 78.

or about the issue date, and each subsequent purchase date.[127] Pursuant to the issuer acquisition agreement, TPL was to assign to the issuer its rights to certain assets and rights of purchase under the TPL acquisition agreement on the issue date.

The proceeds of the notes were to be used by the issuer to pay TPL in relation to the purchase of the initial properties. TPL was also obliged to pay the amount to the originator for the purchase price of the assets, pursuant to the TPL acquisition agreement. In addition, the issuer was obliged to pay the escrow account because of the intended purchase of the other anticipated properties. The payment to the escrow account was made using the proceeds from the notes. The amount was to be released either to TPL for the purchase price of subsequent properties under the issuer acquisition agreement or payment made to the USD transaction account.[128] The main source of payments under the notes was the rental payments, such as the leases and revenue from the sale of the properties. Alternatively, the payment from the selling of the properties to the third parties might be used to pay the notes. The sources also included the expropriation payments from the properties and the insurance proceeds.[129] The amounts standing to the credit of the escrow account could also be used to redeem the notes in certain circumstances.[130] Subsequent to the issue date, Tamweel was to service the initial properties and purchase the subsequent properties and the leases in the agent capacity as lessor and issuer on behalf of TPL.[131] The issuer had the obligation to give the benefit of the rights and asset, pursuant to the TPL security agreement, to the noteholders or *sukuk*holders. The noteholders were to have the benefit of certain assets and rights as the underlying asset of security, granted by the issuer under the issuer security deed and the AED account pledge. The benefit of the security to the issuer was to be granted by TPL under the TPL security agreement.

Nonetheless, there were several legal and *shari'ah* issues pertaining to the structuring, issuing, and investing in Tamweel *Ijarah Sukuk*. The issues were *tanazul*, defining the relationship between the parties in the contract, and the uncertainties of the laws governing *sukuk*. In the case of *tanazul*, the Prospectus clearly stated the risks related to the Notes:

[127] 'Subsequent Purchase Date means each date which is 6 Business Days prior to each Distribution Date falling during the period from the Issue Date until the Subsequent Longstop Date.'- ibid 79.
[128] Tamweel Ijarah Prospectus 2007 (n 100) 7.
[129] ibid.
[130] ibid 11.
[131] ibid 8.

> The Notes may not be suitable investments for all investors; therefore each potential investor in the Notes must determine the suitability of that investment in light of its own circumstances. The conditions will provide that, prior to enforcement, payments to the Secured Parties will rank in the order of priority set out in the Excluded Amounts Priority of Payments (as defined in Condition 2) and the Pre-Enforcement Priority of Payments. In the Event that the Security for the Notes is enforced, payments to the Secured Parties will rank in the order of priority set out in the Post Enforcement Priority of Payments; no amounts will be paid to the holders of a class of Notes until all amounts owing to the holders of every class of Notes having a higher payment priority have been paid in full.[132]

The same Prospectus further stated the possibility of conflict between the classes of noteholders:

> The Trust Deed and the Issuer Security Deed contain provisions requiring the Trustee and the Security Trustee to have regard to the interest of the Noteholders as a whole with respect to all powers, trusts, authorities, duties and discretions *[sic]*of the Trustee and the Security Trustee in any particular case to have regard only to the interests of the holders of the highest class of Notes if, in the Trustee's opinion, there is or may be a conflict between the interest of the holders of the highest class of Notes and the interests of the holders of the lower classes or class of Notes. In having regard to the interests of the Noteholders, the Security Trustee shall obtain and be entitled to rely upon the Trustee's confirmation as to whether, in its opinion, any matter, action or omission is or is not in the interests of or materially prejudicial to the interests of the Noteholders or any class of Noteholders.[133]

The status, security, and priority of the notes are clearly stated in the Prospectus. The Notes represent 'direct, secured, and unconditional obligations of the issuer'.[134] The Conditions state:

[132] Tamweel Ijarah Prospectus 2007 (n 100) 23.
[133] ibid 24.
[134] Tamweel Ijarah Prospectus 2007 (n 100) 38 (Condition 2.1.1).

> An issue of Notes would, unless Noteholders were to agree otherwise, rank pari passu in relation to payments. A Noteholder, by its acquisition and holding of a Note, is deemed to agree that (as provided in the Conditions):
>
> The Noteholders of a class of Notes may agree to dispose of their right to receive payments under the Notes (including payments of principal which are derived from, inter alia, the Rental Payments) as they wish *[sic]*;
>
> The Noteholders of another class of Notes (being co-investors) may receive payments of a higher lower rate of Variable return, as the case may be; and
>
> In the disposition of such rights to receive payments, the Noteholders of one class of Notes may agree that their rights to receive payments under the Notes and the payments when made (but only such rights and payments) are reserved and used to enable the Noteholders of another class or classes of Notes to receive payments under the Notes (including payments derived from, inter alia, the Rental payments) in priority to them.[135]

According to this paragraph, priority is given to the higher-class noteholders over the other classes. Analysing this structure in the light of *ijarah* contract, the waiver of the right by the lessor to the rental payment, to prioritise to the higher class noteholders, could raise *shari'ah* issues. Waiver of the rights of the rental to the lessor amount to the denial of the rights of the lessor over the rental amount. This term contradicts the ruling on *ijarah* contract pertaining to the rental that should be paid to the lessor.[136] Therefore, the term 'deemed to agree' suggests that there is consent by the parties to waive their rights;[137] as these conditions seem to contradict the *shari'ah* ruling since the parties' rights are at risk. The jurists have laid down the freedom to stipulate the conditions in the contract; however, the conditions, as well as the contract, are valid if the conditions or the contract do not contradict *shari'ah*.

[135] ibid (Condition 2.1.2).
[136] See section 2.10.
[137] This consent might be argued as permissible on the basis of freedom of contract in Islamic law in line with the opinion of Ibn Taymiyyah, and the consent also might be justified according to the verse in the Qur'an which highlight the need to have the contract consented by the parties. However, in this context, when the consent will jeopardise the right of the parties in the contract, it will lead to unfairness and oppression which is not compliant with *shari'ah*.

The involvement of many parties in the contract has raised the risk of uncertainties in terms of liability upon default and risks of losses to the noteholders. This is evidenced in the Prospectus:

> the Issuer is party to contracts with a number of entities which have agreed to perform services in relation to the Notes … in the event that any party to the transaction documents or any party appointed by the Issuer under the terms of the transaction documents fails to perform any of its obligations under the transaction documents, the noteholders may be adversely affected.[138]

Furthermore, no parties 'assumed any responsibility or liability' to the issuer to monitor the performance of these entities.[139] Hence, this situation could lead to greater dispute in the event of default. This clause also contradicts the AAOIFI Standard related to the requirement to include the contractual conditions and the specific parties responsible for the loss.[140] In fact, this paragraph indicates the element of excessive uncertainties prohibited in the Islamic law.

The structuring of *sukuk* also raised the problem of uncertainties of the applicable law.[141] These uncertainties were due to enforced adaptation of foreign judgments, the change of Dubai's laws, and the unprecedented *sukuk* issues in the court of Dubai. These concerns are stated in the Prospectus as follows:

> Under current law, the courts of Dubai are unlikely to enforce a foreign judgment without re-examining the merits of the claim and may not observe a choice by the parties of foreign law (such as English law, Cayman Island law or Jersey law) as the governing law of a Transaction Document. This could have an adverse effect on the amounts available to be paid to the Noteholders. Judicial precedents in Dubai generally have no binding effect on subsequent decisions. These factors create greater judicial uncertainty.[142]

These issues have also been raised in the case of Nakheel *sukuk* above.[143] These issues were also the consequences of a change of laws. These are major implications for the governing laws of Dubai, the Federal Laws of the UAE, DIFC laws, English law, the laws of the Cayman

[138] Tamweel *Ijarah* Prospectus 2007 (n 71) 22.
[139] ibid.
[140] Shariah Standard No 17/5/1/8/1.
[141] Irina Marinescu, 'Where Does the Dirham Stop in a Sukuk Default?' (2012) 35 Hastings International & Com L Rev 452.
[142] Tamweel Ijarah Prospectus 2007 (n 100) 33.
[143] See (n 127).

Islands, the laws of Jersey, and the laws of New York, and relevant administrative practices on *sukuk* document transaction. It is clearly stated in the Prospectus:

> No assurance can be given as to the impact of any possible change to the laws of Dubai, the Federal laws of the UAE, DIFC laws, English laws, the laws of the Cayman Islands, the laws of Jersey or the laws of New York or relevant administrative practices after the date of this Prospectus, nor can any assurance be given as to whether any such change could adversely affect the ability of the Issuer to make payments under the Notes.[144]

Bankruptcy and liquidation issues were also raised and should be tested in the Dubai court, as stated in the Prospectus:

> It should be noted at the outset that there is very little in the way of precedent on bankruptcy and liquidation issues in the Dubai courts. Federal law would, however, not apply to a party incorporated under laws other than the federal laws of the UAE and which is not doing business within the UAE. Thus, for example, it would not apply to an entity incorporated in the DIFC that is not doing business within the UAE. However, there is no provision in applicable law which excludes the application of Federal civil and commercial laws to all activities of such a party where, for example, these activities are carried out within the UAE but outside a financial free zone (such as the \DIFC). Whilst it is likely that TPL would be subject to DIFC bankruptcy laws, there is a possibility that the Dubai courts might seek jurisdiction as the company will have assets and activities in Dubai outside the DIFC. However, there is no precedent as to how this issue would be resolved and handled by either the Dubai Courts or the DIFC Court.[145]

Furthermore, Hassan and Kholid claimed that the bankruptcy laws in the UAE, as well as other GCC countries, still need to be developed and there are very few precedents.[146] In fact, the law has no specific definition of bankruptcy, but only provides the situation when a trader is

[144] Tamweel *Ijarah* Prospectus 2007 (n 71) 33.
[145] Tamweel Ijarah Prospectus 2007 (n 100) 128.
[146] Hassan and Kholid (n 52).

declared bankrupt.[147] The Dubai Economic Council (DEC) has reviewed the bankruptcy laws and has tried to take the necessary steps to improve the laws.[148] With regard to precedents, as mentioned previously, it has been doubted whether the Dubai court will apply precedents because this practice is not in line with the legal system applicable in the Arab countries. This was confirmed by the assertion made by Tarbuck and Lester that there was no system of precedent in Dubai or the UAE.[149] They further stated that the publication of judgments from the higher court was not intended to bind the lower court.[150] The intention was only to provide 'useful evidence of future judicial interpretation and practice'.[151] This situation will bring more uncertainties for investors when they transact in these Islamic finance instruments. Thus, it could impede the future growth of Islamic financial transactions.

6.4 Conclusion

The structure of *sukuk* in Dubai faces the risk of re-characterisation due to the similarity of these structures with non-*shari'ah*-compliant contracts or controversial contracts in *shari'ah*. The problem is also exacerbated by uncertainties in the legal system to deal with the transaction. Moreover, the lacunae in the law could aggravate the situation. These issues need to be addressed and resolved systematically in order to facilitate the growth of the *sukuk* transaction as a viable Islamic financial instrument.

The analysis on structures of Dubai *sukuk* also indicates that they too face the risk of re-characterisation due to their similarity with some non-*shari'ah*-compliant contracts or controversial contracts. The problem is also exacerbated when other legal systems are applied to deal with this matter, either in the process of the transaction or in the event of dispute or default, as in the Nakheel Sukuk case. Moreover, the gap in the law could aggravate the situation. These issues need to be addressed and resolved systematically in order to facilitate the smooth running of the *sukuk* transaction. Based on the results of the analysis in this paper, the fundamental factors underlying the *sukuk* issues are a sequence of causes and effects that

[147] UAE Federal Commercial Transactions Law No 18; Hassan and Kholid (n 52); HE Shiri, 'The Court's Approach in Bankruptcy Cases Under Existing UAE Law' <http://www.tamimi.com/en/magazine/la-update> accessed 6 March 2014.

[148] Muzaffar Rizvi, 'DEC Reviews Draft of Bankruptcy Laws' <http://www.khaleejtimes.com/biz/inside.asp?xfile=/data/uaebusiness/2012/May/uaebusiness_May106.xml&section=uaebusiness> accessed 12 July 2012.

[149] Tarbuck and Lester (n 37 9.

[150] ibid.

[151] ibid.

were primarily caused by legal pluralism that has given rise to legal uncertainties in governance; it subsequently compelled re-characterisation of *sukuk* contracts and ultimately raised the issues of *shari'ah* compliance. Given these fundamental factors, the most effective approach towards the solution may also be a sequence of mitigation that should begin, firstly, with the resolution of legal pluralism to mitigate legal uncertainties in governance; thus subsequently enabling mitigation of re-characterisation of *sukuk* contracts, and finally towards solving *shari'ah* compliance issues.