DEAL NEWS / UAE

Can the Sukuk Industry Survive the Dana Gas Dispute?

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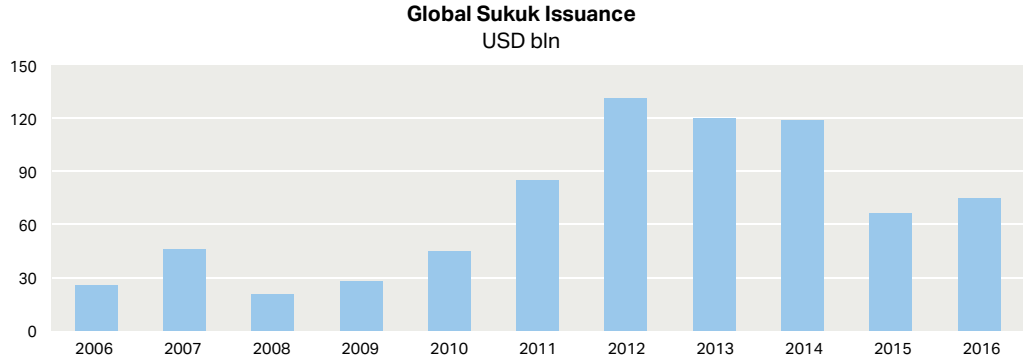
Introduction

Islamic Sharia-compliant bonds, commonly referred to as sukuk (an Arabic term that literally means "instruments"), have been increasingly used in the past few decades in corporate as well as project finance transactions. As sukuk have become increasingly appealing to issuers and investors alike as risk-sharing debt instruments, sukuk issuance grew from U.S.$20.6 billion in 2008 to a peak of U.S.$131.2 billion in 2012, before declining to U.S.$74.8 billion in 2016, when countries predominantly active in sukuk issuances were negatively affected by lower oil prices.

In competing with conventional bonds for investors' liquidity, sukuk offers an investment solution that complies with the requirements of the Islamic faith, and a debt instrument that has, since the global financial crisis, been perceived as less risky than conventional bonds given its asset-backed nature. However, sukuk issuances are still significantly lower in number and volume than conventional bonds, even in countries with predominantly Muslim populations. Part of the explanation for this discrepancy is the fact that, despite various trade bodies' attempts, neither the structure nor documentation for sukuk issuances have become standardized. That lack of standardization has led to some uncertainty and skepticism around the rules governing sukuk, which has been exacerbated recently by a very public dispute between Dana Gas and the holders of its sukuk, that could jeopardize the entire market.

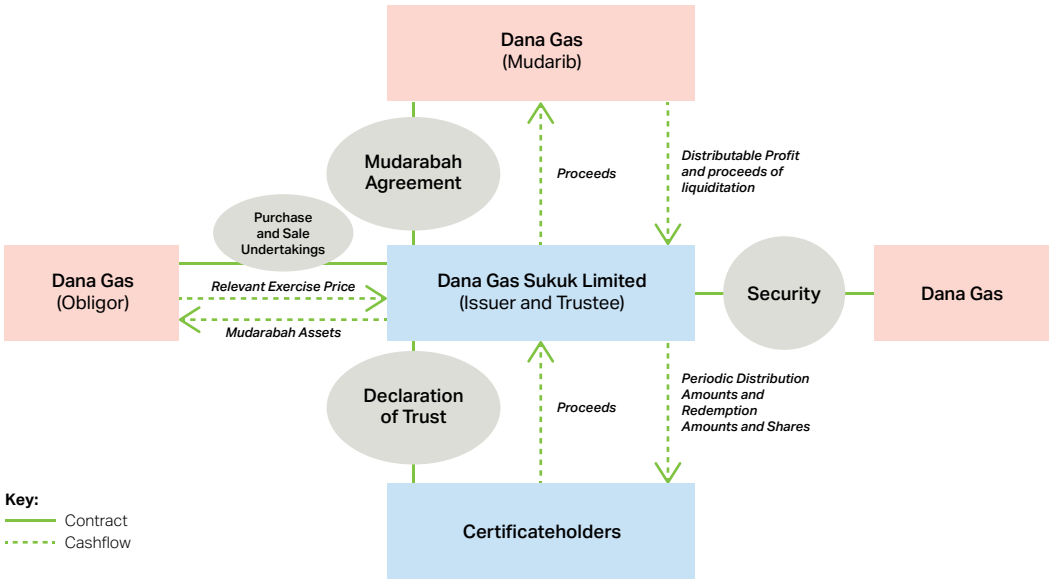
The Dana Gas Sukuk Dispute

In 2013, Dana Gas issued a dual-tranche sukuk with an aggregate principal amount of approximately U.S.$950 million listed on the Irish Stock Exchange. Each tranche of the sukuk was subsequently reduced to U.S.$350 million following sukuk buyback and conversion, bringing the outstanding total principal amount under the sukuk to $700 million due in October 2017. The sukuk were structured as sukuk al-Mudarabah. This type of sukuk involves the establishment of an orphan SPV in an offshore jurisdiction (in Dana Gas's case, Jersey).



Source: Thomson Reuters, MIFC estimates

Figure 1: Structure of the Dana Gas Sukuk



Source: Dana Gas Sukuk Prospectus 2015

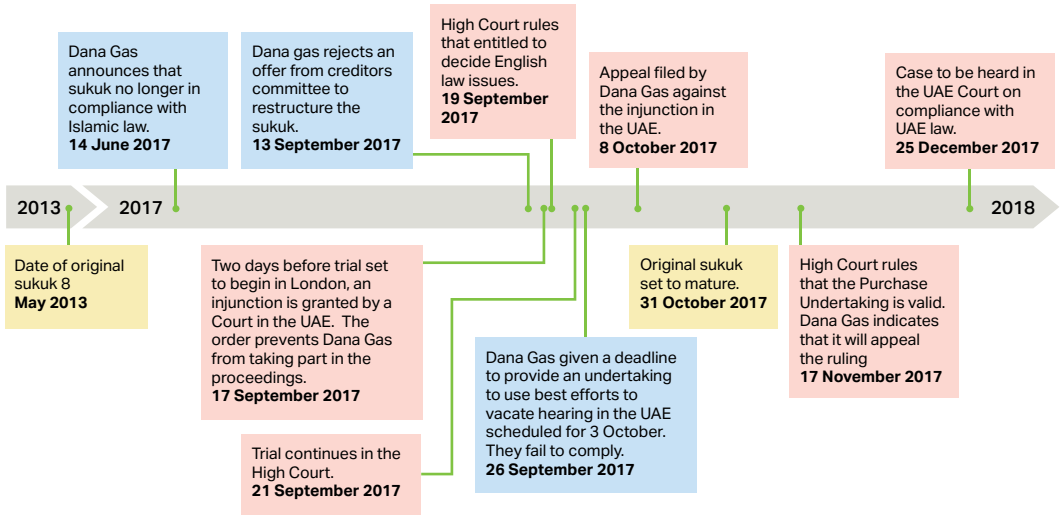
That SPV issues trust certificates to the investors, and uses the proceeds to enter into an investment arrangement (the "**Mudarabah Agreement**") with the underlying obligor pursuant to which the SPV will acquire rights to specified business assets. The investors are entitled to share the returns generated by that investment arrangement – so instead of being structured as a debt obligation, this form of sukuk involves the beneficial entitlement to the financial returns generated by a pool of assets via a trust.

The investors are paid regular profit distributions, and the entire structure will be unwound at maturity (or earlier if certain events occur). At redemption, the underlying obligor is required to repurchase the issuer's rights to the specified business assets, by paying a pre-determined exercise price (the "**Exercise Price**").

Due to the commercial difficulties that Dana Gas has faced in the last few years, in 2017 it had commenced discussions with its investors with a view to agreeing on a restructuring. Those discussions did not progress very far, and in June this year, Dana Gas declared its outstanding sukuk void for their non-compliance with Islamic Sharia law, citing "the evolution and continual development of Islamic financial instruments and their interpretation".[1] Having declared its outstanding sukuk void, Dana Gas proposed to exchange the outstanding sukuk with new four-year Sharia-compliant sukuk that "confer rights to profit distributions at less than half of the current profit rates and without a conversion feature",[2] an offer which was understandably declined by the certificateholders. In September this year, a creditor's committee supported by 70% of the certificateholders offered Dana Gas a restructuring proposal involving a U.S.$300 million cash payment and a three-year extension of the outstanding sukuk's life. The proposal was rejected by Dana Gas, leaving the dispute to be resolved by courts.

In an attempt to pre-empt a declaration of an event of default or enforcement action by the certificateholders, Dana Gas brought an action in the High Court in London requesting that the English law governed purchase undertaking between Dana Gas and the SPV (the "**Purchase Undertaking**") be declared void and unenforceable. Simultaneously, Dana Gas brought an action in the United Arab

Figure 2: Timeline of Events of Dana Gas Sukuk Dispute



Emirates (the "**UAE**") seeking to challenge the validity of the UAE law governed Mudarabah documents for their non-compliance with Sharia law. In challenging the validity of the Purchase Undertaking before English courts, Dana Gas pleaded that (a) its obligation to pay the Exercise Price under the Purchase Undertaking is, upon proper interpretation of the Purchase Undertaking, conditional on the SPV's ability to transfer its rights to the Mudarabah assets to Dana Gas under a UAE law governed sale agreement, which Dana Gas pleaded to be unlawful under UAE law; (b) the voidance of the Purchase Undertaking for common mistake that the Mudarabah Agreement and any related sale agreement will be valid under UAE law; and (c) English public policy prevents the enforcement of the obligations under the Purchase Undertaking when such enforcement will be unlawful under the laws of the UAE.

In November this year, the High Court rendered a preliminary judgment rejecting the arguments put forward by Dana Gas and ruling the English law governed Purchase Undertaking to be valid. In reaching this decision, the High Court (a) found Dana Gas's obligation to pay the Exercise Price to the SPV independent from the ability to lawfully transfer the Mudarabah assets to the SPV; (b) rejected the arguments of voidance of the Purchase Undertaking based on common mistake as the Purchase Undertaking effectively allocates the risk of mistakes to Dana Gas; and (c) rejected the public policy arguments as the obligations under the Purchase Undertaking do not require Dana Gas to do something unlawful "by the law of the country in which the act has to be done".

The decision of the High Court is not surprising, and is in fact consistent with a statement in the prospectus for the Dana Gas sukuk offering, which notes that "prospective investors are reminded that Dana Gas has agreed under the English Law Documents to submit to the jurisdiction of the courts of England. In such circumstances, the judge will first apply English law rather than Sharia principles in determining the obligations of the parties."

The case is still pending before the UAE courts to determine the validity and enforceability of the Mudarabah Agreement under UAE law. Although Dana Gas did not publicly reveal the advice it received from consultants stipulating that the outstanding sukuk are not Sharia compliant, media reports suggest that this advice was based upon (a) the pre-fixation of the Exercise Price; and (b) the

guarantee of a profit payment from the Mudarabah to the certificateholders, which they argue breaches Sharia law's principle that profit cannot be assured and the parties must share the risk in any transaction. As the elements of the Mudarabah causing it to be considered non-compliant with Sharia law are embedded in different transaction documents with different governing laws, the dispute raises challenging conflict of laws questions. While the Purchase Undertaking (which fixes the Exercise Price) is subject to English Law and the non-exclusive jurisdiction of English courts, and has recently been determined by the High Court to be valid under English Law, the Mudarabah Agreement (which sets the profit allocation between the *rab al-maal* (i.e. ultimately the certificateholders) and the *mudarib* (i.e. Dana gas)) is subject to UAE law and to the non-exclusive jurisdiction of UAE courts.

The decision of the UAE courts will largely depend on its interpretation of Sharia law. The role that Sharia law plays in the UAE, as well as several Middle Eastern jurisdictions, is two-fold. First, certain Sharia rules relating to financing arrangements are embedded in legislative instruments such that they constitute part of the country's law. In Dana Gas' case, a UAE court may find the *Mudarabah* agreement void for its non-compliance with the Sharia-inspired rules governing Mudarabah arrangements such as the prohibition on holding the *mudarib* liable for the loss in Mudarabah assets absent negligence from its part.[3] Secondly, Sharia law is considered a secondary source of law in the UAE on matters not expressly regulated by legislation,[4] and, more importantly, a component of public order in the UAE.[5] Specifically, a UAE court could refuse to apply the rules of a foreign law in a dispute brought before it,[6] or deny enforcement of a foreign judgment,[7] on the basis that the foreign law or the foreign judgment conflicts with public order in the UAE, including Sharia law. Therefore, in the Dana Gas dispute, a UAE court could refuse to apply English law to the Purchase Undertaking (to the extent the court considers its validity), or deny enforcement of an English court judgment based on the enforceability of the Purchase Undertaking (including acknowledgment of the validity of the Purchase Undertaking as determined by the High Court), on the basis that the terms of the Purchase Undertaking violate Sharia law and are contrary to public order.

The Outlook For Sukuk Market

The Middle East remains one of the most active regions for sovereign and corporate sukuk issuances, yet most legal systems in the Middle East lack certainty around Sharia rules governing these issuances. Despite the High Court ruling, if Dana Gas ultimately prevails in having the sukuk declared void for non-compliance with Sharia law, confidence in sukuk as a financing instrument will be significantly undermined. To avoid the uncertainty around the enforceability for an issuer's obligations based on their compliance with

the interpretation of Sharia law, investors could insist on subjecting all transactional documents, including the underlying sukuk structure, to the laws of a foreign jurisdiction that can offer certainty around the rules applicable to potential disputes. Investors could also require security packages in foreign jurisdictions that offer certainty around the enforcement of judgments issued for the investors' benefit.

Uncertainty surrounding enforceability could be mitigated if investors:

— insist on subjecting *all* transaction documents to consistently applied set of laws and court jurisdictions; and

— obtain security packages in foreign jurisdictions.

As such moves could raise the cost of sukuk issuance in the Middle East significantly, Middle Eastern countries may wish to consider legislative amendments to codify sharia rules applicable to sukuk transactions, leaving no room for different or unexpected interpretations of Sharia law applicable to the sukuk structure, with clear rules around the applicability of foreign laws and the enforceability of foreign judgments on sukuk disputes.

1. Dana Gas, *Dana Gas Outlines Broad Terms For Sukuk Discussions*, 13 June 2017.
2. Ibid.
3. Article 695 of the UAE Federal Law No 5 of 1985 on Civil Transactions.
4. Article 1 of the UAE Federal Law No 5 of 1985 on Civil Transactions.
5. Article 3 of the UAE Federal Law No 5 of 1985 on Civil Transactions.
6. Article 27 of the UAE Federal Law No 5 of 1985 on Civil Transactions.
7. Article 235 of UAE Federal Civil Proceedings Law No 11 of 1992.

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