

Restructuring Islamic Finance Transactions in the Middle East: A New Frontier for Practitioners

By Hessam Kalantar and Owen Delaney

The idea that Islamic finance instruments somehow offered protection from the wider global financial crisis has generally proven to be false. On the contrary, the market for Shariah compliant financial products appears to have been hit hard by the economic doldrums. Since the peak in 2007, when almost US\$35 billion worth of Sukuk financing was issued worldwide, volumes have dropped dramatically.

Only about US\$15 billion worth of Sukuk were issued in 2008, recovering to approximately US\$23 billion in 2009. Although there are reports that the sector is expected to rally in the near term, the turmoil in the capital markets and continuing hesitation on the part of financiers to resume lending have impacted not only the ability to consummate Islamic finance transactions and demand for Shariah compliant products, but also investors' perception of risk in Islamic instruments.

A series of Sukuk defaults in Kuwait, UAE and Saudi Arabia have precipitated efforts on the part of corporate boards and creditors to restructure financial liabilities, both within and outside the context of insolvency, in order to maximize the value of corporate assets, extend payment terms and avoid litigation of claims whose outcomes are largely untested in local courts.

Since these Sukuk defaults are largely unprecedented, the restructurings that have been devised in their wake are likewise a new frontier for the Islamic finance industry. In forging the new discipline of Islamic restructuring, Islamic finance lawyers are borrowing from best practices under the bankruptcy and insolvency regimes of the West but having to adapt these techniques to be responsive to the issues that arise with maintaining compliance with Shariah, as well as to the fact that there is a general lack of consensual restructuring processes in the jurisdictions where the underlying assets are based.

As can be expected of the highly publicized restructurings of Kuwait's The Investment Dar and Global Investment House, UAE's Dubai World; and several other large conglomerates whose recent defaults have been widely reported, these companies had entered into numerous financing arrangements by means of Sukuk, Wakalah, Murabahah, Tawarruq, Ijarah, Istisnah and other Shariah structures, often accompanied by complex security packages.

Since, due to cross-default provisions, a payment obligation that is not honored under one agreement may also give rise to claims under one or more other financing agreements. A company that is facing multiple default scenarios or has veered dangerously close to the zone of insolvency is likely to want to take stock of its financial position and assess its liabilities vis-à-vis all its financial creditors.

Where there are insufficient funds to meet payment obligations as and when they fall due, the company will be well advised to address its standing with respect to all creditors at once before committing to repayments, since satisfying debts owed to one creditor at the expense of another in such circumstances may give rise to claims that an unfair preference was granted, which claims, in some jurisdictions, may trigger fraudulent conveyance allegations.

General objectives of a restructuring plan

A systematic assessment of all debt claims against the company is the beginnings of a restructuring effort, and will typically involve analysis of all the financings pursuant to which the company (and, where relevant, its subsidiaries) have payment obligations. The assessment will serve the purpose of, among other things, ascertaining the interests of creditors (or alleged creditors) and, ultimately, developing and deploying a plan of restructuring that has been approved by as many of the creditors as possible (or by as large a proportion of the outstanding debt as possible) so that the company can continue operating as a going concern while it performs its repayment obligations in accordance with a plan that has been agreed with those creditors.

A restructuring plan that is arrived at through a consensual process, as opposed to through a court process, typically requires engaging with creditors through a coordinating committee, establishing standstill arrangements with as large a majority of the creditors as possible, seeking to achieve agreement on the quantum, classification and ranking of claims, negotiating the terms of new debt instruments, monitoring, managing and obtaining stays of litigation, and coordinating with regulators to obtain necessary approvals and making timely disclosures, as required, of any plan that is agreed.

As complex and protracted as the process may be, achieving a restructuring that is negotiated and agreed with creditors may be even more preferable in jurisdictions such as the Middle East whose bankruptcy and insolvency laws may not be sufficiently robust to accommodate the complexity inherent in large corporations who have assumed a wide variety of debt and have payee claimants that include banks, government entities and trade creditors across multiple jurisdictions.

Classification and ranking of claims

As with any restructuring, among the first tasks that the company will need to undertake is arriving at a defensible classification and ranking of claims, including whether obligations owed by the debtor are secured against certain of the debtor's property. Characterization of claims under Shariah compliant instruments may be complicated since, unlike conventional financing documents, the bells and whistles that define ranking, priority and security, including remedies upon a default, have traditionally been absent from the governing documents.

Nor is the nature of the Shariah instrument itself necessarily indicative of the nature of the claim that it creates. For example, under Shariah the mere existence of a Wakalah arrangement would not in itself give investors the right of recourse to the assets of the Wakeel (unless the Wakeel breached its duty of care or the investment guidelines to which it is bound), but where the Wakalah is accompanied by an express payment instrument or provision, such as a purchase agreement, promise to pay or guarantee, the Wakalah arrangement can afford investors a degree of capital protection and capital appreciation.

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Similarly, with Sukuk, the precise ranking of a certificate holder among other creditors of the company will depend on interpreting the language in the terms and conditions of the certificates, the declaration of trust and, where applicable, the purchase undertaking executed by the obligor in favour of the trustee. In the absence of standardized loan provisions typical in conventional credit, security and intercreditor agreements, the rights and remedies of creditors in an Islamic finance context can vary considerably.

Sukuk structures have typically been underpinned by real estate assets that generate returns for lenders through, for example, a sale and leaseback arrangement under which the lender buys the real estate assets and the borrower leases it from the lender. This concept of "asset backing" has become increasingly controversial in light of the scrutiny these structures have attracted following recent Sukuk defaults.

Certainly, where certificate holders' claims need to be classified and ranked in connection with a contemplated restructuring, a distinction will need to be made between Sukuk that are truly asset backed and those that are not. In the case of the former, legal title underlying the assets will in most cases have been transferred by the obligor to a special purpose vehicle against which investors in a default scenario could make a legitimate claim under the declaration of trust based on the issuer's legal ownership interest in that asset.

In the case of the latter (which are beginning to attract the name "asset-based"), however, there is a real risk that there was never an effective transfer of an ownership interest in the underlying asset, with the result that the investors have at best a beneficial interest therein (and in many cases nothing more than recourse to the balance sheet of the obligor as opposed to recourse to the underlying assets) and thus fare no better than other unsecured creditors. Indeed, it was recently reported that as little as 4% of the US\$32 billion of Sukuk that Moody's rated in 2009 affords investors direct recourse to the assets underpinning their investments.

Also relevant to arriving at a classification of secured versus unsecured claims is determining whether procedures relating to perfection of security have been duly undertaken. A creditor may have entered into an agreement with the debtor granting the creditor security over a specific asset, only to discover all too late that the security interest created under that agreement was not perfected in accordance with certain jurisdictional requirements, such as having possessory control over the asset, issuing notice to certain parties, or making certain court filings.

The uncertainties surrounding the extent to which one class of creditors may claim to have preference over another class, or recourse to assets in priority to others, serve of course to increase the debtor's leverage as it refines its restructuring plan and negotiates its contents with its creditors. The ambiguities surrounding remedies upon default are likely to entice creditors to agree to a plan as opposed to seek enforcement of claims through the courts. Even if a restructuring plan that is agreed with creditors acknowledges recourse by some or all such creditors to the debtor's assets, the value of those assets may have diminished such that the restructured payment obligations can no longer be adequately collateralized.

In such scenarios the restructuring plan can provide for the inclusion of additional unencumbered assets to fully "asset-back" the new arrangement and include steps, for example, to effect a reorganization of the company's subsidiaries and other assets so that such assets can be consolidated and transferred to special purpose vehicles (where permitted by foreign ownership laws) and pledged in favour of the creditors.

Another layer of complexity to characterizing and ranking claims is that the interpretation of the relevant Shariah financing arrangement, including whether it allows recourse to certain assets, will be impacted by the law that the parties have agreed should govern the arrangement, and the degree to which the application of those laws by the relevant courts would give precedence to Shariah.

Approvals of Shariah boards, creditors and investors

Any successful restructuring of Shariah compliant instruments will require consultation with, and approval from, the relevant Shariah boards. The company's Shariah board will need to approve numerous facets of the restructuring plan, including, for example, the compliance of the various refinancing mechanisms with the precepts of Shariah, particularly the amendments to Shariah compliant financing arrangements and the implementation of the refinancing. While some creditors may choose to rely on such approval, others may require that the relevant refinancing arrangements be approved by their own Shariah board.

Upon a determination by the respective boards that the arrangements are Shariah compliant, fatwas (or Islamic compliance certificates) in relation to the arrangements will need to be obtained. Balancing the interests of multiple Shariah boards may be as time consuming as balancing the competing interests of creditors, and this should be taken into account with scheduling and timing expectations so far as consummation of the restructuring is concerned.

Timing will also interfere with soliciting consents by creditors that are required to approve components of the restructuring and move the process towards adoption and implementation of the plan. For example, a defaulting obligor under a Sukuk Musharakah, arguably the most widespread form of Sukuk in the Middle East region, will be required to negotiate with both trustees and certificate holders to resolve the default or avoid a determination that a default has occurred.

Depending on the circumstances surrounding a potential default or dissolution event, the trustee and/or Sukuk certificate holders will likely need to convene a meeting in order to pass a resolution or extraordinary resolution, as the case may be, for the purposes of approving certain actions such as extending payment deadlines, amending terms of the transaction documents or sanctioning other debt restructuring actions.

In the context of a Sukuk Musharakah, a meeting of certificate holders can commonly be convened by the trustee and also upon requisition in writing signed by certificate holders of, normally, not less than one-tenth in principal amount of certificates outstanding. At least seven days notice must generally be given.

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In light of the procedures that must be followed in connection with disclosure to certificate holders of the restructuring proposals and the solicitation of consents through duly convened meetings, the restructuring practitioner will need to accommodate in the restructuring timetable both various practicalities (such as provision of timely notice) as well as the uncertainty of the meeting's outcome (for example the requisite proportion of the certificate holders not approving the proposed restructuring).

Other considerations

The advantages of undertaking a consultative process with creditors to develop a restructuring plan are more pronounced in the Middle East given the shortcomings of the insolvency laws of many Middle Eastern countries in which Islamic finance products are issued, marketed and held. According to recent reports, these shortcomings include inadequacies in both the legislative and institutional frameworks for insolvency, a need to better balance creditor and debtor interests, the lack of a formal, professional class of insolvency practitioners to serve as trustees or advisors in insolvency procedures, and the need to create out-of-court alternatives for resolution of insolvency issues, including rescue and restructuring.

Specifically, Kuwait and the UAE, where some of the most newsworthy Sukuk defaults have transpired, have only recently begun considering legislation that will facilitate restructuring by, among other things, allowing a plan that has been agreed by a certain threshold of creditors to be binding on all claimants, and allowing the staying of any litigation that may have been initiated in connection with the default.

Pending the enactment of more sophisticated insolvency regimes in, for example, the Gulf Cooperation Council states which will permit a "pre-packaged" plan of restructuring to be developed by and among the debtor and its creditors, and thereafter approved by the court if certain conditions are met, companies seeking to restructure their debts will need to navigate Shariah principles while deploying techniques that have been tried and tested by restructuring practitioners in the context of conventional financings, provided that those techniques are appropriately customized to the realities and nuances of raising capital through Islamic financial instruments and adopted in a manner that considers the legal, judicial and regulatory limitations of the debtor's jurisdiction. ☺

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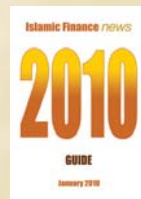
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