PROTECTING THE RIGHTS AND INTERESTS OF SUKUK HOLDERS FROM THE 
RISKS OF DEFAULT/COUNTERPARTY, BANKRUPTCY AND SHARI'AH 
REALITY, DEVELOPMENT AND CHALLENGES 
(SPECIAL ATTENTION TO SAUDI ARABIA)

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Abstract

The Sukuk markets, including the Saudi Arabian market, involve a variety of risks, the most important of which are credit and bankruptcy risks. This relatively new industry should be responsible for protecting the interests of potential Sukuk holders, whether individuals, financial institutions or banks, from credit and bankruptcy risks in order to maintain the reputation of these Islamic investment financial instruments and to increase their pace of growth. This dissertation highlights the negative effects of default on investors in Sukuk and highlights Shari’ah restrictions on various treatment options. We aim to examine the current efforts, with special attention to the Saudi Arabian reality, in dealing with the risks of default and bankruptcy, and to discuss how best to protect potential Sukuk holders from these risks in jurisdictions governed by Islamic law or Islamic arbitration, such as Saudi Arabia. The present research includes some aspects of comparison between traditional debt instruments and Sukuk. In the present research, we develop upon the current financial guarantees and preventive measures provided to combat these risks and provide reinforcing standards and solutions in a way that does not contradict the provisions of Islamic law and finance. Also, we discuss the challenges these proposed solutions may face and offer solutions to addressing some those challenges. The challenges are related to Shari’ah, cultural, and legislative aspects. This dissertation depends on and uses methods of qualitative research concerning Sukuk defaults by focusing on the development of theory, using case studies that are either based on Ijarah (leasing), Musharakah (joint venture) or Murabahah (sale on profit).

Dedication

I dedicate this dissertation to my family, especially my parents who paved the way for me to achieve this feat which is the fruit of their encouragement, prayers and upbringing.
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First of all, I thank and praise Allah Almighty for his apparent and inner graces and for his assistance in accomplishing this feat. The dissertation would never have been produced otherwise.

I extend my special appreciation and sincere gratitude to my advisor Professor Jayanth Krishnan for his tremendous support and insightful guidance and for always being welcoming and patient with my unannounced visits throughout the process of writing the dissertation.

I also sincerely express my heart-felt thanks to Professor Sarah Hughes and Professor Donald Gjerdingen for sharing their valuable insights and comments and for serving as committee members to my defense.

Finally, I would like to express my gratitude to the Maurer School of Law, especially the Office of Graduate Legal Studies and International Programs for the dedicated efforts and efficient services which contributed to this achievement.
Difficulties Encountered by the Researcher

• With respect to the translation into English

We found it difficult to record some names of authors of the Arab references from whom we quoted data and information, and attempted to translate the most commonly used name. In some cases, the researchers who quoted data from these references and sources differ in the writing and spelling of names of the authors. We also found it difficult to decipher the correct English name of many Arabic publishing and printing institutions as well as the Arab periodicals, as some do not have English names. In this case, we wrote the phonetic/symbol of the Arabic names in Latin letters. In some cases, there exists more than one publisher with the same name, making it more difficult, although we tried to verify the correct name as well as the publisher's location, as there is also more than one journal carrying the same name. We also had difficulty translating some of the terms related to Islamic law from Arabic to English, as in some cases, the words can carry meaning that has no equivalent in English or does have a similar word, but it bear less significance and meaning than in the Arabic language. This has often led us to write the phonetic alphabet/symbol of Arabic terms in English or Latin letters, as well as the translation, such as a loan (qard).

• With regard to knowledge of the various doctrines of Islamic jurisprudence and various legal approaches

We had a hard time going back to various Islamic doctrinal references regarding the meaning of words and terms used. Although there are common terms and concepts among the four jurisprudential Islamic doctrines and others doctrines, each one uses specific words and terms to convey specific meaning and significance (i.e. assigns certain words to specific meanings) that differ from what exists in others. This lack of consistency makes it difficult to identify their exact intentions and opinions on certain issues including the issues related to this dissertation. In the opinion of the researcher, some Arab terms that the classical scholars use are vague, which is what warranted further investigation. We also faced difficulty in comprehension when reading some legal cases from various references and sources of Civil Law and Common Law.

• With regard to the subject matter of the dissertation and its related issues
One of the challenges faced by the researcher is a lack of experience in dealing with credit risk and bankruptcy of Sukuk, as well as the lack of references that deal with credit risk and bankruptcy in the field of Sukuk. There is no acceptable model to be followed or compared to in dealing with these risks, specifically models that include applications of Sukuk issued in a country whose laws are subject to Islamic law. Sometimes, creating a product is easier than appropriate dealing with the issues and problems resulting from that created product.

Moreover, some issues related to Islamic finance have not been adequately addressed by Muslim jurists. The researcher sought to address this in relation to the usefulness and effectiveness of the proposed solutions by highlighting the issues related to the Islamic methods of approaching the Islamic dispute among Muslim scholars concerning some applications and transactions, issues related to Ijtihad (the exertion of the utmost effort by a trained Muslim jurist) and Taqlid (imitation). This led us to establish analyses and results from an Islamic and Saudi Arabian Law perspective and to assume potential arguments on some issues that have not been adequately addressed, by focusing on derivation and analogical deduction methods.

- **With regard to references and sources**

One of the difficulties we encountered was accessing and reading the original references without having to rely on what the intermediate references had quoted from the authors of the original references. Sometimes we did not rely on what was quoted, whether literal or figurative, and therefore did not adopt what some researchers understood from what jurists wrote or from the Fiqh councils, but we had to verify the real view of the jurists, especially on some important issues that have significant effects. We were forced to do so because a few researchers have made serious mistakes when comprehending the point-of-view of jurists or concerning restrictions that are neglecting and conditions of the opinions and fatwas of jurists.
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## Abbreviation List

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<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>1.</td>
<td>CRSD</td>
<td>The Committee for Resolution of Securities Disputes of Saudi Arabia</td>
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<td>2.</td>
<td>CMA</td>
<td>The Capital Market Authority of Saudi Arabia</td>
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<td>3.</td>
<td>CML</td>
<td>The Capital Market Law of Saudi Arabia</td>
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<td>4.</td>
<td>SPV/SPE</td>
<td>Special Purpose Vehicle/Special Purpose Entity</td>
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<td>5.</td>
<td>CRAs</td>
<td>Credit Rating Agencies</td>
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<td>6.</td>
<td>SIMAH</td>
<td>The Saudi Credit Bureau</td>
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<td>7.</td>
<td>IIFA</td>
<td>International Islamic Fiqh Academy of Organization of Islamic Cooperation</td>
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<tr>
<td>8.</td>
<td>AAOIFI</td>
<td>Accounting and Auditing Organization for Islamic Financial Institutions</td>
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<td>9.</td>
<td>TID</td>
<td>The Investment Dar</td>
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<tr>
<td>10.</td>
<td>ISB</td>
<td>Ingress Sukuk Berhad</td>
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<td>11.</td>
<td>NFCB</td>
<td>Nam Fatt Corporation Berhad</td>
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<td>12.</td>
<td>ECP</td>
<td>East Cameron Partners</td>
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<td>13.</td>
<td>FSSB</td>
<td>Fatwa and Shari'a Supervisory Board of The Dubai Financial Market</td>
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<td>14.</td>
<td>DFM</td>
<td>The Dubai Financial Market</td>
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<td>15.</td>
<td>IFSB</td>
<td>Islamic Financial Services Board in Malaysia</td>
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<td>16.</td>
<td>IPO</td>
<td>Initial Public Offering</td>
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<td>17.</td>
<td>OC</td>
<td>The Offering Circular</td>
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<td>18.</td>
<td>Jurists/Scholars</td>
<td>Muslim Jurist/Muslim Scholars</td>
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<td>19.</td>
<td>SAMA</td>
<td>The Saudi Arabian Monetary Authority</td>
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<td>20.</td>
<td>ICB</td>
<td>Ingress Corporation Berhad</td>
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<td>22.</td>
<td>SA (in the footnote)</td>
<td>Saudi Arabia</td>
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<td>23.</td>
<td>JO (in the footnote)</td>
<td>Jordan</td>
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<tr>
<td>24.</td>
<td>NCB</td>
<td>The National Commercial Bank (AlAhli Bank) in Saudi Arabia</td>
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<td>25.</td>
<td>IOSCO</td>
<td>The International Organization of Securities Commissions</td>
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<td>26.</td>
<td>IIRA</td>
<td>The Islamic International Rating Agency in Bahrain</td>
</tr>
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Introduction

The Thesis and Hypothesis Concerning Insufficient Protection of Sukuk Holders’ Interests from Default, Bankruptcy and Shari’ah Risks

Nasser, who refuses to engage with conventional financial products that are prohibited in Islamic Shari’ah, has decided to invest in Islamic Sukuk because it is marketed as an Islamic transaction, safer than conventional debt instruments, and is based on real assets. Accordingly, he subscribed to a Sukuk based on Murabahah (sale-plus profit) contract that is based on a forward-sale and issued by a company with a high credit rating. After receiving some periodic returns, the company (the obligor in Sukuk) ceased to pay the periodic returns because it suffered a financial crisis and experienced a lack of liquidity. After negotiations between the company and the Sukuk holders, some holders reluctantly made an agreement with the company to reschedule the debt without receiving interest (riba) against the delay of payment, because the usurious interest is forbidden by Islamic Shari’ah. Meanwhile, Nasser and other Sukuk holders refused to reschedule the debt, as rescheduling would mean they would lose the opportunity to reinvest their capital. As such, some Sukuk holders who refused the reschedule filed a lawsuit to sue the company for payment. Meanwhile, Nasser preferred to sell his Sukuk to investors who were interested in high-risk investment transaction, although later he learned that it is not permissible in Shari’ah to sell Sukuk to a third party if the Sukuk represents a debt. Given that situation, Nasser had only a few undesirable options. If he chose to reschedule the debt, he would not receive interest, which would be typically provided in similar cases in conventional debt instruments, such as bonds, because interest is forbidden in Shari’ah. The interest is commonly provided to dissuade creditors from filing lawsuits against the debtors before competent courts and to promote debt-rescheduling reconciliation. When offering interest, the loss of the opportunity of reinvesting the capital, the rise of interest rates in the market, and the fluctuation of exchange rate and inflation are taken into consideration. If the debt rescheduling included interest against the payment delay, the transaction would likely be revoked if Shari’ah courts or Islamic arbitration were competent judicial parties that adjudicate

* Important Note: The Shari’ah provisions and debate mentioned in this dissertation are not intended to give legal Fatwa or recommend subscription to Sukuk or any other instruments. The only purpose is to contribute a scholarly discussion and examination and to provide a Shari’ah, economic and legal analysis in collaborative efforts aimed to protect the interests of Sukuk holders from default, bankruptcy, non-compliance with Shari’ah and various other legal risks.
the dispute that could possibly arise in these Sukuk, judging them as non-compliant with Islamic Shari'ah. Some clauses or terms that are in breach of the Shari'ah provisions would cause the revocation of the transaction altogether. If Nasser decided to refer the case to the court, the settlement of the dispute would typically take a long time, and furthermore, he would not receive interest against the delay, if, in fact, the Shari'ah courts are the competent judicial party to settle the dispute. The company, which suffers a financial crisis, may be seriously trying to overcome this delay in payment and not taking advantage of the prohibition of usury in Shari’ah in delaying the payment. It may be facing financing challenges, especially if it is obliged, actually or constructively, to deal in Islamic finance for some reasons, for instance, not to drive away the shareholders of the company who refuse to subscribe to or buy the shares of companies engaged in usurious transactions, by giving or taking.

Similar to the account above, Nasser could face these problems if he had subscribed to the Ijarah Sukuk, with regard to the returns on Sukuk, though there are differences between Murabahah and Ijarah Sukuk.

Another hypothesis is that an Islamic bank subscribed to two Sukuk issuances based on a lease-ending-with-ownership (ijara muntahia bittamleek) contract. Both issuances contained bilateral binding undertakings that the obligor in Sukuk - the lessee – purchases the securitized assets on the date of redemption, while the legal ownership (registration) remains in the name of a party - often the seller of the assets who promised to lease them on the basis of Ijara Muntahia Bittamleek - to obtain financing, with an exception for those who subscribe in Sukuk, including the bank, for some reasons including non-payment of taxes and the law-abiding ban on foreigners to own those assets. One of those Sukuk was issued by a country governed by Common Law, which stipulates - in the context of sale and purchase transactions - that the buyer must be the legal and beneficial owner of the assets in order to be able to dispose of them. The other Sukuk was issued in Saudi Arabia, which is governed by Islamic Shari’ah. In the Sukuk issued by the state governed by Common Law, the originator/obligor who sold some of his assets for securitization went bankrupt. When that bank desired to exercise the right of recourse to the securitized assets, it found that the assets would be included among the assets of the bankruptcy estate of the originator, because he is the legal owner. Likewise, the originator of the Sukuk issued in Saudi Arabia went bankrupt. When the bank wanted to have recourse to the assets and sell them - being their real owner - in order to
meet its need for liquidity, it faced some restrictions and obstacles, since the laws in Saudi Arabia do not allow those assets to be owned by foreigners, though Saudi Arabian laws and Islamic Shari’ah do not require registration or documentation to dispose of assets in general. In this instance, the bank, which is prohibited by Shari’ah to engage in contracts of financial derivatives devised for purposes including countering credit risk, attempted recourse to the assets due to the bankruptcy of the originator, its need for liquidity to meet the withdrawal of customers’ deposits and to meet the requirements of Basel III.

The other problem that the bank faced was that the promises - especially bilateral promises - to buy the assets are not binding in the view of the majority of Muslim jurists and schools, including the Hanbali Fiqh School on which Saudi Arabian courts rely. Even if the bank had recourse to the assets, their price at the time of the dispute was much lower than the nominal value of the Sukuk, as the assets were valued at a much higher value at the stage of issue than their market value at that time. The Islamic bank engaged in that transaction because it is, allegedly, in compliance with the provisions of Shari’ah and it is assumed that Sukuk is a low-risk investment instrument. All of these assumptions and problems are discussed in this dissertation beside other issues closely related to the credit and bankruptcy risks of three types of Sukuk: Murabahah, Ijarah and Musharakah.

Financial guarantees and currently implemented precautionary and remedial measures to counter these risks are inadequate, ineffective or non-commensurate with the gravity of the risks. Existing methods to protect potential investors in Sukuk need to be upheld and enhanced through necessary improvements and proposed solutions, some of which may be useful in avoiding or reducing these risks, and may prove effective in aiding successful debt rescheduling negotiations. Some methods may even be instrumental in exercising the asset repurchase promises after making some modifications to the original promises. Meanwhile, it should not be overlooked that Shari’ah, cultural and legislative challenges could restrict some solutions and proposals.

The continuation of the current situation of Sukuk may drive investors away from it and slow down the growth and spread of Sukuk, which has become an important tool on the international investment map. For many reasons, Islamic banks serving as Sukuk investors face additional challenges and have limited options to combat credit
and bankruptcy risks, which could lead to its stunted growth and a disadvantage when competing with conventional banks.

Among the main arguments in this dissertation, which are related to each other, is that Sukuk holders suffer more credit and bankruptcy risks than conventional debt holders. Thus, Sukuk promotion as safer than conventional debt instruments, especially in some applications and structures, is inaccurate. This argument is supported by several reasons explained in present research. Among other arguments is that the current financial guarantees and remedial options offered to the Sukuk holders to deal with these risks are insufficient and some are flawed and need to be corrected. Another argument is that a jurisdiction governing Islamic law, such as Saudi Arabia, gives Sukuk holders the right of recourse to Sukuk assets even if legal ownership remains in another name (the seller/originator for example), a situation that is widely classified as asset-based Sukuk or beneficial ownership-based Sukuk. We proved that the registration is not required but recommended in Islamic law. Also, we argue that for various reasons explained in this dissertation, the reinforcing solutions and proposed developments should be diversified and should not be in a single pattern.

**Dissertation Roadmap**

This dissertation is divided into four main parts. The first part considers the Islamic and Saudi Arabian legal systems. In this part, we present a general background of three types of Sukuk and discuss their evolution as well as the risks associated with them. We examine the most important sources of Islamic law and the Saudi Arabian legal system, as well as the role of the four Fiqh schools in Islam, especially the Hanbali school, and contemporary Shari'ah councils. Also, we provide a brief about the Saudi Arabian CRSD.

The second part discusses the research issue and the negative impacts of this issue, and the distress Sukuk investors experience when facing default and bankruptcy risks. We also review and analyze aspects of three distressed Sukuk case studies as evidence of defaulting Sukuk and to stress that Sukuk holders do not have sufficient protection from default and bankruptcy risks. We selected these cases to help improve the current efforts to protect Sukuk holders from these risks. In this section, we evaluate the current protections provided to Sukuk
holders in preventing these risks. In each of the three cases, we explain how Sukuk holders face default and bankruptcy risks and what Sukuk represents in each stage of its existence.

The third part proposes, with the avoidance of what is unanimously forbidden by Shari'ah scholars, various and reinforcing solutions to combat default and bankruptcy risks and provides solutions to aid in successful debt restructuring negotiations in a way that does not harm the interests of investors and that reduces the discrepancies between Sukuk and conventional debt and investment instruments. We demonstrate the pros and cons and the adequacy and feasibility of each of these proposed solutions from a legal (Islamic and Saudi Arabian law) and economic perspective. The various proposals are not of a single pattern.

The fourth part discusses the challenges these proposed solutions may face and offers possible solutions to addressing some of those challenges. The challenges are related to Shari'ah, cultural, and legislative aspects. We also provide recommendations to several parties related to the protection of investor interest in Sukuk from the risks of default, bankruptcy, and non-compliance of Shari'ah. Finally, we end this dissertation with a conclusion.
Chapter I: The Background and Research Issue

1.1. The Islamic Legal System

1.1.1. Introduction

Islamic Law typically governs cases and civil and penal lawsuits as well as other issues in modern states, like Saudi Arabia. Some Arab and Islamic countries make it a source of legislation, while others rely on it in some of their financial or family issues. Islamic Shari'ah constitutes the basis of many economic entities, such as Islamic banks and companies, whose transactions are free from legal irregularities.

In this chapter, it is important to mention briefly the sources of legislation in Islamic Law that deals with all aspects of life, including financial and economic matters, and the most important principles of Islamic finance. Then, we shall review the legal structure in Saudi Arabia - which is based on Islamic Shari’ah as will be shown below – since this dissertation is particularly concerned with Saudi Arabia. Last, we shall discuss the most important theoretical frameworks of Sukuk.

One of the reasons of referring to the structure and sources of Islamic finance system is that Sukuk is marketed as one of the products of Islamic financial engineering and is presented as an alternative to conventional bonds that are forbidden in Islamic Shari’ah. Hence, Sukuk is one of the products of Islamic finance. Also, one of the objectives of this dissertation is that the precautionary means and financial guarantees that deal with credit and bankruptcy risks and serve the interest of Sukuk holders should not contradict the provisions of Islamic Shari’ah on which the four renowned Fiqh Schools and the Saudi law are based. Further, the present research focuses on Saudi Arabia, whose legal system relies on the most important sources of Islamic Shari’ah, i.e. the Holy Qur’an and the Sunnah, which are mentioned in the course of discussing the Saudi legal structure, since the account on Islamic law will involve the sources of Shari’ah. Finally, the review of some jurisprudential fundamentals of Islamic Shari’ah will reveal some reasons of the juristic dispute among Muslim scholars that will unfold in this dissertation.
1.1.2. Structure and sources of Islamic Law and some of its most important standards of financial transactions

Islamic Law can be defined as a set of rules and proofs through which the legal position of applications and actions is devised. Shari’ah can be defined as the injunctions prescribed by Allah. The word “proof” stands for “the means by whose valid consideration a required judgement can be obtained.”¹ This means the Shari’ah ruling is known through this proof if legal reasoning is practiced genuinely.

1.1.2.1. Sources and proofs of Islamic Shari’ah

Proofs in Islamic Shari’ah can be divided with reference to more than one consideration. In terms of scholars’ agreement or disagreement on their validity, they are divided into three categories.² The first category comprises the explicitly agreed on proofs, namely, the Qur’an and the Sunnah.³ The second is the proofs about which juristic dispute is weak. These include consensus (ijma’) and analogy (qiyas)⁴ which is widely recognized and adopted by the majority of Muslim jurists. The third category includes the proofs whose validity is more contested among Muslim jurists than the previous category, such as the sayings of the companions (sahaba) of the Prophet Muhammad and the pre-Islamic divine laws (shar’u man qablana).⁵

First source: The Holy Qur’an

The Qur’an, whose authority is recognized by all Muslims, was defined in different ways. The provisions (ahkam) of the Qur’an are divided into three sections; the first category involves the provisions of creed,

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¹ DR. TIYAD N. AL-SULAMI, USUL AL-FIQH ALLADHLA YASA’U AL-FAQIH JAHLAH 94 (Dar al-Tadmuriyah for Publishing and Distribution: Riyadh, Saudi Arabia, 1t ed. 2005).
² See id.
³ See id.
⁴ See id. at 95.
⁵ See id. In Islamic Shari’ah, proofs, in relation to the methods of their recognition, are classified into two categories. The first is textual proofs (adila naqliyya), which derive from the Qur’an, the Sunnah, Ijma’, sayings of the Sahaaba, the pre-Islamic divine laws and custom (urf). See id. The second is mental proofs (adilla ‘aqliyya), which derive from Qiyas, public interest (maslaha mursala), elimination of pretexts (sadd al-dharaa’i), juristic preference (istihsan) and presumption of continuity (istishab). See id. However, it should not be assumed that the derivation of the latter category is based on purely mental faculties, but they are mental proofs based on the textual proofs. See id. The Shari’ah proofs, with regard to their significance (dalala), are divided into certain/decisive and clear (qat’i) [which carries only one interpretation or meaning] and non-definite/speculative and uncertain (zanni) [which is open to more than one interpretation]. See id. At 96. One of the definitions of qat’i proof is that it is “a proof clearly establishing the legal judgement with no probability for its opposite.” Id. In contrast, the speculative proof is defined as “a proof that is indicative of a legal judgement with a minor probability of its opposite.” DR. WAHBAB M. AL-ZUHAYLI, USUL ALFIQH ALISLAMI vol. 1, p. 421 (Dar al-Fikr: Damascus, Syria, 1t ed. 1986). Some financial transactions are based on certain proofs, while others are based on presumptive proofs. Perhaps, this is one of the reasons for the dispute among scholars in relation to practical applications.
explaining the tenets of faith that every adult Muslim must have, the second is the provisions of ethics, pertaining to the code of behaviors that a Muslim must have and those that he should refrain from, and the third category includes the provisions of daily life practices, relating to the statements, acts, agreements and dispositions. Among the activities involved in financial transactions and rendered as prohibited in the Qur’an are usury (riba) and gambling (mayser). This prohibition was the most important motive for the emergence of Islamic institutions, banks and products that adhere to Shari’ah principles, and among those products is Sukuk that emerged as an alternative to riba-based bonds.

Second Source: The Sunnah

The prophetic Sunnah, whose authoritativeness is unanimously agreed upon by Muslim jurists, is the second most important source of Islamic Law. It is defined as: "every saying, act or sign of approval - other than the Qur’an - made by the Prophet Muhammad (peace be upon him)." The word tradition (khabar) is used to denote a narration transmitted from the Prophet (peace be upon him) and his companions. Traditions [or Ahadith, pl. of hadith, in view of those who use khabar and hadith in the same sense] are divided into genuine (sahih), fair (hasan) and weak (da’if). The dispute among jurists in judging the rank or authenticity of a hadith is one of the reasons for their disagreement on some applications and legal matters. With regard to its relation to the Qur’an, the Sunnah can be classified into three categories; interpreting the Qur’an, corroborating the Qur’an, supplementing the Qur’an. Yet, the study of the cases of interpreting the sayings and acts of the Prophet (peace be upon him) as obligations, recommendations or other grades are recorded in books of Islamic legal theory and the fundamentals of Islamic jurisprudence (in Arabic, both of them are called Usul al-Fiqh). Among the financial transactions forbidden by the Sunnah and related to Sukuk are the sale of items that are not in the possession of the seller and the riba of excess (riba al-fadl), while the transactions that are permitted by the Sunnah are many, including pawning (rahn) and guarantee (kafala).

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6 See AL-ZUHAYLI, supra note 5, at vol. 1, p. 438.
7 AL-SULAMI, supra note 1, at 103.
8 See id. at 105.
9 See id. at 107.
10 See id. at 115.
Third source: Consensus

Consensus (ijma’) is considered the third source of Islamic Shari’ah. It is defined by the majority of jurists as "the unanimous agreement among the most knowledgeable and highly qualified Muslim scholars in a time after the death of Prophet Muhammad (peace and blessings of Allah be upon him) on a Shari’ah ruling." All Sunni scholars and most of the Islamic sects have undisputedly agreed that consensus has a legal authoritative effect (hujja) in Islam. But, they disagreed on some details, such as the perception of the occurrence of consensus after the age of the companions, the rank of scholars whose legal opinion can be considered as Ijma’, the authoritativeness of silent or tacit consensus (Ijma’ sukuti) in which some scholars expressed their legal view while the rest remained silent, as well as the formation of Ijma after a dispute. The importance of Ijma’ lies in the fact that it is a binding authority; if it has proven that Ijma’ was properly reached on a case, jurists must not contest its decision. If we were to reinterpret many of the Qur’anic verses and Ahadith in isolation of what the companions and their followers had comprehended, we would not be able to make definite judgements based on our interpretations, as other conclusions could be drawn from them, but since we know their agreement on the perception of these verses and Ahadith, we are not allowed to re-interpret them otherwise. However, often a debate occurs among jurists about establishing the Ijma’. Some jurists claim the occurrence of Ijma’ in cases or applications, while other jurists deny the existence of that Ijma’. One of the reasons of disagreement here is that those who claim the occurrence of Ijma’ recognize some conditions for its incidence different from those held by their contestants, or they may mean the concordance of the scholars of the four notable Schools of Fiqh. Among the examples of financial transactions authorized by the effect of Ijma’ and related to Sukuk are sale contracts and the Mudarabah agreements, while among the transactions rendered prohibited by Ijma’, which have to do with Sukuk too, is usury (riba).

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11 AL-ZUHAYLI, supra note 5, at vol. 1, p. 490.
12 See AL-SULAMI, supra note 1, at 126-28.
13 See id. at 124-41.
14 See id. at 129.
Fourth Source: Analogy

Analogy (Qiyas) is considered the fourth source of Islamic legislation. It constitutes an authority according the majority of Muslim jurists, including the four eminent jurists of the four leading Schools of Fiqh in Islam. One of the definitions of Qiyas is that it involves the likening a general case for which there is an explicit text-based Shari‘ah ruling (hukm) with a particular case for which there is no explicit legal text (nass), with both sharing the same underlying cause or ratio legis (‘illah). Qiyas has many provisions (ahkam) and standards (dawabit) that persuaded some to restrict the exercise of Qiyas to the scholars who have reached the order of independent intellectual reasoning (ijtihad). Sukuk involves many aspects whose application legality relies on Qiyas. For example, some Sukuk are based on lease agreement (Ijara). One of the proofs of the legality of Ijara is to analogize the benefits (manafi’) to the properties (a’y-an) in the permissibility of being an object of the contract (mahl al-‘aqd) in view of those who consider that the lease agreement is legally established by means of Qiyas, though the legality of the lease agreement is also established by the Qur’an, the Sunnah and Ijma’.

Disputed proofs and sources in Islamic Shari’ah

There are proofs and sources in Islamic Shari’ah - other than the four sources agreed on among the majority of Muslim jurists – that are controversial among scholars regarding their reliability as legal proofs. Even when their reliability is recognized in general, jurists differed in relation to their ranking priority and the degree of their authority as proofs. Among these sources are the custom of the people of Madinah, which the Malikis have widely adopted, elimination of pretexts (sadd al-dharaa‘i), which the Malikis and Hanbalis have extensively used, preference (istihsan) which the Hanafis have widely used, public interest (maslaha mursala), presumption of continuity (istishab), custom (‘urf), the pre-Islamic divine laws and the sayings of the companions of Prophet Muhammad, which is open to further interpretation, not widely known and was not contested by other companions. Some Fiqh Schools did not recognize some of these sources or rely on them, yet they approved them in a number of Fiqh applications, thus there is a section of each one of those controversial sources that was

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15 See id. at 173.
16 See id. at 142.
17 See id. at 153.
18 See id. at 113-83; see also AL-ZUHAYLI, supra note 5, at vol. 2, p. 733-910.
agreed upon by jurists, especially those belonging to the four Schools of Fiqh. Each one of those sources has standards and provisions that are disputed among those who approve their authority.

1.1.2.2. The role of the four Schools of Fiqh

Scholars of Shari'ah occupy an eminent position in Islamic Law. They possess the tools and deductive rules mentioned in the books of the fundamentals of Islamic jurisprudence (usul al-fiqh) - with which knowledge of Shari'ah rulings is obtained as intended by the Lawgiver. There were scholars - who have fulfilled the conditions of Ijtihad and issuing fatwa (religious dicta) - who had students recording and refining their opinions and extracting therefrom their general approaches of reading and expounding the texts of Islamic Shari’ah. This led to the emergence of the four Schools of Islamic Fiqh whose names were derived from the names or nicknames of their founders or the names of their ancestors. The followers of the four major Schools of Fiqh now represent the vast majority of Muslims in the Islamic world. Among the reasons of the emergence of the four Fiqh Schools is the difference among jurists regarding the legal rulings of some acts of devotion, financial transactions and penal codes due to the disagreement on the recognition of some sources of legislation, the methods of devising the Shari’ah rulings, the various meanings of texts or for reasons that fall outside the focus of the present discussion. To each of these four Fiqh Schools belonged some jurists and judges of the Shari'ah courts who judge cases according to the rules of their particular School of Fiqh. Each of these schools has undergone several stages of development. Some of those stages, such as the foundation stage, exhibited similar features, while others differed in terms of order, such as the stage of revision, adjustment, development and stability. Yet, other stages existed, such as the stage of revision of the revision and the stage of expansion. Countries of the Islamic world

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19 See AL-SULAMI, supra note 1, at 113-83; see also AL-ZUHAYLI, supra note 5, at vol. 2, p, 733-910.
20 See AL-SULAMI, supra note 1, at 113-83; see also AL-ZUHAYLI, supra note 5, at vol. 2, p, 733-910.
21 See Scholarly Research Unit of the Fatwa Department at Kuwait Ministry of Awqaf and Islamic Affairs Almadhahib Alfaqhiat Alarbet 'Aymatuha - 'Atwaraha - 'Usuliha – Atharuha 17-21, 69-71, 132-34, 175-82. Reviewed by Dr. Ahmed A. al-Kurdi, Sheikh Ali K. al-Sharbaji, Dr. Boumia M. al-Said & Sheikh Adnan S. al-Naham. (Kuwait Ministry of Awqaf and Islamic Affairs, 1t ed. 2015). The founders of the four Islamic school are Abu Hanifa al-Nu'man ibn Thabit, Malik bin Anas, Muhammad ibn Idris al-Shafi'i and Ahmad ibn Hanbal, whose Fiqh Schools were established between the second and third centuries of the Islamic calendar. In spite of the existence of other grand scholars who have reached a status in knowledge no less than that of the four leading jurists, their schools of Fiqh were not widely spread or followed for many reasons.
22 See id.
23 See id.
differ in the extent of their reliance on Islamic Fiqh. Some of them follow the views of one of the four Schools of Fiqh, such as Saudi Arabia, whose legal system adopts the Hanbali School, while others implement some aspects of one of the four Schools of Fiqh, such as financial transactions and personal status. Along history, each one of the four Schools of Fiqh was once the legislative authority of an Islamic state.

1.1.2.3. The role of contemporary jurists

Like their predecessors, contemporary Shari’ah scholars play an important role in relation with the applications and the emerging events, as well as many provisions of acts of devotion, financial transactions, family issues and penal codes that remain fixed in nature and form in all ages. This role requires high qualifications and deep knowledge of Islamic Shari’ah as well as other technical and newly emerged issues. It is not sufficient that those who give fatwa or assume a judiciary work in the Shari’ah courts or arbitration under Islamic law to be knowledgeable in the Shari’ah without the ability to conceptualize and contextualize the cases under consideration within the real life, or to be knowledgeable in the practical aspects without having deep knowledge of the Shari’ah. So, the lack of combining these skills leads to defective conclusions and bad consequences, especially with the ignorance of the provisions of the Shari’ah law and the dynamics of real life. This, among other reasons, perhaps was the context in which some Sukuk that could be judged as non-compliant with Islamic Shari’ah in some respects, such as protection of Sukuk holders from credit and bankruptcy risks - as will be discussed later in this dissertation - were issued. The opinion of acknowledged Muslim jurists regarding the contemporary issues, including financial transactions and products, has a significant impact on their followers, which could jeopardize or constrain the growth and spread of these products, if judged as not adhering to Islamic Shari’ah. This is clearly evidenced by the reluctance of many Saudi investors to invest in companies whose activities were declared as non-compliant with Islamic Shari’ah by Muslim jurists, and the resort of conventional banks in Saudi Arabia and many other countries either to adapt their activities with the standards of Islamic finance, especially those agreed upon, or to open Islamic branches. Perhaps, the choice of highly renowned and widely reputed Shari’ah scholars in the society where they belong to work in the Shari'ah committees affiliated with Islamic banks and companies is intended to attract and reassure investors desirous to engage in Islamic financial transactions only, despite the
presence of underprivileged jurists who may be of higher scientific rank than those chosen. Despite that Muslim jurists by themselves are not sources of Islamic legislation, many of the lay people – as is the case of most investors – who do not meet the conditions of Ijtihad or have the tools of interpreting the Shari’ah texts are bound to consult jurists following a particular methodology and standards determined in field of Usul al-Fiqh. For example, they should follow the opinion of the jurist whose knowledge and piety are attested, and they should not deliberately select the easiest and most permissive opinions in contended issues, as this might potentially lead to their negligence of Shari’ah obligations in many Fiqh questions. It is worth mentioning that a large number of subsidiary (fiuru’) and juristic questions are disputed among jurists, and the embracement of the permissive views and deliberate seeking of the concessions issued by scholars are considered by some jurists as an act of heresy and evil, as will be pointed out in the chapter discussing the Shari’ah, legal and cultural challenges with regards to the development and suggestions presented in this dissertation.

1.1.2.4. The role of Fiqh bodies

It is important to highlight the role of the Fiqh bodies (majaami` fiqhiyya), since this dissertation will often refer to the decisions and standards of some of these bodies, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Fiqh Academy (IIFA). To a lesser extent, reference will also be made to the decisions of other Fiqh bodies and Shari’ah committees. Despite that reaching the correct Shari’ah ruling does not necessarily have to correspond to the view of the majority, since the minority or individuals may be more successful in that, as attested by countless cases. However, the positive effects of these councils and bodies cannot be overlooked. Hence, their importance appears in adopting collective intellectual reasoning (ijtihad), which is often more assuring to people, even outside the realm of Fiqh and law. Besides, scholars with high academic degrees and extensive expertise in Islamic Shari’ah and experts in economy and finance who have major contributions to practical and academic research are affiliated with them. Further, these bodies and councils have financial means that enable them to achieve their goals. The importance of these councils is further emphasized by the fact that their resolutions are based on the views of a group of specialized jurists, they have access to many facilities, many governments recognize and highly value them, although at
variant levels. In addition, many organizations, corporations and Islamic banks follow their legal views or try to adapt their policies and products so as to conform to these views.

In recognition of their influential role and the importance of their decisions and standards, there is hardly any book or scholarly research devoid of reference to the Fiqh decisions of some Fiqh councils and Shari’ah committees and bodies. Moreover, many of the judgements of the Shari’ah courts in Saudi Arabia were based on the views of some of these bodies, especially in contemporary financial applications that were not dealt with by the early jurists, although it is possible to use scholastic analogy (al-qiyaṣ al-madhabī) or derivation of practical Shari’ah rulings (al-takhrij al-fiqhi) by judging a contemporary issue in resonance with one of the issues dealt with by early jurists by virtue of the same ‘Ilāh (cause) and meaning existing in the two issues. It should be noted that the Fiqh bodies that are not affiliated with commercial institutions are far from the suspicion of favoritism and conflict of interests of which the Shari’ah committees of banks and companies were accused, although the good will is presumed for everyone. Another reason for considering the views of these legal councils is that many of the newly-emerged economic and medical issues have become so complex that they require individuals invested with high legal qualifications, research skills and technical capabilities in order to reach a degree of certainty about their legality in Shari'ah that will not be disputed by those who lack the rank of Ijtihad and issuing fatwa. This is to eliminate any constraints to people at the economic level, for example, in matters where convenience is promoted, or vice versa. Many of these Shari'ah bodies have dealt with some of the Sukuk provisions and suggested some preventive measures and remedies to protect investors from the default and bankruptcy risks.

1.1.3. Some of the most important principles and standards of financial transactions in Islamic Shari’ah

The importance of the general rules and principles of Islamic Shari’ah comes from the fact that incidents, practices and human actions are countless and endless, which entails the development of general principles to govern them. Islamic law – of which the finance and financial transactions are among its sections - includes many rules and principles, some of which are established in the Qur'an and the Sunnah, while others are inferred by
induction. These principles distinguish Islamic finance products, such as Sukuk, from conventional financing instruments, such as bonds. They can interpret the reasons of the permissibility or prohibition of applications and practices.

The exposition of the provisions of all financial transactions in Islamic Shari’ah is unattainable, so we will limit the account here to some of the most important rules and principles, particularly those related to Sukuk. Moreover, in the course of this dissertation, we will discuss some other Shari’ah provisions to the extent as necessitated by the purpose of this dissertation.

Many researchers who dealt with topics related to Islamic finance and its applications, when talking about the standards of this finance, focused only on prohibited issues in financial transactions, especially usury (riba), gambling (mayser), uncertainty (gharar) and commercial activities prohibited by Islamic Shari’ah. Yet, the provisions and restrictions of Islamic transactions, of which Sukuk is a newly-emerged application, are not exclusively restricted to these prohibitions, but there are many other provisions whose discussion is too large to fit into this dissertation. Failure to comply with these provisions may result in the revocation of contracts, due to the existence of clauses that contradict the Shari’ah laws, or the invalidation of the false clause only, subject to each case, the nature of the invalid condition or the rules of each of the four Islamic Fiqh schools. For example, the various sale contracts (buyoo’), lease (Ijarah), participation (Musharakah), profit-sharing partnership (Mudarabah), pawning (rahn), guarantee (kafala) and other transactions require certain conditions and standards different from those pertaining to conventional transactions, though the existence of common denominators, taking into account the contesting views of Fiqh schools that led to dispute among Shari’ah scholars regarding the details of those contracts. In addition, there are terms and conditions for the sale of debt, imposing more restrictions on Islamic financial products than those existing in conventional laws. To avoid repetition, we will review some of these issues in the course of this dissertation. One of the most important principles of Islamic financial transactions is the prohibition of usury (riba) and uncertainty (gharar) in aleatory sale transactions and engagement in activities that are forbidden by Islamic Shari’ah or as forbidden by the ruler for the public interest. The rationale of the illegality of some financial applications prohibited by the Shari’ah is the elimination of
unfairness or harm, or because they may lead to conflict or enmity between the parties concerned or to inflation. However, Shari’ah scholars differed in relation to the details of these principles and the origin of some general rules, such as the fact that the origin in financial transactions is permissibility. This also explains their disagreement over many financial transactions.

1.1.3.1. Elimination of usury (riba)

Ribā in the Arabic language literally means an excess (zeyada). It is defined as "an excess in specific things." Ribā is absolutely banned by the Qur’an and the Sunnah, and is unanimously forbidden by scholars of Islamic Shari’ah. Ribā comes under the guise of two different types: usury of surplus (ribā al-fadl) and usury of waiting/repayment (ribā al-nasee’ah), which incorporates ribā of debt (ribā al-dayn) or ribā of loans (ribā al-qurood), which are among the main products of conventional banks. As for the meaning of ribā al-nasee’ah, it is: "delay of the repayment of a debt in exchange for an excess above and over the original amount in the form of a predetermined interest, or the delay of one of the two compensations in the exchange of one of the ribawi items (i.e. any kind of wealth or property that is inherently susceptible to riba) for its kind." Here, wealth (mal) is intended in its technical sense, and not just the conventional sense that people know today of currency money. Ribā al-fadl means "an excess in one of the two compensations over the other in exchanging one of the ribawi items for its kind simultaneously, such as gold for gold or dates for dates." Traditionally, amwal ribawiya refer to any of the six substances (items) that are sold by weight or measure, literally: gold, silver, wheat, barley, dates and salt, which are mentioned in one of the Prophet's hadith. Muslim jurists differed concerning the analogy of other items to these six items and held two different views. The first view is that riba is applicable to other items

24 See ABDULLAH A. IBN QUDAAMA, AL-MUGHNI [THE SELF-SUFFICIENT] vol. 4, p. 3 (Dar Al-Kaherah: Cairo, Egypt, 1968).
25 Id.
26 See id.
27 See id.
28 See ABDULSAMIE A. IMAM, NAZARAT FI'USUL ALBAYUE ALMAMNUEAT FI ALSHRYET AL'IISLAMIAT WAMAWQIF ALQAWANIN MINHA 152 (Islamic Awareness Magazine: Kuwait, 1st ed. 2012).
29 Id.
30 According to the technical use of the majority of jurists, it denotes wealth and stands for "any valuable things that require compensation in case of damage." DR. WAHBAH M. AL-ZUHAYLI AL-FIQH AL-ISAMI WA ADILLATU vol. 4, p. 2877 (Dar al-Fikr: Damascus, Syria, 4th ed. n.d.). This is the sense adopted in the Law, as it stands for "everything that has value." Id.
31 IMAM, supra note 28, at 153.
32 See id. at 155; see also IBN QUDAAMA, supra note 24, at vol. 4, p. 4.
that have similar underlying cause or ratio legis (illah). This is the view of the majority of scholars, who see that the cause in gold and silver is one, and the cause in the other four items is one too, though the difference in the nature of the cause. If the cause in the four food items is that they are items of food, then all what is eaten will be judged the same. The second view, which is the opinion of few Muslim jurists and the deniers of Qiyas, is that *riba* does not apply except to these six items. The exchange of *ribawi* items must be handled with immediate transfer of possession, but not necessarily of identical items, if the two countervalues are different in kind, such as the exchange of a kilogram of gold for two kilograms of silver, but without postponement of transferring of the possession of one of the them in the contracting session. Immediate transfer of possession and equality are conditional to the exchange of *ribawi* items for an in-kind countervalue, like the exchange of a kilogram of gold for a kilogram of gold, and the transfer of the countervalues must be made in the same contracting session. As to the exchange of gold or silver in return for one of the rest of the four items, immediate transfer of possession and equality are not required. So many applications may involve usury. Some are unanimously prohibited, such as the interest-based loans, and loans that incur a benefit to the lender, one of whose images is the combination of the contracts of loan and commutation (*mu’awada*), such as combining a sale agreement and a lease agreement in one contract. Some applications are disputed among scholars in considering them as *riba*-based, such as the cases of Da’ wa Ta’ajjal (waive part of the debt and bring forward repayment) and Bai’ al-Inah (sale with immediate repurchase), which are prohibited by the majority of Muslim scholars. These restrictions pose more challenges to Sukuk applications and the protection of their holders from credit and bankruptcy risks. For example, when restructuring the debt owed by the Sukuk originator, the structure must not involve interest.

1.1.3.2. Elimination of uncertainty (gharar)

Gharar, i.e. hazard or uncertainty, has different definitions, and some of these definitions are limited to a number of its financial applications. One of these definitions is "the transaction whose consequences are uncertain

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33 See IBN QUDAAMA, supra note 24, at vol. 4, p. 4-5.
34 See id.
or ambiguous." This is the opinion of the vast majority of Muslim scholars. The Qur'an did not explicitly mention gharar, but jurists resonated it to the devouring of people's wealth unlawfully, which is forbidden by the Qur'an. There are some prophetic traditions that forbad gharar in general, while other traditions forbade some of its applications. Scholars of Shari'ah unanimously agreed that it is obligatory to know the object of exchange. In general, they agreed that excessive gharar in sale is forbidden. Among the elements that Muslim jurists counted as gharar are ambiguity of engulfing the price and the subject matter (object of exchange), selling a non-existent item, as is the view of the majority of scholars, and selling a non-deliverable item. There is a relationship between uncertainty (gharar) and gambling (maysir), and jurists differed as to what is incorporated in the other. Some made gharar a type of gambling, while others considered gambling a type of gharar. AAOIFI has listed some standards for gharar that invalidates financial transactions. Muslim scholars differed as to whether the prohibition of a contract or an image results in its revocation. The vast majority of scholars view that prohibition causes revocation and, accordingly, the contract has no effect, while other scholars considered that it does not invalidate the contract. In Sukuk, the securitized object and its price must be known in order to avoid gharar. Among the applications that involve gharar that the present researcher has not found in the Sukuk are the securitization of future returns generated from a future project, though they also involve usury as will be

38 See id. at 78.
39 See IMAM, supra note 28, at 99.
42 See AL-DARIR, supra note 37, at 61.
43 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), in its Shari’ah Standard No. (31) related to Controls on Gharar in Financial Transactions, states: "[g]harar violates the transaction when it satisfies the following four conditions: a) If it is involved in an exchange-based contract or any contract of that nature. b) If it is excessive in degree. c) If it relates to the primary subject matter of the contract. d) If it is not justified by a Shari’ah-recognizable necessity." ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS (AAOIFI), SHARI’AH STANDARDS: FULL TEXT OF SHARI’AH STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS AS AT SAFAR 1439 A.H. -NOVEMBER 2017 A.D. 772-73 (Saudi British Bank (SABB): Riyadh, Saudi Arabia, 2015).
44 See AL-DARIR, supra note 37, at 84-5.
explained in the chapter on the evaluation of guarantees and preventive measures of dealing with credit and bankruptcy risks facing Sukuk holders.

1.2. The Saudi Legal System

1.2.1. Introduction

Many countries in the Islamic world that are predominantly Muslim are influenced by the Civil Law, and few of them are influenced by the Common Law, yet all of them rely on Islamic Shari’ah in some aspects and at different levels. In contrast, Saudi Arabia is one of the countries whose legal system is based on Islamic Shari’ah. In this section, we will briefly discuss the legal authority of laws in Saudi Arabia and present a brief background about the legislative and judicial authorities there, because of their relation with Sukuk and the legality of the financial guarantees and preventive measures against credit and bankruptcy risks.

1.2.2. The legislative and judicial referentiality in Saudi Arabia

Many Saudi Arabian laws and statutes clearly state that the Kingdom is a country ruled by Islamic Shari’ah. Numerous articles emphasize that actions and applications should comply with Islamic Law or must not contradict Islamic Shari’ah whose sources and some of its principles have been presented above. For example, Article 1 of Basic Law of Governance describes the country as an Arab Islamic state whose constitution is based on the Qur'an and the Sunnah. Article 5 of it states that people’s oath of allegiance to the ruler is sworn on the Qur'an and the Sunnah. Article 7 provides that the Qur'an and the Sunnah are the reference for all the laws of the state. Article 1 of the Law of the Judiciary states that judges are independent and are not subject to provisions other than the Shari’ah and the proper rules and disciplines. Article 11 specifies that the Supreme Court oversees the integrity of the application of the provisions of Shari’ah and the decrees issued by the ruler that are not in breach of it in the cases within the jurisdiction of the General Courts. In the Law of Saudi Arabian Monetary Agency (SAMA), Article 2 provided that it is not permitted to pay or receive interest. Article 121 of the Companies Law states

46 See id. §5.
47 See id. §7.
49 See id. §11.
that a joint stock company should comply with the Shari’ah provisions when issuing debt instruments.\textsuperscript{51} The adoption of Shari’ah by Saudi Arabia, which is considered one of the prominent countries economically, politically, diplomatically and a member of the G20, is an experience worth studying in terms of the relationship between religion and prosperity.

\textbf{1.2.3. Legislative authorities}

Although there is no explicit statement on how laws in Saudi Arabia are enacted, they are - in accordance with constitutional norms and custom - issued through several channels and in different methods. Each method has its characteristics in terms of formulation, power and purpose.

\textbf{1.2.3.1. Royal Orders and Decrees and High Orders}

Laws in Saudi Arabia can be enacted through Royal Orders,\textsuperscript{52} Royal Decrees\textsuperscript{53} and Supreme Orders. The enactment of Saudi laws can also be made by the Council of Ministers.\textsuperscript{54}

\textbf{1.2.3.2. The role of the Shura Council}

The Shura Council has several roles. In addition to discussing the cases and issues referred to it by the Council of Ministers, it studies laws, international conventions and treaties and discusses reports submitted to it by ministries and government entities.\textsuperscript{55} The Council’s decisions may be approved or dismissed by the King.\textsuperscript{56}

\textsuperscript{51} See Companies Law, Royal Decree No. (M/3) SA § 121. (2015).
\textsuperscript{52} The enactment of principal laws, such as the Succession Commission Law, the Statute of the Supreme Economic Council or appointments of senior state positions, such as ministers, are typically issued by Royal Orders, which can be described as the most powerful legislative instruments, since they are issued by individual and direct Royal will and are not subject to formalities. However, there is a team of highly qualified consultants with varying specializations offering consultation to the King. One of the advantages of this means is the promptness of enacting urgent laws and appointment of senior state officials. As such, this process overrides the lengthy formal procedures and the complexities of voting required for the enactment of laws in the Saudi Council of Ministers or the legislative councils and parliaments in most countries of the modern world.
\textsuperscript{53} Most of the Saudi laws, such as the Capital Market Law (CML), the Companies Law, are issued in this way. This is based on our general observation of the issuing process of Saudi laws. The issuing is typically preceded by a general debate about the law draft in the Council of Ministers after the Shura Council had referred some of these drafts to it. The King, then, issues a Royal Decree on the presented draft law for general discussion and voting before the Council of Ministers, if the draft is supported by at least two-thirds of the present members, which is a prerequisite for the validity of the council’s meeting. In some exceptional cases, the meeting becomes valid with the presence of half of the members, and the resolutions require the approval of at least two-thirds of the present members to be adopted. \textit{See} Law of the Council of Ministers, Royal order No. (A/13) SA §§ 7, 20. (1993). This must be followed by the publication of the Royal Decree in the official Gazette [the Umm al-Qura newspaper]. The law becomes effective from the date of publication, unless otherwise specified. \textit{See id.} § 23.
\textsuperscript{54} It is considered an important legislative tool as it is often issued weekly to respond to the daily life issues of citizens. This tool does not require the consent of the King, which makes it distinct from the Royal Decree that requires the approval of the decision of the Council of Ministers. A minister may propose a draft law or a regulation relating to his ministry. \textit{See id.} § 22. It is noted that, to a large extent, the Council of Ministers combines the legislative power and the executive power.
\textsuperscript{56} \textit{See id.} § 17.
However, it is noted that it does not have the privileges of the parliamentary assemblies; it does not have the power, in any case, to enact laws. In general, its role, as name suggests, is close to an advisory board.

1.2.3.3. The role of the Council of Senior Scholars (Ulama)

It is important here to refer to the Saudi Council of Senior Scholars, which is considered the highest religious body in the country, because of its relationship with the laws in the Kingdom. The Council, formed of a select group of Shari’ah senior scholars, was founded by Royal Decree in 1971, and its members are selected by a Royal Decree.57 Among the most essential purposes of its establishment is "to scrutinize the cases referred to it by the Ruler and form an opinion about them based on the Shari’ah proofs," as well to give "recommendations on religious issues concerning the determination of general consultative provisions to the Ruler based on research prepared and conducted for this purpose".58 Islamic Shari’ah is considered a discipline in which scholars specialize and have a deep understanding of it. One of the tasks undertaken by a Shari’ah jurist (faqih) is to give a legal opinion (fatwa) about the laws that the state is intending to enact, especially if they are related to religious issues. The Grand Mufti of Saudi Arabia, who is selected by the King, chairs the Council.59

One of the cases that a former King of Saudi Arabia had previously requested the Council to consider was the issuing of the legal opinion (fatwa) regarding the codification of the most preponderant views of Shari’ah scholars so that judges would adhere to them. For many reasons, the majority of the Council members rejected to do that and provided some reasons to justify their position.60 But, later we shall see that the Saudi judiciary issued a decision involving a request that the Shari’ah courts in Saudi Arabia rely on views of the doctrine of Imam Ahmad ibn Hanbal, save in exceptional cases. The question remains as to whether the Council of Senior Scholars see that its decision with regard to codification of the most preponderant views of Shari’ah scholars extends to the issue of committing to a specific juristic school. There are many laws in the Saudi Kingdom related to the commercial

57 See THE GENERAL SECRETARIAT OF THE COUNCIL OF SENIOR SCHOLARS IN SAUDI ARABIA, THE COUNCIL OF SENIOR SCHOLARS. Available from: http://www.ssa.gov.sa/%D9%87%D9%8A%D8%A6%D8%A9-%D9%83%D8%A8%D8%A7%D8%B1-%D8%A7%D9%84%D8%B9%D9%84%D9%85%D8%A7%D8%A1/. (accessed on 29th October 2018).
58 Id.
59 See id.
and financial aspects, such as the Companies Law, the Law of Commercial Papers, and the CML, and some criminal aspects, such as the Law of Criminal Procedure, and the Anti-Money Laundering Law. However, it is noted that most of these laws were likely codified because they relate to newly emerged or contemporary financial and criminal issues that were not directly addressed by the literature of the four Fiqh Schools, to some applications in which one of the parties are tradesmen, to issues of foreign investment, to legal matters emphasized by Islamic Shari’ah, or to matters pertinent to rules of Islamic governance, such as the restriction of permissible acts as accorded to the ruler by the Shari’ah under certain conditions whose details fall outside the focus of the present research. There are almost no laws codified in the form of articles on civil cases and most criminal cases.

From the above, it can be concluded that the King in Saudi Arabia has considerable power in the enactment of laws, which must be compliant with Islamic Shari’ah as provided in the Basic Law of Governance and many of the Saudi laws, which the Shari’ah scholars exercise much influence on them.

1.2.4. Judicial authorities and the role of the Hanbali School and Fiqh councils and bodies in judicial judgments

The one who surveys the reality of the judicial system in Saudi Arabia can observe that according to the subject matter, there are three types of judicial authorities, namely the General Judiciary, the Board of Grievances (the so-called administrative court) and the Quasi-judicial Committees. Each one of the General and Administrative courts is characterized by a peculiar judiciary law.

1.2.4.1. The General (Shari’ah) courts

The General judiciary Law, commonly referred to as the General Courts or Shari’ah Courts, consists of the Supreme Court, the Appellate Courts, which comprise civil, criminal, personal, commercial and labor circuits, and the First Instance Courts, which comprises courts with almost the same names as those of the Appellate Courts. This judiciary system considers conflicts involving individuals or legal entities, except what the regulations excluded. The designation of this type of courts as Shari’ah courts does not connote that other courts

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61 See Law of the Judiciary, supra note 48, §§ 9, 16.
and judicial committees do not judge according to the Shari’ah provisions, as evident in their verdicts. However, there are judgements by the judicial and quasi-judicial committees that are not based on Islamic Shari’ah.

### 1.2.4.1.1 The Role of the Hanbali doctrine

The Saudi Arabian judiciary system relies in its rulings on the views of the Hanbali School. This is partially because the majority of the Saudi population follow the Hanbali School. That has generally reflected on the judiciary system and judges who graduated from faculties of Shari’ah where they studied Fiqh and its fundamentals according to the Hanbali School. The former Judicial Control Board issued on 7/1/1347 AH a decision announcing that the judicial judgements must be compliant with the juristic views made by Imam Ahmad ibn Hanbal, specifying the Hanbali reference books that judges must primarily refer to, with the possibility of adopting the views of other Fiqh schools if the application of the Hanbali views proved to cause hardship and disruption to public interest.62

The Hanbali reference books that are commonly consulted are “Sharh Muntaha al-Iradat” (Explanation of Muntaha al-Iradat Manual) and “Kashshāf al-Qinā’ 'an Matn al-Iqnā’” (Explanation of al-Iqnā’ Manual), and when a conflict arises between them, superiority and reliability are given to the former.63 In the absence of a decisive text clarifying the case considered by the judge, it is possible to refer to “Rawd al-Muraba’” (The Square Garden) and “Manar al-Sabil” (the Beacon of the Path).64 If there is no clear relevant text in these sources, it is possible for the judge to refer to the texts of other Fiqh schools and choose the view that sounds convincing to him.65 In reference to the published legal judgements, reliance on the Hanbali reference books is apparent, particularly in cases and lawsuits whose content and images are not different from what is stated in these books.

63 See al-Mousa, supra note 62, at 9-20; see also al-Tai, supra note 62, at 123.
64 See al-Mousa, supra note 62, at 20; see also al-Tai, supra note 62, at 123.
65 See al-Mousa, supra note 62, at 20; see also al-Tai, supra note 62, at 123.
1.2.4.1.2. The role of the Fiqh assemblies and Shari’ah bodies that exercise collective intellectual reasoning (ijtihad)

We mentioned earlier the decisive influence of the Shari’ah and Fiqh bodies and assemblies that are distinguished with their exercise of collective intellectual reasoning. By virtue of their role and importance, many of the Saudi judicial judgements, especially those relating to contemporary applications, rely on the decisions of these assemblies, councils and bodies and take them into account when issuing the judicial judgements. One of the most important of these councils and bodies are the International Islamic Fiqh Academy and the Saudi Council of Senior Scholars that have investigated some Sukuk applications or issues related to it.

1.2.4.2. The Board of Grievances (Diwan al-mazaalim)

This administrative judiciary Board, which is referred to as Administrative Tribunals, is independent of the judiciary system. Its jurisdiction extends to cover disputes in which the state is a party in its capacity as an administrative authority, disputes arising from administrative contracts in which the administration is a party, and cases of enforcement of foreign judgments and judgments of foreign arbitrators.\(^66\)

1.2.4.3. Quasi-judicial committees

Committees that exercise the role of courts but outside the judiciary system are called Quasi-judicial Committees.\(^67\) All these committees work under executive authorities, which legislators seek to disentangle by the incorporation of the committees to the General or Administrative courts. Some researchers counted them in 2009 and the total amounted to 74 committees or bodies.\(^68\) There are some reasons for their formation, but this is

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\(^67\) They are defined as "a group of specialists- outside the judicial system - whose task is to investigate disciplinary and penal suits or settle specific civil or commercial disputes under an exceptionally approved law, and to take decisions thereon." Youssef Al-Hadithi, Quasi-Judicial Bodies. (Center of Judicial Studies Specialist, 2009). Available from: http://www.cojss.com/article.php?a=226&h=%C7%E1%CC%E5%C7%CA+%D4%C8%E5+%C7%E1%DE%D6%C7%C6%ED%C9 . (accessed on 29th October 2018). The literature accessible to the present researcher does not distinguish between the judicial and the quasi-judicial committees, and most of it use the latter. It is noted that there are few committees consisting of two degrees: primary and appellate, and it is not possible to appeal against their decisions. There are also many committees that do not go beyond one degree, and that their decisions can be appealed against before the administrative courts. Due to these differences and the significant distinction between these different committees, as appear in the first and the second designations, it is better to label the first type as “judicial committees” and the second type as “Quasi-judicial committees”. This is to distinguish between them, despite the fact that the implementing mechanism of the Judicial system and the Board of Grievances named, as will be shown below, all the bodies outside the General judiciary and the Administrative judiciary as quasi-judicial committees.

\(^68\) See id.
not the suitable place for mentioning them. After the recent structure of the General and Administrative judiciary Laws and the promulgation of the implementing mechanism for them, some of these committees, such as the Commission for Settlement of Labor Disputes, were transferred to the jurisdiction of the General Judiciary system. The mechanism provided for the transfer - except for some exemptions - of the jurisdiction of quasi-judicial committees that deal with penal, commercial or civil cases to the general Court, while considering the status of the committees that deal with administrative disputes and whose decisions can be appealed against before the Board of Grievances and making further suggestions. The mechanism excluded the quasi-judicial committees of banks, securities and customs cases, requesting the Supreme Judicial Council to conduct a comprehensive study of their status.

1.2.5. The Committee for Resolution of Securities Disputes (CRSD) and its jurisdictions

This committee, which is under the control of the Capital Market Authority (CMA), was established under the CML, whose statutory system provided for the formation of this committee. The committee consists of two degrees; first or primary degree and appellate degree whose decisions are final and cannot be contested. With regard to its jurisdictions, the following is found on its website:

The subject-matter of CRSD jurisdictions can be summarized in the following: review claims against decisions taken and procedures adopted by CMA or the Exchange Market, what is known as Administrative Suit; review complaints arising between investors relating to the Capital Market Law and its implementing regulations as well as CMA and the Exchange Market regulations, rules and instructions in terms of public and private actions, what is known as Civil Suit; consider suits brought by CMA -as a general prosecutor- against violators of the Capital Market Law and its implementing regulations, what is known as Penal Suit.

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69 See the Implementing Mechanism of the Judicial Law and the Board of Grievances, Royal Decree No. (M/78) SA. (2007).
70 See id.
72 See id.
The review of suits relating to Sukuk issued, for example, by joint-stock companies, as pointed out by the Companies Law, is among the jurisdiction of this Committee, since Sukuk is a debt instrument and, therefore, is securities, as stated by the CML.

1.2.5.1. Legal referentiality of the Committee and the prediction of its decisions regarding Sukuk

The legal referentiality under which the Committee issues its decisions is not clear. The CML, under which this committee was established, and the CMA's Implementing Regulation only mentioned specific irregularities and the penalties. However, Sukuk involves applications and clauses undetermined by the Law, which raises a question about the referentiality by virtue of which the Committee judges the legality of those applications, their clauses, the remedies and validity of financial guarantees. The question here relates to whether the Committee will judge by the articles of the Civil Law or the provisions of Islamic Shari'ah, and whether it is governed by the same judicial principles issued by the Supreme Court as the judges of the General Court. The CML states: "[t]he Committee shall consist of legal advisers specialized in the jurisprudence of transactions and financial markets, with expertise in commercial and financial affairs and securities." The Committee of Appeal of this Committee consists of three members; a member of the Ministry of Finance, a member of the Ministry of Commerce and a member of the Body of Experts affiliated with the Council of Ministers. This committee, whose judgments are issued by a majority is made up of two members not specialized in law or Shari’ah, on the assumption that the member of the Body of Experts is a specialist in them. This is another element added to its shortcomings. In this Code, there is no explicit indication that the judicial judgements must be Shari'ah-compliant. When investigating and evaluating the financial guarantees and preventive measures against credit and bankruptcy risks involved in the three Sukuk selected in this dissertation, and when proposing a set of enhancing solutions, the present researcher does not seek to predict the point of view of this Committee, but rather to predict judicial judgements that may be issued by General Judiciary Courts – Shari’ah Courts - in financial transactions to which Sukuk can be resonated. The reason for this can be attributed to two purposes. The first is that the present researcher could

74 See Companies Law, supra note 51, § 122.
75 See Capital Market Law, supra note 71, §§ 2, 6.
76 Id. § 25.
77 See id.
not find a judgement issued by the Committee regarding Sukuk or other financial transactions that can be analogized to Sukuk provisions. Therefore, it is difficult to predict the Committee's views on Sukuk that involve the items proposed by this dissertation if they were referred to the committee, since the precedents are not binding in the Saudi judicial system, but they can be taken into consideration only. Meanwhile, we found in the judgments of the General Courts some clues that can help predict the point of view of these courts whose judgements are supposed to be similar to the judgements of this committee since the referentiality is the same, i.e. Islamic Shari’ah, as provided in the Basic Law of Governance and other laws. The second purposes is that the State has a tendency to incorporate quasi-judicial committees into the General or Administrative Courts. It has already integrated a number of competent committees with certain jurisdictions, such as labor and laborers committees, and the integration of more committees is underway. As such, the Committee concerned with settling disputes relating to securities may therefore be integrated into the General Courts, since this quasi-judicial committee is subordinate to an executive body, which may be seen as inconsistent with the theory of separation of powers. But, this possibility can be difficult due to the fact that securities need a committee whose members have expertise in the technical aspects of securities, which a lot of the judges in Shari’ah courts lack, and that the Committee is more tolerant and compromising in terms of compliance with Islamic Shari’ah. Moreover, there is nothing in the present regulations to demand the incorporation of this Committee into the General Judiciary.

1.3. The Research Issue

1.3.1. Introduction

Many private investors, Islamic banks, financial institutions and companies are inclined to invest in sukuk or wish to obtain finance and cash through them. The reason is that sukuk are consistent with the provisions of Islamic Shari’ah. Besides, the structure of some sukuk types has some privileges, especially at the theoretical level, that attract the capital of investors even from Western and Asian countries who are not concerned with compliance of sukuk with Islamic Shari’ah provisions. This is attested by the status quo in primary and secondary markets of sukuk in non-Islamic countries and at government and corporate levels. Over the years, and after several issuances, some questions arose with respect to the financial rights of sukuk investors and the adequacy of
provided guarantees, given the fact that sukuk are prone to credit risk and sukuk holders are not immune to it. This was confirmed by cases of investors not receiving their money invested in sukuk, or obtaining some of it only after some years of struggling, and by the negative approach of many corporations that had benefited from the proceeds of sukuk and yet defaulted on the repayment or went into bankruptcy. One of the main drawbacks of Islamic sukuk industry is that sukuk investors, as claimed, lack adequate protection from default risk and bankruptcy risk. Weak protection arises from lack or inadequacy of existing remedial options and guarantees provided to sukuk holders to counter the default or insolvency risk of sukuk originators and their sponsors, or when the sukuk contain some flaws.

This section is divided into three sub-sections. The first sub-section tackles the characterization of the problem and its impact on sukuk holders. It highlights the sukuk investors’ suffering from the risk of default and bankruptcy compared to their counterparts in bonds and conventional securitization. Sub-section II is subdivided into three parts. Part One will explain the meaning and theory of the risk of default, and it will survey other researches that limited this risk to specific cases and narrowed down its manifestations. Part Two will explain the concept of bankruptcy risk that the beneficiary of financing through Islamic securitization may face. It will also discuss the difference between bankruptcy applications in sukuk and in conventional securitization, and it will show how bankruptcy risk in the latter is, in some respects, lower than in sukuk. Both parts deal with the most perilous forms of credit risk and bankruptcy risk in the three types of sukuk under discussion, as these two forms of risk are considered the highest risks that capital markets, especially Sukuk, encounter due to the direct threat they pose to

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78 The beneficiary obtaining financing in Islamic sukuk or conventional securitization is referred to by different designations, but they all express the same denomination in many structures. Sometimes it is called the (sponsor). Also, it is called the (originator) if the issuance process involves the establishment of a special purpose company (SPV) whose task is to issue bonds and securities. In other cases, it is labelled the (issuer) if that party had originally sold some of its assets directly and issued securities representing them without establishing a special purpose company. Further, it is called the (seller), but the nature of the seller's relationship with investors in conventional securitization differs from that of sukuk in a manner that typically requires the existence of more than one contractual relationship in the sukuk. It is also called the (lender) in conventional securitization. For example, a bank or a financial institution becomes a lender to a group of debtors and customers, and, through conventional securitization, it sells its debt and loans to others. However, in sukuk, Islamic Shari’ah forbids the lender to sell its outstanding debts to others. It is conceivable that in some types of sukuk, the sukuk are issued by a third party. For instance, one of the applications of Murabaha sukuk can be that, a trader issues securities that represent common ownership of goods or assets. Then, after the investors have subscribed to those securities or assets and legally taken possession of them, they sell them on credit to the party that is desirous to obtain financing, who in turn sells the assets in the market for cash.
investors' returns and capital and because of the restrictions imposed by Islamic Law. Part Three will explain the concept of risk of non-compliance with Shari'ah. The third sub-section will underline the need to protect investors from these risks and to provide the sukuk industry with adequate financial guarantees and protective hedges to deal with these risks and reduce them. It will also suggest a mechanism to achieve this goal.

1.3.2. The Issue

When investors provide their capital for sukuk with the expectation of achieving a profit, it often happens that the beneficiary of financing through sukuk defaults on or is in arrear with fulfilling its fiduciary obligations. Those obligations include the periodic payments as well as the amortization of sukuk, that some call the par value, which represents the sukuk holders’ capital, at the end of the sukuk term. This in turn exposes sukuk holders to the risk of not getting back their money. The financial repercussions of the default risk are much more serious to investors in sukuk than to their counterparts in conventional securitization and bonds. For, under Islamic law, Sukuk holders are forbidden to receive riba-based interest, as stated in the Prospectus or the legal documents, even in the case of debt restructuring. Their ability to gain their dues depends on the guarantees or hedges set out in the Prospectus and based on the legal setting.

Outside of sukuk and Islamic finance markets, the risk of default is suffered by many and varied parties, whether in the money and credit markets or even at the level of individuals in their inter-personal contracts. Yet, many of them fend off the risk of default and, thus, protect their agreements with prudential guarantees without having to comply with the provisions of Islamic law. As such, they have a wider scope of remedial and prudential options. They also have greater flexibility when insolvency occurs, by asking for additional interest when they consent a settlement or postpone their due payments, without facing losses such as those borne by sukuk holders.

1.3.2.1. Some negative impacts of default on investors in Islamic sukuk in particular

In addition to the default or bankruptcy as risks per se threatening the capital of investors in instruments described as one of the most secure and stable investment tools, default and financial insolvency in sukuk have more serious and damaging consequences than in conventional securitization. Among the reasons for this are the restrictions preventing the circulation of sukuk that represent a debt, thus resulting in the difficulty of liquidating
investors’ assets, such as banks. Other reasons are investors’ missing the opportunity to reinvest their funds, since Islamic Shari’ah forbids to receive interest as compensation for delays and debt restructuring; investors’ vulnerability, when default happens, to most of sukuk and bonds risks, - such as interest rate risk, exchange rate risk, and inflation risk- more than bonds investors; the existence of some prominent legal views in Islamic Fiqh that make it obligatory to grant the insolvent a respite to a time of ease; lack of credit risk management tools, in contrast to the situation in conventional debt markets; and the difficulty of breaking up credit risks. This requires the exertion of more effort in order to protect investors and sukuk holders. Despite that Sukuk are marketed as safe in virtue of being asset-backed securities, sukuk holders in many issuances suffer for years as a result of not receiving their arrears and returns. Their capital may even be at stake, besides losing the opportunity to reinvest their money. However, the problem does not end at this, for the default may also cause the sukuk holders, especially banks and pension institutions, which prefer to invest in safe and low-risk instruments for reasons - such as abiding by the rules of central banks and other government bodies monitoring banks and financial institutions and their investments- to meet their obligations and fiduciary duty.

First: Restrictions preventing the circulation of sukuk that represent a debt

There are restrictions on selling debts in Islamic Shari’ah that prohibit the trading of Islamic securities if the Sukuk represent debts against the originator in the Sukuk (i.e. the company seeking to finance through Sukuk).  

79 Selling debts includes many cases and applications and the Shari’ah ruling depends upon the case. One of these applications is that of selling the debt to whom the debt is against (i.e. to the debtor). Dr. Osama Al-Lahim said that the majority of Muslim jurists approved this case with various conditions and disagreement among them on these conditions. See DR. OSAMA H. AL-LAHIM, BAYE ALDIYN WATATBIQATIH ALMUEASIRAT FI ALFAQIH AL'ISLAMI’ [SELLING DEBT AND ITS CONTEMPORARY APPLICATIONS IN ISLAMIC JURISPRUDENCE] vol. 1, p. 123 (Dar Al-Maiman for Publishing and Distribution: Riyadh, Saudi Arabia, 1t ed. 2012). Al-Lahim attributes this view to Hanafis, Malikis, Shafa’is, Hanbalis and others. See id. He says: "Jurists who authorize the selling of debts to whom the debt is against differ in opinion on the legality of Shari‘ah, basing that opinion on the conditions of the sale. The conditions can be traced back to three general conceptions agreed upon in general, even if the dispute occurs in their applications." See id. at 133. Then he mentions that these three conceptions or conditions are agreed upon in general - according to his opinion - namely, the prohibition of usury with its types; usury of surplus (riba al-fadl) and usury of waiting/repayment (riba al-nasee‘ah), the prohibition of the sale of object before possession and the prohibition of selling debts in return of debts. See id. at 133, 135. He attributes the view that selling debts to the debtor is prohibited to only few scholars. See id. at 124. The second application is selling debts to a third party. Al-Lahem says that the scholars differ on this case in two opinions. See id. at 345. The first opinion on selling debts to a third party is that it is permissible under various conditions and terms which are disputed among jurists who adopt this view. See id. at 345-47. He attributes the second opinion: prohibiting the sale of debts to a third party, to the Hanafis, Hanbalis and Dhahiris and to one of the views of the Shafi’i school. See id. at 347-48. IIFA allows the selling of debts on condition that it be a like-for-like sale by way of transfer of debt (hawala). See INTERNATIONAL ISLAMIC FIQH ACADEMY (IIFA), QARARAT WATAWSIAT MAJMAE ALFAQIH AL’ISLAMI ALDUWALII (1403– 1430 A.H. / 1988-2009 A.D.) (19 SESSIONS) [RESOLUTIONS AND RECOMMENDATIONS OF INTERNATIONAL ISLAMIC FIQH ACADEMY (1403–1430 A.H / 1988-2009 A.D.) (19 SESSIONS)] 413. Collected by Abdelhak Laifa. (n.d.). Because there are conditions on the sale of debt in the view of those who authorize it, the selling of debts - as in some applications of Sukuk – proves difficult and rare because of the existence of the Shari’ah restrictions.
This can be imagined in most Sukuk structures. For example, Sukuk represents a debt at the early stage of issuance in Murabahah Sukuk when investors sell the Murabahah assets to the originator on the bases of the credit sale contract (al-bai’ bithaman ajil (BBA)) and the cost-plus profit (murabahah) contract. Some types of Sukuk also end in debt at the redemption date when the originator and investors enter into a new contract to fulfill the promise to purchase the Sukuk assets in case these Sukuk include a binding unilateral promise, in view of those who see this promise as permissible by Shari’ah with specific conditions, or in case these Sukuk include a binding bilateral promise, in view of those who see it as permissible and legal by Shari’ah with specific conditions. In these cases, Sukuk represent a debt after the new contract is concluded until the originator/buyer pays the price (a consideration) of the assets.

In conventional debt securities markets, investors from western or Asian countries who are not interested in Shari’ah compliance might resort to selling these securities, either to meet a financial obligation or to avoid possible future default - even with a slight loss to secure the remaining portion of their capital- since some investors favor high-risk investments. This situation poses an additional challenge to Sukuk and highlights the need to deal more seriously with credit and insolvency risks, as it is difficult to liquidate assets of investors in cases where Sukuk represents debt. Similar to this, Islamic banks do not resort to conventional securitization, wherein the bank, for example, sells a loan portfolio by means of securitization. As aforementioned, this is due to controls in place that prevent the sale of debts in general.

Second: Missing the chance of reinvesting the sukuk defaulted funds and the prohibition of Riba-based interest in sukuk industry

Additional interest on late loans or debt rescheduling plays a pivotal role in various activities, including debt markets, corporate and government financing. From a traditional economic perspective, this interest has several benefits that can be summed up as compensation for missing the opportunity to reinvest overdue sums, which the debtor pledged to pay as periodic payments and principal to the investors on time, and as compensation for other potential bonds risks that may arise when the term is extended. Additional interest spurs the debtor to honor its repayment, and it gives more flexibility to the concerned parties in negotiation. In this way, investors would be
satisfied as they are entitled to receive additional benefits, while debtors or issuers feel relaxed as their outstanding financial obligations have been postponed.

Financial guarantees, compensations and remedial options in Islamic sukuk should be compliant with the provisions of Islamic Shari’ah. This compliance is the most essential feature that distinguishes sukuk from conventional bonds and securitization. Yet, this poses a challenge to sukuk when encountering the risk of default or bankruptcy. When the beneficiary of financing fails to fulfill its obligations, it deprives Islamic securities holders not only of reinvesting their funds but also of regaining their share capital. Meanwhile, it is prohibited to agree with the defaulted party to pay a compensation in the form of additional interest, in light of the regulations of Islamic financing rules, as consideration for the debt restructuring, even with the consent of all the parties concerned. In principle, Islamic sukuk must be categorically devoid of this settlement tool at all stages, whether in the Prospectus, upon default or when seeking debt rescheduling.

Now, the beneficiaries of Sukuk financing may take advantage of these Shari'ah rules, which prescribe that the financial transactions be free of interest. They may cease to pay the periodic revenues and tend to default on their obligations, which include the amortization or repayment that is typically equal, as in reality, to the capital of the investors or close to it. In this vein, Ali Tariq says: "[t]he rescheduling of debt at a higher mark-up rate is not existent due to the prohibition of interest. Consequently, counterparties would be more inclined to default on their commitments to other parties."\(^{80}\) For example, in Dana Gas sukuk, there has been default on payment for several years, and the case is still pending in the British and Emirati courts.\(^{81}\) Whatever the court's rulings, the sukuk holders will likely not receive additional interest vis-à-vis the delay, due to the non-stipulation of such remedy in the Prospectus, especially if these courts act upon the legal provisions of Islamic Shari’ah when making a settlement to recover debts.

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Based on the above, if the debtor in sukuk defaults, the sukuk holders have two options: either to accept the restructuring of the debt without getting additional interest as a financial settlement, or to resort to litigation that could be time-consuming and require high financial costs. In both cases, it means the investors’ would miss the opportunity to reinvest their money, and, at the end, they may receive only some of their capital, if the issuing company's bankruptcy is declared. Adding to this is the risk of securities, exchange rate volatility, inflation rise, assets depreciation and interest rate rise, as will be explained in the third impact of sukuk default.

In contrast, conventional bonds and financing instruments typically incorporate such an option, making bonds more flexible and attractive to investors than sukuk in this regard. Accordingly, bonds investors have the economic incentive to approve potential debt rescheduling or delay of the repayment, as there is nothing to ban the concerned parties from agreeing that the bondholders will receive additional interest as consideration for the delay in order to settle the financial dispute. The issuance prospectus may also contain clauses stating that the bonds issuer is bound to pay additional fee in the event of delay Therefore, when there is a default on the payment or delay in the bonds amortization, the bondholders are entitled to receive additional interest. These clauses are to compensate for the bondholders’ non-reception of their dues in the assigned time and to make up for missing the opportunity to reinvest their funds. The clauses can also recompense the consequential damages resulting from the delay of investors’ entitlements, such as failure to meet their obligations to a third party, as doing so was dependent on their receipt of the bonds returns and the capital.

When calculating the additional interest in the event of rescheduling the debt in conventional bonds, the interest rate risk, exchange rate risk and inflation risk must be taken into consideration. A rise in the interest rate and depreciation of the currency are likely to happen, and if that happens, it would reflect negatively on the returns of bonds and their holders. Among the advantages of imposing additional interest or delay fees is to cut the way to those who tend to default on their financial obligations. When the procrastinator sees that there is nothing to compel it to pay, it may be tempted to default on the payment. Moreover, in the event of bankruptcy of the corporation seeking financing through bonds, the bondholders are likely to receive their full capital plus additional interest, if the bankruptcy estate of the corporation issuing the bonds can cover those debts.
In this context, the bondholders have an advantage over the sukuk holders in terms of protection against credit risk from an investment and economic perspective; they receive a compensation to make up for the non-commitment of the securities issuer. As a result, bond issuers should be punctual in meeting their financial obligations, as delay would result in additional punitive measures. Therefore, it is logical that investors would prefer to invest in the bond markets because the compensation is better, especially if they are not concerned with compliance with the regulations of Islamic finance system, such as Western and Asian investors.

**Third: Investors’ vulnerability to most of the sukuk risks when default occurs**

In Sukuk, there is a strong correlation between the default risk on the one hand and the risks of exchange rate, inflation, liquidity, assets, interest rate, and non-compliance with Islamic Shari’ah on the other hand. Conventional bonds may also face all those risks except the risk of non-compliance with Islamic Shari'ah. So, when debt rescheduling is needed with the consent of bondholders', these risks are put at the table when negotiating the amount of additional interest to make up for the default. This is what the sukuk industry lacks as being an interest-free Islamic product. In this section, this correlation and its negative impacts on investors, which are difficult to address in Sukuk, will be investigated. In the event of default on Sukuk amortization or periodic payments, sukuk holders are likely not only to miss the opportunity of reinvesting their money and its yield, but also to face depreciation of the currency evaluating their sukuk returns, inflation rise and decline of the value of the securitized assets, in case they have recourse to those assets upon insolvency of the originator/the beneficiary of financing (i.e., the “issuer” in conventional bonds).

In addition, holders of Sukuk that represent debt will encounter restrictions in liquidating securities, because the Shari’ah stipulates conditions in the sale of debt, and these conditions may be difficult to meet. In general, Islamic jurisprudence councils forbid securitization of debts and loans and trading of securities that represent debt. Some types of Sukuk represent debt at the first stage of Sukuk issuance as Murabahah Sukuk after selling of Murabahah assets to the buyer/originator. Also, certain applications of certain types of Sukuk, such as some of applications of Ijarah and Musharakah Sukuk, include debt at the redemption date if these Sukuk include promise

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82 See supra note 79.
to repurchase the Sukuk assets, and the promise is fulfilled by entering into a new contract. This happens when
the date of the redemption falls due and investors – in case of that they are the promised party - choose to exercise
their right of option according to the purchase and sale promises. This is in view of those who see that the promise
made by the parties to purchase or to sale is binding only on one of the parties and see that such promise is
permitted by Shari’ah if specific conditions are met.\footnote{For example, AAOIFI, in its Shari’ah Standard No. (8) concerning Murabahah, states: "2/3/1 It is not permissible that the document of promise to purchase (signed by the customer) should include a bilateral promise which is binding on both parties (the Institution and the customer). 2/3/2 The customer’s promise to purchase, and the related contractual framework, are not integral to a Murabahah transaction, but are intended to provide assurance that the customer will complete the transaction after the item has been acquired by the Institution. If the Institution has other opportunities to sell the item, then it may not need such a promise or contractual framework. 2/3/3 A bilateral promise between the customer and the Institution is permissible only if there is an option to cancel the promise which may be exercised either by both promisors or by either one of them." AAOIFI, supra note 43, at 202-03. AAOIFI also, in its Shari’ah Standard No. (9) concerning Ijarah and Ijarah Muntahia Bittamleek, states: "8/1 In Ijarah Muntahia Bittamleek [Ijarah or leasing ending with ownership transfer/lease-to-own agreement], the method of transferring the title in the leased asset to the lessee must be evidenced in a document separate from the Ijarah contract document, using one of the following methods: a) By means of a promise to sell for a token or other consideration, or by accelerating the payment of the remaining amount of rental, or by paying the market value of the leased property. b) A promise to give it as a gift (for no consideration). c) A promise to give it as a gift, contingent upon the payment of the remaining instalments. In all these cases, the separate document evidencing a promise of gift, promise of sale or a promise of gift contingent on a particular event, should be independent of the contract of Ijarah Muntahia Bittamleek and cannot be taken as an integral part of the contract of Ijarah. 8/2 A promise to transfer the ownership by way of one of the methods specified in item 8/1 above is a binding promise by the lessor. However, a binding promise is binding on one party only, while the other party must have the option not to proceed. This is to avoid a bilateral promise by the two parties which is Shari’ah impermissible because it resembles a concluded contract." Id. At 249-50. Also, regarding the subjects of discharging of promise and Murabahah for the orderer of purchase, IIFA in its resolution 40-41 (2/5 & 3/5) states: "First: Murabahah sale by purchase orderer is permissible on goods already in the physical possession of the seller, as required by Shari’a, provided the seller carries the risk of loss before delivery or the consequences of returning the purchased goods because of concealed defects or any other reasons justifying the return of the goods after their reception, provided the conditions of the sale are met and with the absence of any impediments. Second: According to Shari’a, a promise (made unilaterally by the purchase orderer or the seller), is morally binding on the promisor, unless there is a valid excuse. It is however legally binding if made conditional upon the fulfillment of an obligation, and the promisee has already incurred expenses on the basis of such a promise. The binding nature of the promise means that it should be either fulfilled or a compensation be paid for damages caused due to the unjustifiable non fulfilling of the promise. Third: Mutual promise (involving two parties) is permissible in the case of Murabaha sale provided that the option is given to one or both parties. Without such an option, it is not permissible, since in Murabaha sale, mutual and binding promise is like an ordinary sale contract, in which the prerequisite is that the seller should be in full possession of the goods to be sold, in order to be in conformity with the Hadith of the Prophet (PBUH) forbidding the sale of anything that is not in one's possession." INTERNATIONAL ISLAMIC FIQH ACADEMY (IIFA), RESOLUTIONS AND RECOMMENDATIONS OF INTERNATIONAL ISLAMIC FIQH ACADEMY 1985-2000 86-7 (Islamic Development Bank - Islamic Research and Training Institute: Jeddah, Saudi Arabia, 1st ed. 2000). For further details on a unilateral promise and a bilateral promise, see p. 93.\footnote{AAOIFI, in its Shari’ah Standard No. (49) concerning Unilateral and Bilateral Promise, states: "[a]ny promise in a sale contract made by the buyer or the seller that results in a repurchase contract ('Inah) is prohibited by the Shari’ah, whether the promise is part of the sale contract or is given prior or subsequent to it, such as purchasing an item on credit and promising to sell it back on spot for a lower price or selling an item on credit and promising to buy it back on spot for a lower price (reverse 'Inah). The same prohibition applies if the parties collude with a third party to act as an intermediary in the repurchase." AAOIFI, supra note 43, at 1165. For further details on 'Inah, see p. 85.}}
religiously, the promisor and the promised party should enter into a new contract which includes an offer and acceptance to fulfill the promise. Based on this view, Sukuk assets ownership is not automatically transferred to the promisor until the new contract is concluded. AAOIFI excluded one case that does not require entering into a new contract to fulfill the promise. Based on the foregoing, after entering into a new contract, these Sukuk will represent debts against the buyer/originator, who fulfilled his promise to buy the Sukuk assets (redemption of Sukuk), until the price of the assets is paid to investors. Thus, these Sukuk will be subject to the provisions of the debts. In case of late payment of the consideration, the investors/sellers can not liquidate and sell these Sukuk unless the conditions of the sale of debts stipulated by Shari’ah jurists are met.

The relationship between the default risk and the risk of a rise in the interest rate or profits margins appears, for example, when there is default on payment of periodic returns or the amount of amortization. This will cause investors to lose the opportunity to trade in other sukuk that provide higher returns, due to the rise in the interest rate in the market. If the company issuing the sukuk has defaulted on payment and the parties concerned agreed to restructure the debt, which is supposed to be interest-free, investors will not be compensated vis-a-vis missing the opportunity to reinvest their funds. As such, they will not have the same merit available in case of debt rescheduling in conventional debt instruments. In conventional debt instruments, it is taken into account, whether there was a rise in the interest rate during the rescheduling arrangements or it was foreseen in the future, as previously mentioned, that the prospect of a rise in the interest rate increases in long-term bonds.

The relationship between the default risk and the risk of non-compliance with Islamic Shari’ah unfolds if the Sukuk are declared void. In this case, sukuk holders will be able to recover only their subscribed capital, but they

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86 AAOIFI states: "8/4 In case the Ijarah contract is combined, through a separate document, with a gift contingent upon the condition that the remaining rent instalments be paid, the ownership to the leased property is transferred to the lessee if the condition is fulfilled, without the need for any other procedure to be adopted or a document to be signed. However, if the lessee’s payment is short of even one instalment, the ownership to the property is not transferred to him, since the condition has not been fulfilled." See AAOIFI, supra note 43, at 250.
will not be entitled to receive any returns or yield, in general, from the sukuk as consideration of their investment. Perhaps, in other circumstances, the sukuk will be rendered as legitimate, with the annulment of certain clauses that gave sukuk holders some privileges related to their returns or financial guarantees.

Fourth: Islamic Fiqh prescribes to grant a respite to the insolvent

Among the reasons underlining the importance of investigating the financial guarantees and protective hedges is that many Shari’ah jurists and legal schools of Islamic Fiqh, including the Hanbali school, which is often relied on in the Saudi courts, see the necessity of granting the insolvent a respite, if and when insolvency is proved. In this case, the insolvent cannot be forced to pay the debt, put under house arrest, let alone be imprisoned.87 The insolvent or bankrupt party in view of Islamic Fiqh is the one whose debts outbalance his wealth.88

Fifth: Restrictions on financial instruments used to manage credit risk

Islamic Shari’ah places numerous restrictions on derivatives,89 including swaps, futures, forward contracts, and the like,90 which are typically employed by financial institutions and conventional banks when dealing with credit and counterparty risk. When sukuk originators default on their financial obligations and fall behind with their payments, their default will be more detrimental to sukuk investors, especially Islamic banks that have fewer options than conventional banks when dealing with these risks, than to conventional bondholders, if bond issuers defaulted.91

88 **See id.**
89 Derivatives defined by Tariqullah Khan and Habib Ahmed as: “an instrument whose value depends on the value of something else. The major categories of derivatives are futures, options, and swap contracts. Futures are forward contracts of standardized amounts that are traded in organized markets. Like futures, options are financial contracts of standardized amounts that give buyers (sellers) the right to buy (sell) without any obligation to do so. Swap involves agreement between two or more parties to exchange set of cash flows in the future according to predetermined specifications.” **DR. TARIQULLAH KHAN & HABIB AHMED, RISK MANAGEMENT: AN ANALYSIS OF ISSUES IN ISLAMIC FINANCIAL INDUSTRY** 48 (Islamic Research and Training Institute affiliated to Islamic Development Bank, Jeddah, Saudi Arabia, 1st ed. 2001).
90 For a broader discussion of the Fiqh ruling on derivatives from the perspective of Islamic law, see **Dr. Khalid A. Al-MuAnna, AlMushtaAqat Almalyt: Dirasat Faqahiyya [Derivatives: FiQH Study]** 222-26 (SABIC Chair for Islamic Financial Market Studies - Research Chairs Program in Imam Muhammad Ibn Saud Islamic University: Riyadh, Saudi Arabia, 2013).
91 In this respect, Ali Tariq says with regard to those risks: “[i]f the relationship involves a contractual arrangement than the counterparty risk is the probability that the counterparty retracts on the conditions of the contract. The consequences can be severe with a decline in the value of a bank’s assets. The credit and counterparty risks inherent in Islamic finance are unique owing to the nature of Islamic financial instruments that become the foundation of the sukuk asset pools. Unlike conventional financial institutions, Islamic banks do not have access to derivative instruments and other credit risk management mechanisms due to Shari’ah considerations.” **Tariq, supra** note 80, at 48.
Sixth: In some conventional debt instruments, credit risk is spread over a large segment of borrowers

In conventional securitization, in particular, securities holders own a common share in the securitized assets, which are typically pool of loans that the lending bank has securitized to respond to its need for financing. In this case, those obliged to make the repayment are a group of borrowers, and it is rare that they unanimously agree on defaulting. However, the situation is different in sukuk, as the obligor to payment is not a group but usually one party, i.e., the originator of the sukuk. The structures of those sukuk imply indebtedness and obligation to pay by the originator, as in Murabahah sukuk, Ijarah sukuk as well as in other types of sukuk that are originally contracts based on profit-sharing and loss-bearing, such as Musharakah sukuk. But, often in sukuk markets, the latter are converted into debt if the originator undertakes a pledge to purchase the assets at the amortization date. However, this will be elaborated on when talking about the risk of bankruptcy in the next section.

Seventh: Limited funding options

Both parties in the Sukuk (i.e. the originators and investors) face limited financing options if they commit or prefer to comply with Islamic finance principles for religious or investment reasons. When the originator is on the verge of default, it is unlikely to resort to the conventional loan option which is widespread and includes interest because it is forbidden in Shari’ah. As for creditors in defaulted Sukuk, such as Islamic banks, who may owe third parties as a result of financial transactions or may be obliged to have a certain level of liquidity, financing options are also limited, as they are committed to adherence to Shari’ah.

1.3.3. Default risk in sukuk

1.3.3.1. Sukuk investors are exposed to default risk

One of the most significant risks that Islamic financial instruments suffer – of which sukuk are considered one of the most important structures - is credit risk, (aka default risk), which has not received sufficient research to in order to protect sukuk holders. This risk also has a negative impact on banks, financial institutions and conventional bonds. James Gleason counted credit risk among the overall risks to banking institutions in
Islamic banks and financial institutions are not spared from this dilemma, as they are based on the same contract structures on which sukuk are issued, such as Murabahah contracts and lease-to-own contracts, which turn into a debt against the beneficiary of financing, Musharaka contracts as well as other Shari’ah-compliant contracts. The scope of research varies among researchers when it comes to the question of credit risk facing Islamic financial industry. Some focused on Islamic banks; some devoted their theses to the field of Islamic trade financing formulas; while others focused on sukuk. In all these studies, credit risks, their impacts and images are almost the same, because Islamic banks and sukuk are based on formulas or contracts recognized by Islamic finance system. Dr. Adel Bogari pointed out that conventional banks are vulnerable to credit risk, which is the inability of the borrower to meet its financial obligations, while Islamic banks do not face this type of risk, according to the author. However, the Islamic banks are vulnerable to other risks, such as financing risk, investment risk and indebtedness risk. Yet, we have a reservation on the exclusion of credit risk from Islamic banks, because debt does not only arise from interest-based loans, but it can also arise from the forward sale, the rent generated from Ijarah, and the like. The reason for that exclusion may be that the author confined credit risk to loan contracts. However, this dispute is not of great significance as long as the author counted the risk of indebtedness among the risks facing Islamic banks. In his research, Ali Tariq focused on the risks of sukuk structures, and he briefly discussed credit and counterparty risk. He pointed out that sukuk based on Murabahah, Ijarah, Salam (Advance payment and future delivery of a product sale contract) and Istisna’a (commissioned manufacture) are exposed to these risks. Najla’ al-Baqmy discussed in her research Sukuk risks and their underlying formulas, stressing that Murabahah and leasing Sukuk face credit risk. Sukuk holders are vulnerable to the risk of default or delay in the periodic payment or the amortization of sukuk. This can happen due to

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93 See Dr. Adel A. Bogari, Makhatir Siagh Altumwil Alitjariat Al'iislamiat Fi Albunuk Alsewdy [Risks of Islamic Financing Forms in Saudi Banks] 115 [Unpublished dissertation submitted to the Faculty of Shari’ah and Islamic Studies of Umm Al-Qura University, for a PhD in Islamic Economics, 2005].
94 See id.
95 See Tariq, supra note 80, at 48.
financial constraints, lack of liquidity encountering the beneficiary of financing, or for any other reason involving ill-will or procrastination by the debtor to seize another investment opportunity, particularly in light of the limited financial guarantees provided to investors that should be strict enough to ban any procrastination or delay.

1.3.3.2. Meaning of the default/credit risk

Having considered many definitions of credit risk, which some call financial risk,97 we find that these definitions are almost identical. For the sake of space, we mention here only one of them offered by the Basel Committee on Banking Supervision, which defined it as the possibility of the bank borrower or counterparty not meeting its financial obligations as stated by the contract.98

1.3.3.3. When does the default risk occur?

In Sukuk, when there is a possibility that it not possible to recover or to regain the debts or assets, or that there is a delay in the process of their retrieval, that is considered as a credit risk.99 Credit risk in bonds can affect the periodic payments/coupons, and the principal, which represents the bondholders' capital. Credit risk in sukuk, in contrast, varies according to the type of sukuk. The risk may be related to the periodic installments accruing from the forward sale of a commodity, or to the redemption of an asset sold by a party desirous of financing that has pledged to lease it out for a fixed term and repurchase it at the maturity and amortization date, as is the case with Ijara and Musharakah Sukuk.

1.3.3.4. Sukuk are more prone to credit risk than conventional bonds

Sukuk are more vulnerable to credit risk than conventional debt instruments, as some of them have already been explained. In addition, the sukuk process goes through specific stages and procedures ordained by Islamic financing standards and the nature of their underlying contracts. Each stage has its own risks, regulations and contracting parties. The longer the procedure takes place, the more diverse the parties to the contract, or the more there are restrictions or a certain limit or ceiling to deal with a situation or dilemma posed, the less remedy options

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97 See Dr. Badruddin Q. Mustafa, Altahawut Wa’iidarat Almakhatir Fi Almuasasat Almaliat Al'iislamiati [Hedging and Risk Management in Islamic Financial Institutions] 4 (A paper presented to the Khartoum Forum for Islamic Financial Products, entitled Hedging and Risk Management in Islamic Financial Institutions, April 5-6, 2012).


99 See Tariq, supra note 80, at 48.
there will be. Complexity of the solutions make them crippled by obstacles and barriers, as is the case in the sukuk markets.

1.3.3.5. **Credit risk associated with the Sukuk structures of Murabahah, Ijarah and Musharakah**

In Sukuk, the features of default risk vary subject to the structure of the sukuk and the type of underlying contract on which the sukuk are based. As the scope of this research covers only three types of sukuk: Murabahah, Ijarah and Musharakah, the focus will be on these types. Also, when discussing the case studies, we will explain how that risk arises.

1.3.3.5.1. **Credit/default risk in Murabahah Sukuk**

In Murabahah Sukuk, the risk of default appears in many ways, depending on the stage of the sukuk. For example, the risk arises when the buyer (i.e., the “issuer” in conventional bonds) of securitized asset fails to pay the periodic installments or the sum of the amortization. It also arises when the party pledging to buy the commodity goes back on its words after investors have bought it, in view of jurists who see that the pledge is not binding. Reneging on the pledge could also be made by the owners of the commodity (Murabahah Sukuk investors) when a third party is desirous to purchase it at a higher margin, in view of those who regard that the pledge is not binding.

It is important to note that AAOIFI states that the promised party is entitled to receive compensation for the actual damage arising from the customer’s breach of a binding promise.\(^{100}\) This applies to several contracts such as Murabahah, according to AAOIFI.\(^{101}\) It, in its Shari’ah Standard No. (8) related to Murabahah, states: "[t]he actual damage to the Institution may not include the loss of its mark-up in the Murabahah transaction, that is, its opportunity loss."\(^{102}\) A promisor, who breaches his promise to buy the Murabahah asset, is obliged to pay the difference between the price of the cost of Murabahah assets and the price at which these assets are sold to a third party, according to AAOIFI. Here, potential Sukuk holders may be exposed to the default risk because there is

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\(^{100}\) See AAOIFI, *supra* note 43, at 210.

\(^{101}\) See *id.* at 210, 239, 1168.

\(^{102}\) *Id.* at 205.
possibility that the promisor/originator in Sukuk, who breached his promise to buy the Murabahah assets, would not pay the compensation on time.

1.3.3.5.2. Credit/default risk in Ijarah Sukuk

As to the credit risk faced by Sukuk al-Ijarah Muntahia beltamleek (lease-to-own sukuk), it has several images. Among those images is when a lessee defaults on paying the rentals (coupons) or the consideration of the Sukuk assets when he fulfilled his promise to buy such assets, through entering into a new contract as many Fiqh councils state, in redemption date. This default could happen due to insolvency or inexcusable procrastination. It is important to note that, AAOIFI, in its Shari’ah Standard No. (9) related to Ijarah, states:

[I]f the customer, in case of Ijarah associated with a promise to transfer ownership, breaches his promise, the promisor shall be charged either the difference between the cost of the asset intended to be leased and the total lease rentals for the asset which is leased on the basis of Ijarah Muntahia Bittamleek to a third party, or, in case of operating Ijarah, the promisor breaching his promise shall be charged the difference between the cost of acquisition and the total selling price if sold to a third party by the Institution (promisee). Otherwise; i.e., in case it is not sold, the promisee shall not be entitled to receive any compensation.

So, potential Sukuk investors face the default risk because there is possibility that the promisor/originator in Sukuk, who breached his promise to lease the assets on the basis of Ijarah Muntahia Bittamleek, would not pay that compensation on time.

1.3.3.5.3. Credit/default risk in Musharakah and Mudarabah Sukuk

Some researchers excluded Musharakah Sukuk and Mudarabah Sukuk from the financial structures that can be vulnerable to credit risk. Perhaps, this is because Musharakah Sukuk and Mudarabah Sukuk are based on risk-sharing and profit-sharing ground, besides they are variable-income contracts and, in principle, not contracts that create indebtedness relationship. As such, there is no obligation to pay a fixed sum, but a percentage of the profits, if any, of the investments of the asset sold to the investors. However, credit/default risk can occur

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103 See p. 3506.
104 AAOIFI, supra note 43, at 239.
105 See AL-BAQMI, supra note 96, at 92.
theoretically and practically in Musharakah Sukuk and Mudarabah Sukuk, but these structures may be less vulnerable to such risk compared to some other structures. In Musharakah and Mudarabah Sukuk, theoretically speaking, the beneficiary of financing that has sold its assets to investors or shared assets with them and is managing assets on behalf of the sukuk holders with a pledge to repurchase the assets as partner, shall not guarantee the capital of investors, which is the par value of the sukuk when the IPO of the sukuk was made. It is not permitted in Islamic law to stipulate that the originator in Sukuk as a manager or partner guarantees the capital of investors. However, the securitized assets’ manager that is often the beneficiary of the financing is obliged to felicitously invest them. Therefore, when the capital is adversely affected as a result of the negligence or dereliction of the manager of these assets, the manager may become liable to the capital of the investors in Islamic law.

Here the capital of investors would be as debt against the manager. Thus, the contract of Musharakah and Mudarabah may include indebtedness and here the default risk may arise. Perhaps, this is the reason for why AAOIFI allows [investors] to obtain guarantees - from the Mudarib in Mudarabah contract or from another partner in Musharakah contract - that can be enforced in cases of misconduct, negligence or breach of contract on the part of such Mudarib or on the part of such another partner. Also, the risk of default may arise when the originator in the Musharakah Sukuk defaults on paying the consideration of the Sukuk assets at the redemption date when he fulfilled his promise to buy back these assets - which was sold to investors when the Sukuk was issued - as per their market value or as per agreement at the date of buying. This promise should be fulfilled through entering into a new contract as many Fiqh councils state. This risk can also occur when

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107 AAOIFI, supra note 43, at 331, 348, 372; see also Al-Khowaiter, supra note 106, at 256-57.

108 AAOIFI, supra note 43, at 331, 348, 372; see also Al-Khowaiter, supra note 106, at 256-57. In its resolution No. 178 concerning Islamic Sukuk, IIFA states that one of Sukuk characteristics is "the dismissal of the liability of the agent (proxy or managing partner)". International Islamic Fiqh Academy (IIFA), Resolutions and Recommendations of International Islamic Fiqh Academy (1403-1430 A. H. / 1988-2009 A.D.) (19 Sessions) 413. Collected by Abdelhak Lafa. (n.d.). It also states: "the agent of sukuk is a trustee and shall not guarantee the value of sukuk except in case of encroachment, negligence, breach of the terms of Mudarabah, partnership or agency in the investment. Sukuk may not be amortized at their par value, but they shall be amortized at their market value or at the value agreed upon upon redemption”. Id. at 413; see also Al-Khowaiter, supra note 106, at 256-57; see also al-Morsheedi, supra note 106, at 90.


110 See p. 35-6.
investors sell assets to third party as a result of promisor's refusal to fulfill his promise to buy such assets. However, AAOIFI does not mention the method of compensation in case the promisor does not fulfilled his promise to purchase the assets of the Musharakah or Mudarabah contract. Perhaps, the reason is that AAOIFI states that the purchase promise in these contracts at the redemption date must be exercised only at market value or as agreed by the parties at the time of fulfillment of purchase promises. So, there is no promised specific value, unlike Murabahah and Ijarah Muntahia beltamleek. However, it is likely that the AAOIFI considers that the promisor is obliged to pay the difference between the market value of the assets and the price of selling of the assets to a third party if later price is lower than the market value.

To summarize this part, Murabahah, Ijarah, Musharakah and Mudarabah sukuk, like conventional debt instruments, may face the risk of default in many ways. Therefore, that should be met by providing adequate financial safeguards in order to eliminate those risks and protect sukuk holders.

1.3.4. The risk of bankruptcy in Sukuk

Despite the close relationship between Sukuk and bankruptcy risk, the latter, being one of the most significant risks faced by investors, particularly as it may jeopardize a large share of their capital, has not adequately been addressed as a separate type of risks, according to the literature we reviewed. Perhaps, this is because bankruptcy risk was listed under the risk of default. Based on how researchers understood it, the risk of bankruptcy was defined as, "[t]he risk that a firm will be unable to meet its debt obligations. Also, it is referred to as default or insolvency risk." The lack of cash flows caused by increased operating expenses and under-sales is a direct cause for financial stumbling of corporations, which in this case may resort to short-term borrowings. They would be at risk of bankruptcy and insolvency if the corporation's attempts to improve its financial situation did not succeed. Technically speaking, a company would be insolvent if it failed to meet its debt obligations including paying the interest, the principal and the income tax liabilities, although the value of its assets may

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113 See id.
exceed the value of its liabilities. Meanwhile, a company would be legally insolvent if its liabilities outbalance the value of its assets. In case it failed to meet its debt obligations and filed a bankruptcy petition, now it is declared bankrupt.

1.3.4.1. Bankruptcy issues and ways of its risk arising in Islamic sukuk and conventional securitization

One of the possible reasons of not giving bankruptcy in sukuk as much attention as the default risk in sukuk, bonds and conventional securitization is that some believe that Islamic and conventional securitization have many things in common, including the parties concerned and the nature of the securitized assets. Yet, such assumption has no foundation. This point is worth clarifying not only for the sake of discussing this probable conjecture but also to briefly underline the difference related to the issue of bankruptcy and the type of securitized assets between Islamic and conventional securitization systems. By understanding this difference, the distinction in the applications and the concerned parties at risk of bankruptcy becomes clear, so that the conventional securitization scenario does not loom on Islamic securitization. Once the difference between the two systems is manifest, some of the sukuk investors' sufferings and high-level risk will unfold in terms of bankruptcy risk, compared to conventional securitization and bonds.

1.3.4.2. Difference between the arising of bankruptcy in Islamic and conventional securitization systems

Bankruptcy risk and credit risk are different in the above Islamic and conventional securitization systems, with a higher risk possibility in sukuk that reflects more negatively on the rights of potential sukuk holders than on conventional securitization investors. The differences associated with these risks can be envisaged in the quality of the assets, the nature of the concerned parties and the interrelationships that are determined by the type of...
securitization. However, this issue will be discussed in some detail when assessing and analyzing the financial guarantees and protective hedges in the relevant chapter.

1.3.4.3. Type of securitized assets in Islamic and conventional securitization systems

The first difference between Islamic and conventional securitization systems is that the assets securitized in conventional securitization are typically receivables and future cash flows, while assets in Islamic sukuk are objects, usufructs, services or enterprises, as referred to in the course of discussing the theoretical aspects of sukuk. Conventional securitization is defined as: "sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets."\(^ {117} \)

Based on this definition, conventional securitization represents ownership interests in a pool of segregated or income-producing assets. It may also signify debt instruments secured by one of those assets. Apparently, the

\(^ {117} \) See Thomas J. Gordon, Securitization of Executory Future Flows as Bankruptcy-Remote True Sales 1320 (The University of Chicago Law Review, Vol. 67, Issue No. 4, Article 7, Pages: 1317-1346, 2000). Available from: https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=5898&context=uclrev. (accessed on 29th October 2018). In some countries, asset-backed securities have many images. For example, one of the most popular forms of asset-backed structures in the U.S. are residential and commercial mortgage-backed securities. See JOSEPH C. H. ASSET SECURITIZATION THEORY AND PRACTICE 52 (John Wiley & Sons (Asia) Pte. Ltd, 2011). Experts differed regarding the classification of the types of asset-backed securities and about what falls under each class. As this dispute falls outside the scope of the present research, we will hereunder briefly mention some of those different classifications. Many researchers and financial institutions, such as the US Federal Reserve, divided asset-backed securities into two main categories, notably the pay-through structure and the pass-through structure. See FEDERAL RESERVE BANK, FEDERAL RESERVE SYSTEM, AN INTRODUCTION TO ASSET SECURITIZATION 10. Available from: https://www.federalreserve.gov/boarddocs/srletters/1990/SR9016a2.pdf. (accessed on 29th October 2018). Some classified securitization in consideration to cash flow into three categories; the abovementioned two categories in addition to a third category, the collateralized debt. See World Bank, Securitization - Key Legal and Regulatory Issues, Global Financial Markets Department, 7 [A paper No (39554) submitted to IFC-sponsored project]. (IFC’s Global Financial Markets Department, Securities Market Unit, Jan 1, 2004). Available from: http://documents.worldbank.org/curated/en/747401468092077080/pdf/395540Securitization.pdf. (accessed on 29th October 2018). Some listed the three categories under mortgage-backed securities. See Ammar Boutoukuk, Dawr Altawriq Fi Nashat Albnk: Halat Bank Al-Tanmiyat Almahaliya [The Role of Securitization in Bank's Activity: A case Study of Bank al-Tanmiyat al-Mahaliyah] 31-3 [Unpublished thesis submitted in partial fulfillment of the requirements for the degree of master of Economic Science at the University of Mentouri-Constantine, 2008]. However, some specialists described the pay-through structure as asset-based securities, whereas the pass-through is asset-backed securities. See Dr: Abdulrahim A. al-Sa’aati, Awažayif Ala’iqatisadiat Lilsuuk: Nazrat Mqasyd [Economic Functions of Sukuk: an Objective Perspective] 6-7 [A paper presented to the symposium of "Islamic Sukuk: presentation and evaluation" held at King Abdul Aziz University in cooperation with the International Islamic Fiqh Academy of the Organization of the Islamic Conference, and the Islamic Research and Training Institute of the Islamic Development Bank, Jeddah, Saudi Arabia, May 24-26, 2010]. The pass-through structure is defined as: "the simplest way to securities assets with a regular cash flow, by selling direct participation in the pool of assets. In other words, a pass-through certificate represents an ownership interest in the underlying assets and thus in the resulting cash flow. Principal and interest collected on the assets are "passed through" to the security holders; the seller acts primarily as a servicer." World Bank, at 7. The pay-through structure is defined as: "a borrowing instrument, not a participation. Under the pay-through structure, the assets are typically held by a limited purpose vehicle that issues debt collateralized by the assets. Like a pass-through, the debt service is met by cash flow "paid through" to investors out of the pledged collateral. Investors in a pay-through bond are not direct owners of the underlying assets; they have simply invested in a bond backed by some assets. Therefore, the issuing entity can manipulate the cash flows, into separate payment streams. Thus, pay-through securities may be structured so that asset cash flows can be reconfigured to support forms of debt unlike those of the underlying assets." World Bank, at 7.
definition did not specifically identify the quality of the assets, albeit it implicitly referred to it by saying that the aim is to reduce certain risks related to lending, namely credit risk, and transferring those risks to the investors. However, the definition did not confine that to lending, as apparently understood from the phrase "owning" that means owning those assets whose type was not determined. Practically, however, in conventional securitization, the intended assets are loans and future receivable cash flows that are derived from the pool of assets. These assets, which are intended to be sold to the SPV and then be securitized, are either secured by guarantees, such as mortgage loans, or unsecured loans, such as credit card receivables. In case of assets not secured, the importance of credit enhancements is highlighted.

Sukuk, according to the definitions of a number of established entities and Fiqh bodies, such as AAOIFI\textsuperscript{118} and IFSB,\textsuperscript{119} represent a common share in the ownership of objects, usufructs, enterprises or services, with the exclusion of debts and receivables, especially if they are the principal target and not a subordinate. Thus, conventional securitization that is structured in this way is forbidden in Shari’ah, besides that these debts arise from interest-bearing loans that are prohibited in Islamic Law. Hence comes the merit of Sukuk, if applied as they should be, in the types where sukuk holders own the assets and have recourse to them in specific cases, such as the default of the originator of sukuk, the company seeking financing, on the periodic payments or when the originator goes bankrupt.

However, this merit is restricted to two cases. The first is that the Sukuk must be structured in accordance with contracts whose underlying objects are particularly the assets, and not usufructs, such as Murabahah and Ijarah, the latter being of the type where the assets are sold to investors and leased out by the originator on a lease-to-own agreement. The second case is when the nature of the Islamic contract on which the sukuk are based requires

\textsuperscript{118} According to AAOIFI, "[i]nvestment Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after 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." AAOIFI, *supra* note 43, at 468.

\textsuperscript{119} According to IFSB, Sukuk are “certificates with each sakk representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture (such as a mu'ārabah). These assets may be in a specific project or investment activity in accordance with Shari'ah rules and principles.” ISLAMIC FINANCIAL SERVICES BOARD (IFSB), CAPITAL ADEQUACY REQUIREMENTS FOR SUKUK, SECURITISATIONS AND REAL ESTATE INVESTMENT 3 (IFSB, January 2009). Available from: https://www.ifsb.org/standard/eng_%20IFSB-7%20Capital%20Adequacy%20Requirements%20for%20Sukuk,%20Securitasations%20and%20Real%20Estate%20Investment%20(Jan2009).pdf. (accessed on 29th October 2018).
that the Sukuk holders have the right to own the assets throughout the issuance period, such as the lease agreement described in the abovementioned example. In this way, Murabahah Sukuk are excluded from this merit because the assets are sold to the originator or finance seeker at the early stage of Sukuk issuance. The term of owning and holding the assets by investors depends on the type of contract according to which the sukuk are issued. For instance, the nature of Musharakah and Ijarah Sukuk in which the ownership of the assets is transferred by way of shareholding and selling, such as the two types of defaulted Sukuk we shall address in this dissertation, is that the Sukuk holders are assumed to be the owners of those assets until the maturity date when the originators are expected to repurchase the assets. As to Murabahah Sukuk, the sukuk holders own the assets, albeit the period of their ownership of the assets is only at the early stage of the Sukuk life. This is because they will sell them as futures to the originator who will be bound to pay the installments throughout the term of the issuance. Stability of conventional securitization depends on the credit enhancements and collaterals securing the securitized receivables. In some types of Sukuk, such as Musharakah and some modes of Ijarah Sukuk, investors, as alleged at the theoretical level, hold possession of the assets that are existent and available for sale in the market in specific circumstances. This is unlike the receivables that could be defaulted by the debtors. Thus, conventional securities are regarded as inferior to Sukuk, even if the earlier are secured by mortgaged assets, since their holders may take a long time to foreclose those assets or fail to recover their capital in case the debtors go into bankruptcy.

1.3.4.4. The nature of the parties involved in the two securitization systems

One of the major differences between the two forms of securitization is that the relationship between the originator and the investors in conventional securitization differs from that of Islamic sukuk, and this difference defines the nature and origin of bankruptcy. In conventional securitization, the relationship between the originator and the investors is created in the first securitization procedure. Once the assets/pool of loans have been sold, the relationship between them is almost terminated and the responsibility of the originator, e.g. the lending bank, is disclaimed, except as per what is often stated in the prospectus or securitization documents, such as the interest transfer services and cash flows from the sold assets, as will be discussed later. In sukuk, the relationship between the originator or finance seeker and the investors remains constant until the end of the issuance term. The
originator may be a buyer on credit. In some sukuk structures, he may sell the assets to investors in cash and then buy them back on credit, as is the case with one of the defaulted sukuk that will be discussed later in this dissertation. The originator may also be a leaseholder in a lease-to-own contract after had sold the assets to the investors, or he may be a partner in Musharakah Muntahiah beltamleek (a participate-to-own agreement) after pooling his assets under the contract of participation.

Based on this distinction, it appears that the risk of the Sukuk originator’s bankruptcy is much higher than the risk of its counterparty in conventional securitization. The reason is that the bankruptcy of the sukuk originator results in the risk of default on payment to the sukuk holders because the originator is committed to them under one of the contracts on which the sukuk are based, which often create a creditor - debtor relationship. The risk of default and the risk of bankruptcy in sukuk arise from the same origin, which they share with conventional bonds. However, in conventional securitization, if the originator goes bankrupt, the securities holders will not be affected. This is because the contractual relationship is either between them and the borrowers - as the originator (e.g., a lending bank) sold the receivable loans it holds to the SPV that in turn issues securities in which investors subscribe, in case the issued securities represent undivided ownership interest in those assets (loans) - or between them and the SPV in the event that the SPV issued bonds secured by the assets transferred to it. Those securities, in this event, represent a debt. The most efficient procedure to hedge against the bankruptcy of the originator in conventional securitization is to ensure the valid transfer of the assets from the originator to the investors. Assets, loans or receivables, must be transferred from the originator to the SPV as a true sale transaction so that the securities holders are not harmed by the originator’s bankruptcy. For this reason, many legal researches focused on two issues to safeguard investors' rights: the confirmation that the SPV is independent from the originator and that the transfer is made through a true sale of the assets, as will be covered in the chapter on assessing existing guarantees provided to investors. In sukuk, even if the assets were transferred from the originator to the sukuk holders, their returns would be affected if the originator went bankrupt, in case the relationship between them was an indebtedness relationship, as is the case with most of sukuk. This indebtedness relationship lasts throughout the issuance term or it takes effect at the amortization date as effected by the promises made by the originator.
The different nature of the parties concerned in the two systems of securitization has a fundamental effect, i.e. investors in sukuk are more vulnerable to the risks of default and bankruptcy of the originator/the obligor than their counterparts in conventional securitization. In the latter, the borrowers or the obligors are a large group, which would exclude the possibility of their unanimous agreement on default. As such, credit and bankruptcy risks are divided and distributed among them, unlike the case with sukuk as the obligor is typically a bank or a company and the risks are concentrated in the hands of one party.

1.3.4.5. Inadequacy of legal research on some aspects of Sukuk

Conventional securitization has assumed an important position by virtue of the available instructions, academic studies and legislations that are clearer in conventional securitization compared to sukuk. This is in addition to the uniform standards, such as those related to the separation between corporation and SPVs, free trading in the secondary market, methods to avoid the bankruptcy of SPV and the concept of trust. Sukuk, in contrast, did not receive the same attention. For example, literature on Islamic legal research, especially in relation to the Gulf States, concerned with separation from the perspective of Islamic Shari'ah is very scarce. In the meantime, the Fiqh councils have not yet tackled the criteria of separation between companies or the legitimate foundation and its impacts on beneficial ownership that forms the basis of most of sukuk structures and is the subject of the interest of a limited number of experts and specialists. They did not address some of the important aspects that this dissertation aims to tackle. The growing number of Sukuk defaults almost ruined Sukuk credit, and their introduction to the market was a test of feasibility of their theoretical concepts. Hence, a need has emerged to reassess the status quo of Sukuk and to raise pivotal questions about the extent to which investors are protected from bankruptcy. This demanded the consideration of whether the problem was inherent in the procedures or in the theoretical framework. Based on that, a set of sub-questions branched off, as to whether investors’ ownership of the assets is true or the contract sale between them, through SPV, and the originator is superficial. Other questions also rose regarding the beneficial ownership and the promises made to the Sukuk holders.
1.3.5. Risk of non-compliance with Islamic Shari’ah

This type of risk is unique to Islamic financial transactions, under which Islamic sukuk fall. Some have defined that risk as: "the loss of asset value as a result of the issuer's breach of its fiduciary responsibilities with respect to compliance with Shari'ah." However, this definition is contestable; it identifies that risk with some of its possible effects. A more precise definition would be, the possibility that all or some the effects of the contract - or the effects of the sukuk process - will not be realized from the perspective of the Islamic Shari'ah. This is because the contract includes an embedded clause that nullifies or undermines it – by annulling one or more of its clauses or terms - when the authority competent to deal with this dispute is governed by Islamic Law or recognizes Islamic contracts. That risk may also arises, though with a lighter effect than the first case, if a Fatwa (Shari'ah-based advice) by one of the eminent Muslim jurists is issued prohibiting one of the issuances. The implications of this situation could reflect negatively on the subscription to or trading of the sukuk, in case they are tradable in the secondary market, as investors would be reluctant to invest in them. If the financial contract includes a condition in direct contravention of the Shari’ah, such as a transaction that includes Riba or Gharar, it will render the contract invalid in view of the majority of Muslim jurists of the four Fiqh schools in addition to other Muslim jurists. For example, Standard 31 of AAOIFI quoted cases of gharar that invalidate financial transactions. Some scholars of Islamic Shari’ah elaborated on the conditions that may or may not invalidate the contract, with a wide disagreement among them. Some of them endorsed the enforcement of the contract even if it includes shart batil (a false condition), disregarding that condition, while others rendered it invalid altogether.

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120 See Tariq, supra note 80, at 49; see also Zhamal K Nanaeva, How Risky Sukuk are: Comparative Analysis of Risks Associated with Sukuk and Conventional Bonds 27 [Unpublished Dissertation submitted in partial fulfillm of the degree of MSc in Finance and Banking, May 2010].

121 See Tariq, supra note 80, at 49.


123 See AAOIFI, supra note 43, at 772-73. It states: "Gharar violates the transaction when it satisfies the following four conditions: a) If it is involved in an exchange-based contract or any contract of that nature. b) If it is excessive in degree. c) If it relates to the primary subject matter of the contract. d) If it is not justified by a Shari’ah-recognizable necessity." Id.
1.3.5.1. Meaning of invalidity of the contract

The meaning of the invalidity of the contract is that the contract does not have any effect, and therefore each party to the contract will have to give back to the other what it has received. For instance, if the transaction is a sale contract, the seller would have to return the price, and the buyer would have to return the mabee’ (object) or the sel’ah (commodity). This is clearly envisaged in countries abiding by the provisions of Islamic Shari’ah and whose courts are competent to deal with financial disputes or in countries with quasi-judiciary bodies adjudicating under the Shari’ah Law. Invalidity of the contract can also be declared if the contract states that litigation and arbitration would be conducted under the laws of states that abide by Islamic law as their judicial system, or if the contract names an arbitrator who relies on the Shari’ah rules. Courts adjudicating this case within their jurisdiction and not abiding by the laws of Islamic Shari’ah will accordingly apply their respective laws, whereby the transaction might be rendered void if they are in conflict with courts’ respective laws.

1.3.5.2. Meaning of compliance with Islamic Shari’ah

It is difficult to formulate a precise definition for the meaning of compliance with the provisions of Islamic Shari’ah. The Shari’ah includes legal issues that are the subject of controversy among Muslim jurists. In this way, it is hard to unify the Shari’ah standards. The problem does not lie in the fact that some issuances do not follow the Shari’ah standards issued by some Muslim jurists or from the scientific and Fiqh councils. For even if such standards were observed, the dilemma remains. For example, in a financial transaction (such as Sukuk), if the standards of one of the Fiqh bodies or legal schools of Fiqh were observed, and the transaction or one of its terms was in conflict with the teachings of other schools, there is still a possibility that the transaction is nullified should the Shari’ah court or arbitrators not agree with the opinion of the body that has ratified the financial transaction. In general, if the financial process features the necessary terms and conditions as unanimously endorsed by the majority of Muslim jurists, this is sign of basic compliance with Islamic law. But, if the process does not include any condition that is prohibited by any Muslim jurist, here a high degree of compliance with Islamic law is

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achieved by virtue of consensus among jurists, which is one of the fundamentals of Shari’ah and has a binding force. In other words, if the financial process is consistently valid, there will be no legitimate risk. However, it is hard to imagine a contract devoid of any contestable item, as this would severely restrict the scope of transactions of traders and investors. Therefore, none of the jurist of Shari’ah stipulates the unanimous approval of the contract or clauses by Muslim jurists, because it is difficult to find a financial process that is consistent with the views of all Islamic jurists. However, getting out of the juristic dispute (al-khuruj min al-khilaf) is recommended (mustahab) in Shari'ah in case that dispute can be avoided, according to consensus of Muslim jurists. Some took advantage of this issue in a negative way. For example, in Dana Gas sukuk, the originator of the sukuk, who benefited from the proceeds of the offering, demanded that the sukuk be treated in the same way as that of conventional debt and bonds, as this would be in his favor in many respects. The originator claimed that the sukuk did not comply with Islamic law. Therefore, investors were intended to be vulnerable to less protection, as they would be denied some of the privileges granted to them by Islamic law in sukuk.

1.3.6. Views of competent scientific circles about the risks of default and bankruptcy

1.3.6.1. Academic circles and experts’ perspective to defaults and distressed Sukuk

The issues of Sukuk default has occupied the interest of experts in the scientific, academic and trade circles. Concerning this, Mohd Kamarudin, Norlela Kamaluddin, Siti Khadijah Manan, and Gairuzazmi Ghani say, "[t]he issue of sukuk default had gained particular attention in the recent years, especially after the global financial crisis that hit the world economy." They pointed out that those risks cause much concern to investors, arguing that, "one of the most significant risks for sukuk investors to consider is credit risk. Credit risk, also known as default risk, is the risk that a sukuk issuer will default on their payments of profit, rental and principal." They emphasized that before investing in sukuk, investors must clearly understand credit risks and their impacts on the

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125 See p. 332 in the present research.
128 Id. at 279.
value of sukuk. Default on payment or delay in making it may arise for voluntary reasons, as if the originator of sukuk defaults on payment despite its ability to meet its debt obligations. It may also result from adverse financial circumstances, as when the corporation or company issuing the sukuk becomes insolvent, a legal ruling is issued against it and freezes its account, or a declaration of its bankruptcy, voluntarily or involuntarily, is made.

1.3.6.2. The reasons of the need for protective hedges and financial guarantees to investors

In order to hedge investors against the default risk, the efficiency of financial guarantees should be optimized in Sukuk higher than that in conventional bonds for some reasons. Among those reasons are finding an alternative to additional interest prohibited in Islamic Law and overcoming the negative repercussion caused by some restrictions on Islamic financial transactions. Corporations and financial institutions desirous to obtain financing through sukuk have worked hard to provide financial guarantees to Sukuk holders in order to reassure them. Dr. Hamed Merah says,

Islamic investment banks have attempted to reduce the risks of sukuk so that they would match the level of bond risks and be classified and priced with the same classification and pricing mechanisms. Islamic financing engineering has utilized several tools in order to reduce the size of risk in sukuk and keep it abreast to bonds, from this angle, as much as possible.130

With regard to the degree of protection of the sukuk holders from credit risks, Hafizi Majid, Shahida Shahimi, and Mohd Abdullah explain that: "[t]his has created the perception that sukuk may not be any safer than conventional bonds in terms of investor protection and the treatment of defaults."131 Among the indications of the need for further research on Sukuk guarantees is what Dr. Abdullah al-Omrani mentioned following his talk about capital guarantees in sukuk and other instruments. He says,

129 See id. at 279.
By reviewing the existing types of guarantees, they were found unsuitable for guaranteeing, either because of their violation of Islamic Shari’ah provisions, their economic infeasibility, or for some other reasons. As a result, there was an inclination towards cooperative insurance, capital protection and risk management. On this occasion, it is worthy to stress the importance of continuing research to develop Islamic formulas to comply with Islamic regulations and legal objectives.\(^\text{132}\)

Relevant to this, which underlines the limitation of the methods of dealing with these risks at present, Dr. Badruddin Mustafa said that among the challenges facing Islamic financial institutions in general is "the lack of Islamic hedging tools to ward off risks."\(^\text{133}\) Majid, Shahimi, and Abdullah state that, "[s]o far, studies on sukuk defaults are very limited as compared to conventional bond defaults."\(^\text{134}\) Sukuk in general need further empirical research. Zhamal Nanaeva says, "Islamic financial market is a reliably new subject of research. Academic literature has few examples of empirical comparison of Islamic banks with conventional financial institutions... In spite of their rapid growth and increasing public attention, sukuk and Islamic capital markets are still under-searched and lack empirical analysis."\(^\text{135}\) The pressing need to study guarantees and risk hedges is highly emphasized when considering that in 2017, the AAOIFI, one of the most important financial institutions that issue Islamic financing standards, called upon stakeholders interested in this industry to submit blueprint proposals relevant to risks reserves,\(^\text{136}\) which represent a tool to protect investors. This was a first step taken in this direction by such influential institution worldwide to identify and set up credit risk standards.

\(^{132}\) Dr. Abdullah M. al-Omrani, *Aldamanat Fi Al'sukuk Al'iislamiati [the Guarantees in the Islamic Sukuk]* 264 (Majallat al-Jam'iyyah al-Fiqhiyyah al-Sa'adiyyah, Issue No. 16, 2013).

\(^{133}\) Mustafa, *supra* note 97, at 21. Speaking about the mechanisms of hedging against these risks, Najla' al-Baqmy emphasized the importance of finding proper hedges, adding, "these procedures are legitimately requisites obligated by Islamic Shari'ah for the sake of preserving wealth, which is one of the legal objectives of Islamic Shari'ah... Hedging against risks and trying to avoid them is a legal requisite because it is consistent with the objective of the preservation of wealth in Islamic Shari'ah." \(^{134}\) AL-BAQMI, *supra* note 96, at 125.

\(^{134}\) Majid, Shahimi & Abdullah, *supra* note 131, at 2. They also said, "[t]hus, it is interesting and important to investigate the issue of defaults, so that the implication of sukuk defaults on the Malaysian capital market could be minimized in future." \(^{135}\) Id. At 10.

\(^{136}\) Nanaeva, *supra* note 120, at 21.

1.3.6.3. Reasons of the necessity of evaluating financial guarantees and the inclusion of Shari’ah-compliant remedial options

Finding ways to protect Sukuk holders from default and bankruptcy risk is an important issue. Islamic financing rules are not void of many forms of financial guarantees and hedges, which companies desirous to obtain financing through Islamic Sukuk should provide in order to attract investors. In order to reassure investors in Islamic securities market and other Shari’ah-compliant debt instruments, adequate and effective alternatives to riba-based interest should be devised. At present, if we look at the situation in the sukuk markets, we find that there is nothing to distinguish Sukuk from conventional bonds. Rather, it can be said that Sukuk are not able to keep pace with bonds as the latter have outperformed sukuk in debt restructuring in the case of default. Other than this, both types of securities have almost the same conventional financial guarantees, such as mortgages and the guarantor party. However, when discussing the financial guarantees and remedial options, there will appear many restrictions on some of these guarantees. As to the claim that Sukuk are in a better position by virtue of being asset-backed securities, this is still contestable, and it cannot be taken for granted that all Sukuk types are asset-backed at each stage of the their term, and one of those cases are Murabahah Sukuk. Practically speaking, most Sukuk issuances, including Ijarah and Musharakah Sukuk, are structured in a controversial manner described as depriving Sukuk holders from some privileges inherent in the theoretical concept of Sukuk, which denotes that they have, for example, recourse to some types of the securitized assets in certain cases. However, this will be explained in the chapters on case studies and evaluating the current guarantees.

Leniency in accepting financial guarantees that are incompatible with Islamic Shari’ah and the inclusion of some clauses that violate it in the process of Sukuk issuing so that the Sukuk match conventional bonds will cause the sukuk to lose their fame as Shari’ah compliant. Unless the current protective hedges are reassessed and satisfactory Shari’ah-compliant alternatives are provided, the reputation of Sukuk will also be harmed in the eyes of investors from different backgrounds. When a dispute rises between the Sukuk holders and the beneficiary of financing and the case is considered before a Shari'ah-compliant court, non-compliance with the Shari'ah provisions may render the entire Sukuk process void. Consequently, the Sukuk holders will only regain their
capital, and a court may demand investors to give back the returns or yield, if any, they received on account of the nullification of the contract.

Sukuk investors are more vulnerable to many risks, especially the risk of default and the risk of bankruptcy, than their counterparts in conventional securitization and bonds, given the various negative impacts of those risks and the limitations imposed by the Islamic financial industry restrictions. To counter this, many specialists in the Islamic financial industry have supported and demanded the investigation of the current situation and the guarantees provided to investors that would guard them against those risks and make their rights safe.

There is much need for reassessing and enhancing the existing options and guarantees, determining what Islamic Law can provide to investors and for developing additional vital hedges for several reasons. This will help eliminate investors' concerns and reassure them about the seriousness and effectiveness of the financial guarantees. It will also alert Sukuk originators desirous to obtain financing of the consequential effects of the delay in the periodic payment and of their bankruptcy. This would make them disinclined to default on their debt obligations and prompt them to engage with the sukuk holders as positively and intently as possible. This is typically the situation in bonds, which, for example, impose additional interest when restructuring the debt. In this way, bond issuers are highly cautious of and alerted to the implications of default risk. Thus, bonds currently have an advantage over sukuk, the matter that should motivate sukuk specialists to reduce this gap by employing all possible tools and incentives. The ideas and results contributed by this dissertation will help to reassure not only potential sukuk holders who prefer to invest in Islamic financial products for religious purposes, but also Western and Asian investors. They will give them the green light to invest in sukuk markets, thereby expanding the sukuk market activities, particularly in the light that the present research investigates three case studies of sukuk default. In fact, sukuk need empirical studies in order to fill the research gap in this area. Zhamal Nanaeva says: "[l]imited historical data on sukuk performance, lack of research and absence of empirical studies are among the most serious bottlenecks in the area of sukuk development."137 The discussion based on empirical study is more likely to lead to better results than relying solely on theoretical concepts.

137 Nanaeva, supra note 120, at 35.
In the science of risk management, viable practical options to deal with risks after identifying and assessing them are either to be recognized but no action is taken, to be avoided by taking appropriate steps, to be reduced by finding other alternative approaches, or to be handled by a combination of them.\(^\text{138}\)

**1.3.7. The dissertation mechanism for achieving a better position of Sukuk, and legal referentiality of the present research to countering default and bankruptcy risks**

This dissertation will consider the possible means of avoiding or minimizing credit and bankruptcy risks that form a threat to investors’ investments. This includes investigating the repercussions of the risk of non-compliance with Islamic Shari’ah on Sukuk returns and investors’ capital. It should be noted here that the legal referentiality in Saudi Arabia is Islamic Shari’ah,\(^\text{139}\) and Sukuk is one of the Islamic financial products offered as an alternative to conventional bonds or securitization. Accordingly, the present research focuses on certain pivotal issues relative to preventive measures against default and bankruptcy risks, evaluation and development of guarantees provided in the defaulted sukuk cases selected in this dissertation and suggested remedies and solutions to counter or reduce those risks from Islamic law perspective. Since Muslim jurists have a vital role in understanding Shari’ah and in interpreting its texts, the present research mentions the views of the four schools of jurisprudence in Islamic law - especially the Hanbali School, which Saudi Arabian general courts follow its legal views as mentioned earlier -\(^\text{140}\) on many of issues presented in the present research. Also, Sukuk and their applications are one of the contemporary issues and subjects that have not been directly addressed by classical jurisprudence Schools of Islamic Shari’ah. To fill this gap, we mention the view of the most renowned international Jurisprudence councils. The jurisprudence councils whose views are quoted in the course of the description, analysis and discussion of this dissertation are AAOIFI, IIFA, FSSB of DFM and the Shari’ah Advisory Council of Bank Negara Malaysia.\(^\text{141}\) Reference will be occasionally made to classical jurisprudence schools, especially the Hanbali School, on emerging issues when they are not considered by any of those councils or a definitive opinion about them is not

\(^{138}\) See André Söderlind, *Risk Management in IT-projects* 21 [Unpublished thesis in Master of Science, the Master Degree Programme - International Project Management, Chalmers University of Technology, Göteborg, Sweden, 2007].

\(^{139}\) See p. 19-20 in the present research.

\(^{140}\) See p. 23 in the present research.

\(^{141}\) We will refer to the opinions of other Shari'ah councils and committees when needed.
made. In such case, the researcher shall rely on scholastic analogy (al-qiyaṣ al-madhābi) or derivation of practical Shari’ah rulings (al-takhrij al-fiqrī) by judging a contemporary issue in resonance with one of the issues dealt with by early jurists by virtue of the same ‘Ilāh (cause) and meaning existing in the two issues.

When talking about preventive measures against credit and bankruptcy risks and remedies, special reference will be made to Saudi Arabia in some respects, when necessary, highlighting what Saudi Arabia lacks in this regard. As mentioned earlier, and will be seen later, Saudi Arabia is way behind in the policies of dealing with Sukuk. So, there is a pressing need to address certain issues and problems relative to sukuk prior to the occurrence of credit and bankruptcy risks. For this reason, this study will make use of the experience of some countries that dealt with sukuk and debt instruments at an earlier time, which is reflected positively on countering sukuk risks and reassuring investors. It will also suggest avoiding the mistakes and gaps in the experience of some countries – based on the researcher’s observations - in this regard. As such, this dissertation will not only contribute to the development of tools and mechanisms of protecting potential Sukuk holders in Saudi Arabia but also in the Islamic financial industry that attracts many investors: individuals, corporations or governments. In the following chapters, we will come to know more about the guarantees that Islamic finance has to protect investors against credit and bankruptcy risks and the remedies it offers.

In order to achieve the desired objectives and after characterizing part of the Sukuk structures in comparison to conventional financial structures, this dissertation will evaluate and develop the financial guarantees and preventive measures of credit and bankruptcy risks stated in available documents of three case studies of defaulted Sukuk or provided to holders of these Sukuk, and it will review the scope of work of these financial guarantees. This will include holding a comparison, if possible, between the nature of the effectiveness and feasibility of each guarantee and its corresponding guarantee in conventional securitization or non-Islamic debt instruments. The dissertation seeks to consider the possibility that each issuance of the three distressed sukuk may benefit from the recognized guarantees and hedges invested in the other, to scrutinize the shortcomings in the guarantees, and to see whether they are effective enough to eliminate those risks and protect investors in sukuk. In addition, the dissertation will examine some of the legal clauses and formulas contained in the OC of the defaulted sukuk,
which aroused a wide controversy. However, the present research will not expand on determining the preponderant view among Muslim jurists on many legal and Fiqh disputes as there is no chance to end that dispute and would lead to a bifurcation of research because determining the preponderant view would require the presentation and argument of each team's evidence.

The three defaulted Sukuk issuances will be dealt with in a separate chapter that presents a general background about them and discusses them in general without going into depth in studying the financial guarantees and preventive measures provided to Sukuk holders to counter default and bankruptcy risks. A separate chapter will be dedicated to the evaluation and development of those guarantees. In the following chapter, the remedies provided by Islamic jurisprudence to deal with the default and bankruptcy risks will be discussed. Some precautionary options and protective tools will also be suggested, other than those provided by the defaulted companies, which are applied in other financial and investment fields outside of the sukuk markets, in addition to some innovative Shari’ah-compliant solutions to protect Sukuk holders by means of financial and jurisprudential engineering. In a subsequent separate chapter, the researcher will review the challenges that are likely to face those development and solutions, whether they are self-imposed or external.

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142 The financial and jurisprudential engineering is defined by Dr. al-Sa’atti as, "the designing and development of innovative financial instruments and mechanisms, or the structuring or deconstructing Islamic contracts in order to formulate creative solutions to financing problems. Among the legitimacy conditions of those creative solutions is that they must not be in conflict with Islamic text, a recognized juristic ruling, an objective of Islamic Shari’ah, or an established juristic consensus. In addition, the means and objectives pursued must not be in breach of Islamic Shari’ah." Al-Sa’atti, supra note 117, at 9.
Chapter 2: Description and Analysis of three Case Studies without in-Depth Investigation of Financial Guarantees and Protective Hedges against the Risk of Default and Bankruptcy

2.1. Introduction

Despite what is said about Sukuk as an investment instrument more secure than conventional bonds and securities, some issuances have dramatically suffered financial default. This situation evidently marked the pressing need for the study of some Sukuk cases to bolster the position of Sukuk, particularly in relation with Sukuk holders’ protection. For example, between 2003 and 2012, the number of defaulted Sukuk issuances reached more than 33 cases.\textsuperscript{143} In the GCC States, the overall value of defaulted Sukuk from 2009 to 2012 amounted to more than US $ 5 billion, according to the aggregate value of issuances in a chart published by Najla’ Al-Baqmy.\textsuperscript{144} In 2008, East Cameron Partners (ECP), the US-based gas company, defaulted on its Sukuk issued on the basis of the Musharakah (participation) contract worth US $ 166 million.\textsuperscript{145} The company requested protection against bankruptcy under Chapter 11, claiming that it was unable to pay the periodic returns.\textsuperscript{146} In 2009, in the GCC markets, there was a number of Sukuk defaults, such as Investment Dar Sukuk, which are based on the Musharakah contract whose arrears amounted to US $ 150 million.\textsuperscript{147} In the same year, Saad Group, located in Saudi Arabia, defaulted on paying the second coupon payable every two years for the Golden Belt-1 Sukuk, whose issuance is worth US $ 650 million.\textsuperscript{148} These Sukuk were based on the Ijarah (lease) contract.\textsuperscript{149} In the same year too, the Dubai-based Nakheel Company defaulted on the maturity amount of its US $ 3.5 billion Ijarah-based Sukuk.\textsuperscript{150} In 2012, the Dubai-based Dana Gas company defaulted on its US $ 920 million Sukuk, which were issued on the basis of the Mudarabah (profit-sharing) contract.\textsuperscript{151} That issuance, made in 2007, is different

\textsuperscript{143} See AL-BAQMI, supra note 96, at 174.
\textsuperscript{144} See id.
\textsuperscript{145} See id.
\textsuperscript{147} Gustina, Sakeey Mateeyoh, Ilyia Hanis & Suthinee Suayngam, Case Study: The Investment Dar (Tid): Default of TID Global Sukuk I Limited 23 (Kulliyyah of Economics and Management Sciences Islamic Capital Markets, International Islamic University Malaysia, 2011).
\textsuperscript{148} See AL-BAQMI, supra note 96, at 174.
\textsuperscript{149} Wijnbergen & Zaheer, supra note 146, at 24.
\textsuperscript{150} See id. at 28.
\textsuperscript{151} See al-Baqmi, supra note 96, at 173.
from the company's second issuance announced to be launched in 2013 as an attempt to reschedule most of the
debts of its original issuance, as only a small sum of the dues were paid to Sukuk holders.\textsuperscript{152} The company indeed
issued Sukuk worth US $ 850 million [equivalent to the debts owed to the Sukuk holders of the first issuance],
based on the Mudarabah contract and the Maturity date was set to October 2017.\textsuperscript{153} However, the company
defaulted on that latter issuance too, and the case is still pending in the British courts.\textsuperscript{154}

In Malaysia, between 1997 and 2010, the number of defaulted Sukuk amounted to 24 cases, all of which were
issued on the basis of the Aajil (Forward) and Murabahah (cost plus) contract, such as Nam Fatt Corporation
Berhad Sukuk, except for one case based on the Ijarah contract, i.e. Ingress Sukuk Berhad.\textsuperscript{155}

The companies that collected cash through these Sukuk have defaulted despite the high credit ratings they
obtained from notable credit rating agencies. Some of them in fact had other forms of guarantees, yet, these
guarantees did not manage to protect Sukuk holders. The above default cases have given rise to some significant
questions, such as: were the presented guarantees and hedges per se not effectively adequate; were the defaults
due to the adopted procedures or legislative setting of the Sukuk; did the requirements imposed by Islamic
Shari’ah weaken the effectiveness of those guarantees; were the contracts underlying the Sukuk and recognized
by Islamic Shari’ah not adequately and rigorously considered, in the course of making Sukuk in parallel to bonds
structure; and is there a pressing need to increase the guarantees and not to be content with a few of them?

In order to achieve the desired aims of safeguarding investors' rights and evaluating and developing the efficiency
of the protection and prudential measures provided to them to deal with the risks under discussion in this
dissertation, it is useful to look at three companies that benefited from Sukuk as a financing tool as three case
studies. The aim is to scrutinize the conditions and financial guarantees they provided in order to find out whether
they were adequate and effective enough to safeguard against the risk of default and bankruptcy.

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\textsuperscript{155} Majid, Shahimi & Abdullah, supra note 131, at 10.
2.2. Case studies

This chapter presents a brief account of the conditions of three cases of Sukuk of different structures whose issuers had benefited from their proceeds and yet defaulted. The account is based mainly on their Prospectuses and legal documents, in addition to what was written about them. Further, this chapter will provide a general analysis of the description and information obtained from those sources without delving into an in-depth study of financial guarantees and the protective hedges which protect against the risks that this dissertation focuses on, which will be evaluated and discussed in the next chapter in order to boost their effectiveness. This chapter will also discuss some issues, such as the privileges accorded to the main elements of the three cases of defaulted Sukuk, i.e. investors, companies that obtained the financing through Sukuk and their proceeds, nature of the contract underlying the issuance, and the risk of default and bankruptcy facing each type of those Sukuk.

The selected cases are as follow:

1. The Investment Dar Sukuk located in Kuwait, based on a Musharakah contract, with a total value of its two issuances reaching US $ 200 million, and the default was in 2009.\textsuperscript{156}

2. Nam Fatt Corporation Berhad Sukuk located in Malaysia, based on the Murabahah contract [as claimed], and the size of issuance was RM250 million [exceeded US $ 60 million in the current exchange rate], and the default was in 2010.\textsuperscript{157}

3. Ingress Sukuk Berhad located in Malaysia, based on an Ijarah contract [as claimed], and the issuance amounted to RM160 million [equal to almost US $ 40 million in the current exchange rate], and the default was in 2009.\textsuperscript{158}

2.2.1. Reasons of selecting these Sukuk as case studies

The case of the Investment Dar Sukuk was selected because the Sukuk are based on a Musharakah contract. These Sukuk are one of the most notably debated issues that have attracted the interest of investors and capital markets economic and legal analysts, especially in the Middle East. Despite the fact that this case has been highlighted and examined in many aspects, remedies, guarantees, and dealing with the risk of default and failure

\textsuperscript{156} See Wijnbergen & Zaheer, supra note 146, at 18.
\textsuperscript{157} See id. at 12.
\textsuperscript{158} See Majid, Shahimi & Abdullah, supra note 131, at 11.
to pay, it must be included due to the large value of the issuance size. The Ingress Sukuk Berhad case was included given its structure as based on an Ijarah muntahia beltamleek contract, and because of the large value of its issuance worth US $ 40 million, as mentioned previously. It became one of the important issuances for many analysts to investigate and discuss. Although several aspects of this case are broadly approached by discussion and analysis, the default risks have not been analyzed or evaluated adequately from a legal perspective.

The case of Nam Fatt Corporation Berhad Sukuk was selected given their structuring on a Murabahah contract and the size and value of that issuance, making it one of the largest issuances. There are no other examples of defaulted Sukuk based on this form of contract in the Middle East, so the researcher chose to study this case located in Malaysia. The maturity dates of those issuances had elapsed, and commitments and financial obligations and hedges provided to be met were supposed to be fulfilled, as the redemption dates of the Investment Dar Sukuk, Ingress Sukuk Berhad, and Nam Fatt Corporation Berhad Sukuk passed many years ago. Since the default occurred, those cases are worthy of analysis, especially with reference to adequacy of guarantees provided and their weaknesses and strengths, preventive measures to counter default and bankruptcy risks, evaluation of the measures stated in the legal documents of those Sukuk as remedies and guarantees to potential Sukuk holders, and identification of certain factors and issues that might jeopardize investors’ rights with regard to their returns and capital, such as Shari'ah-non compliance risks. More than one type of Sukuk have been selected to explore and analyze whether all or some of the proposed guarantees and remedies were suitable and effective for each type of these selected cases, or they were only useful for some forms and contracts underlying those Sukuk.

2.3. A general overview and analysis of the Investment Dar (TID) Sukuk Case

2.3.1. A general overview of TID – at the time - and its Sukuk

2.3.1.1. The background of TID and its two issuances

In 2005, the commissioned partner of the investment Dar Company (TID), the ABC Islamic Bank, issued sukuk worth US $ 50 million from the State of Bahrain through a special purpose vehicle (SPV) for a five-year
These Sukuk were listed on the Bahraini Stock Exchange. In 2006, additional Sukuk amounting to US $ 150 million were issued for another five-year term and were listed on the Dubai International Financial Exchange (DIFX). This enabled the Sukuk to be traded on the secondary market. On May 12, 2009, these Sukuk became the first default case in the Gulf region. The amount owed by the company [on which the beneficiary, TID, of the Sukuk proceeds defaulted as a result of expanding its business activities] was US $ 100 million. The company's aggregate debts on these Sukuk and other debts almost reached US $ 3.5 billion. Because of liquidity problems the company encountered at that period, among other reasons, it entered into a restructuring process of its debts and requested a temporary suspension of meeting all its debts obligations, which coincided with the maturity date of the second Sukuk issuance.

2.3.1.2. Some information about the Sukuk originator – TID

As a shareholding company, TID was established in 1994 in Kuwait with a capital of US $ 83.3 million, starting its activities in line with Islamic Shari’ah provisions. Its shares were listed on the Kuwait Stock Exchange in 1999. Within a few years, the company's business expanded and it became a large holding company, and its activities spread over several sectors such as finance and banking, project management and logistics transportation. In 2005, the total value of the company’s assets and shares amounted to KD 669.6 million and KD 177 million, respectively. Income sources of the company were diversified, with 50% of the income source coming from investment activities, 32% from real estate activities, while the remaining part came from financing operations. From 2004 to 2007, the company acquired stakes in several companies with

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160 See Wijnbergen & Zaheer, supra note 146, at 19.
161 See Our History / Milestones. (Investment Dar, n.d.), supra note 159.
162 See Wijnbergen & Zaheer, supra note 159, at 18.
163 See id. at 18.
164 See id. at 19.
165 See id. at 19-23.
167 See Our History / Milestones. (Investment Dar, n.d.), supra note 159.
168 See id.
169 See Wijnbergen & Zaheer, supra note 146, at 19.
170 See id. at 19.
different percentages and at different times, such as buying the majority shares of Aston Martin company specialized in the manufacture of luxury cars.\textsuperscript{171} Capital Intelligence upgraded the TID’s rating from BB- in 1999 to BBB+ in 2007, while the International Content Rating Association rated it as A- class.\textsuperscript{172}

\textbf{2.3.1.3. The contract underlying the Sukuk issuance}\textsuperscript{173}

The reason behind TID’s desire to obtain financing through Sukuk issuing is that the company’s main activity at the time of its establishment was consumer financing.\textsuperscript{174} It has long-term debts against its customers that can not be collected before their maturity date.\textsuperscript{175} Because it needed cash and at the same time owned leased assets in the form of vehicles that generate a monthly rental, TID preferred to take advantage of those assets that generate income through Musharakah Sukuk.\textsuperscript{176} Hence, both issuances were based on a Musharakah contract.\textsuperscript{177}

\textbf{2.3.1.4. Mechanism of issuance and method of dividing the capital}

The second issuance process occurred through the establishment of a SPV named TID Global Sukuk I Limited, which was based in the Cayman Islands.\textsuperscript{178} The SPV contracted, as a first party, with TID, as a second party, which had established the SPV to issue Sukuk and represent investors, that each party will contribute a stake of the capital under the Musharakah contract. The investors’ contribution was in the form of cash, which represents the proceeds of the Sukuk, while TID’s contribution is the leased vehicles and some specific assets.\textsuperscript{179} But, Wijnbergen and Zaheer – according to what they quoted from the Prospectus – stated: ‘‘[s]imultaneously, the originator, TID, contributed its share by transferring ‘all rights, benefits and entitlements to the TID vehicles and property’ to musharakah...’’\textsuperscript{180} Thus, under the partnership agreement between TID and investors represented by the SPV, the assets of that Musharakah agreement became the financial assets contributed by the Sukuk holders.

\textsuperscript{171} See Our History / Milestones. (Investment Dar, n.d.), supra note 159.
\textsuperscript{172} See Corporate Profile. (Investment Dar, n.d.). supra note 166.
\textsuperscript{173} The present researcher has earnestly attempted to obtain the Prospectuses of the first and second issuances of the Investment Dar, but he was unable to do so. Instead, he managed to obtain other sources that focused only on some details of the second issuance.
\textsuperscript{174} See Dr. Essam K. al-Enzi, Sukuk Almusharaka: Dirasat Shareiat Tatbiqiat Eamalia [Sharing Sukuk (Bonds) - Legal Applied Scientific Study] 8.
\textsuperscript{175} See id.
\textsuperscript{176} See id.
\textsuperscript{177} See id.
\textsuperscript{178} See Wijnbergen & Zaheer, supra note 146, at 20.
\textsuperscript{179} See Gustina, Mateeyoh, Hanis & Suayngam, supra note 147, at 7.
\textsuperscript{180} Wijnbergen & Zaheer, supra note 146, at 34.
in addition to the rights of vehicles and real estate identified. The financial assets pooled through the subscription will be invested in vehicles and real estate assets. The Musharakah assets were divided into 150 units, with TID receiving 76.83 units, while the issuer representing the Sukuk investors (SPV) acquired 73.17 units. The vehicles’ value was estimated at US $ 157.5 million by a third party, and the valuation was agreed upon by the partners. By virtue of that division, the investors’ stake amounted to 48.78% of the share capital of the Musharakah contract, while the remaining 52.22%, which was contributed by TID, was in the form of leased vehicles and real estate assets. Thus, the share capital of the Musharakah contract amounted to US $307,500,000.

2.3.1.5. Method of sharing profits and losses

Some who studied those defaulted Sukuk mentioned that their legal documents stated that the investors’ dividends are 80%, while the dividends of TID as a partner are 20%, although the capital was equally contributed by the two parties. The truth is that the capital was almost equally contributed by them. As to the losses, they were borne according to the share of each partner in the capital, and thus the loss is divided [almost] equally between the two parties. Based on the Prospectus, the distribution of Sukuk holders’ returns will be carried out twice a year, according to Wijnbergen and Zaheer. They added that, pursuant to the Prospectus, the issuer (SPV) will distribute the periodic returns equal to LIBOR plus 1.25 basis points per annum as margin for the first three years, and LIBOR plus 1.75 basis points for the remaining years of the issuance term, according to the same source.

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181 See Gustina & Mateeyoh, Hanis & Suayngam, supra note 147, at 7; see also Wijnbergen & Zaheer, supra note 146, at 20.
182 See Wijnbergen & Zaheer, supra note 146, at 20.
183 See id. at 20.
184 See id. at 20.
185 See id. at 20.
186 See Wijnbergen & Zaheer, supra note 146, at 20.
187 See id. at 20.
188 See Wijnbergen & Zaheer, supra note 146, at 20.
189 See id. at 21. Part of this description stated by the two researchers, concerning the mechanism, percentage and periodization of the distribution of returns on an annual basis contradicts what they later quoted. As they indicated above, the distribution is made every six months. However, the nature and purpose of the present research are not concerned with determining whichever of the two possibilities is true. Whether the distribution of the returns is made on an annual or semi-annual basis will not establish any substantial conclusion relative to the present research. Here we will quote what they have written about this matter. They first state: "[t]he first 5-year musharakah (co-ownership) sukuk was issued by TID with the collaboration of ABC Islamic Bank (Bahrain) in 2005. It offered 6-month LIBOR plus 2% annual, whereas the 2006 sukuk issue promised LIBOR plus 1.25 percent for the first 3 years and LIBOR plus 1.75 percent for the rest of the time period, distributed semi-annually." Id. At 19. Then they state: "[t]he very first page of the preliminary OC of the sukuk states that the issuer would make a payment of periodic distribution profit amounts to sukuk holders equal to LIBOR
2.3.1.6. **Management of the Musharakah Assets**

Pursuant to the management agreement established between the originator (TID) and the SPV, the earlier assumes the management the Musharakah contract assets for a token lump sum of US $ 100, and it is also entitled to a percentage of the profits in its capacity of being the assets manager in the event of achieving a return in excess of a certain percentage as an incentive fee, according to Dr. Essam Al-Enzi.\footnote{See al-Enzi, supra note 174, at 17-18} Some have determined that percentage -based on what was conceived from the Prospectus– to mean any excess beyond the LIBOR and fixed margin.\footnote{See Wijnbergen & Zaheer, supra note 146, at 21.} According to the above agreement, the manager is responsible for leasing the securitized assets, collecting the rental, insurance, opening an account for the company in which the proceeds are deposited, working on obtaining the necessary permits for those assets and promises the marketing operations.\footnote{See al-Enzi, supra note 174, at 17 n. 2.}

2.3.1.7. **Undertakings of TID as the manager of the Musharakah Assets**

The inter-agency agreements stipulate that TID, as the manager of the Musharakah assets, is not liable for any loss or damages save in cases of infringement and negligence affecting investments or the Musharakah assets.\footnote{See id. at 21.} The agreements listed some forms of infringement such as default, failure to transfer assigned periodical payments to investors, as well as default on paying any outstanding debts resulting from transactions necessary to the Musharakah contract.\footnote{See id. at 21-22.} They also require the manager to fulfill its obligations and ensure its competence in carrying out the commissioned tasks [and to safeguard the rights of investors and its accountability for them in the event of proven infringement or negligence], such as providing partners with the TID’s approved budget, avoiding being a guarantor for anyone, controlling TID’s debts to facilitate its performance of its tasks and preserving the company’ capital so as not to fall below a certain minimum.\footnote{See id. at 22.}
2.3.1.8. Mechanism of Maturity

At the end of the Sukuk term or under certain circumstances mutually specified by the partners, TID has undertaken to purchase the Sukuk holders' assets through a calculation process of the value of those assets.\textsuperscript{195} Among these circumstances in which TID as a partner has undertaken to purchase the Sukuk assets -the Sukuk holders share- are when the TID is dissolved as a result of its bankruptcy or insolvency; when it has breached the provisions of the agreement; or when it faltered in its promises and commitments stipulated in the agreement.\textsuperscript{196} In addition, TID undertook to purchase certain percentages of the assets of the Musharakah Sukuk periodically until it has fully acquired all the assets at a definite time. Nowadays, this process is conventionally known as ‘diminishing Musharakah’.\textsuperscript{197}

2.3.1.9. Position of the Shariah Board

The TID Shari’ah Board approved the issuance regarding it as based on the Musharakah contract, without clarifying the underpinnings of the approval.\textsuperscript{198}

2.3.1.10. Financial position of TID after issuance of the Sukuk

In the period between 2004 and 2007, the company acquired various percentages of shares in diverse sectors such as banks, automobile manufacture, construction works and hotels.\textsuperscript{199} The financial conditions of the holding company originating the Musharakah Sukuk were clearly good.\textsuperscript{200} In 2007, the company’s net profits amounted to KD 132 million,\textsuperscript{201} approximately equivalent to US $ 436 million at the current exchange rate, taking into account of the change in the currency exchange rate since then. The total assets value was worth KD 1.27 billion [US $ 4.2 billion, at the current exchange rate], and the owner’s equity reached KD 387 million [approximately US $ 1.3 billion at the current exchange rate].\textsuperscript{202} But, in 2008 [which witnessed the global financial crisis], the net losses of the company amounted to KD 80 million [more than US $ 263 at the current exchange rate] for the

\textsuperscript{195} See id. at 8.
\textsuperscript{196} See id. at 22.
\textsuperscript{197} See id.
\textsuperscript{198} See id. at 8.
\textsuperscript{200} See Wijnbergen & Zaheer, supra note 146, at 22.
\textsuperscript{201} See id. at 22.
\textsuperscript{202} See id.
first time since its establishment, which led to the downfall of the company.\textsuperscript{203} In October 2008, the company defaulted on its debt obligations due to lack of liquidity, as its short-term debt exceeded its liquid assets.\textsuperscript{204} The value of its assets and its owner’s equity have dropped to KD 1.2 billion [approximately US $ 4 billion at the current exchange rate] and KD 168.5 million [approximately US $ 555 million at the current exchange rate], respectively.\textsuperscript{205} In 2009, the company recorded a net loss for the second year of KD 15 million [US $ 50 million at the current exchange rate].\textsuperscript{206} Its assets value fell to KD 971 million [US $ 3.2 billion at the current exchange rate], while its total liabilities amounted to KD 766 million [Approximately US $ 2.5 billion at the current exchange rate].\textsuperscript{207} The company's delayed submission of financial statements on time resulted in the suspension of trading its shares on the Kuwait Stock Exchange in April 2009.\textsuperscript{208} Accordingly, Capital Intelligence reduced the company's rating in February 2009 from BB to SD-selective default, with a negative outlook for failing to meet one of its financial obligations.\textsuperscript{209}

2.3.1.11. Debt Rescheduling

In order to reschedule its debts and liabilities, in January 2009, TID appointed Credit Suisse Group AG as financial advisor to oversee the reschedule plan.\textsuperscript{210} In September of that year, Central bank of Kuwait appointed a supervisor to oversee the reschedule process and the financial accounts of the company, and the company agreed in the same month with its creditors and investors to temporarily freeze the claims until March 2010.\textsuperscript{211} The company then needed to borrow US $ 1 billion to repay its debts.\textsuperscript{212} It was reported that the company had agreed

\textsuperscript{203} See id.
\textsuperscript{204} See id. at 23.
\textsuperscript{205} See id.
\textsuperscript{206} See id.
\textsuperscript{207} See id.
\textsuperscript{208} See id.
\textsuperscript{209} See Gustina, Mateeyoh, Hanis & Suayngam, supra note 147, at 23.
\textsuperscript{210} See Wijnbergen & Zaheer, supra note 146, at 23.
\textsuperscript{211} See id. at 23–4. They state: "[i]n March 2010, a Kuwaiti court granted protection to TID from creditors under the Financial Stability Law (FSL). This FSL stipulates that no lawsuit or execution of any court judgment against TID from minority banks and investors would proceed until the court has approved it. In January 2011, an enhanced restructuring plan was approved both by the creditors’ coordinating committee and also approved by the shareholders. The plan, effective from June 2011, included repayment of the debt in tranches of senior facility (KD 405 million payable in 3–4 years) and junior facility (KD 600 million payable in 6 years). Also some part of the debt was converted into equity in the company. Besides, injection of fresh liquidity up to KD 20 million had to be made by shareholders in a year." Id. at 24.
\textsuperscript{212} See id.
a deal with 80% of its creditors, and that "[t]he government facility would help it get the consent of the rest of the creditors on its restricting plan."213

2.3.2. Analyzing and discussing some aspects of TID Sukuk Case

2.3.2.1. Introduction

The previous section reviewed the reality, activities and financial conditions of TID, provided basic information on the nature and structure of the issuance and given some details related to the returns of that type of Sukuk and the status quo of the Sukuk and TID itself. This section is devoted to analyzing some points pertinent to some of the privileges, rights and duties of the parties to these Sukuk, in addition to the hazards related to the risk of default. This will be achieved by discussing some provisions as stipulated in the legal documents and prospectus in relation to the rights of investors and their compliance with Islamic finance standards. The section will also study the structure of the contract on which the issuance was based and review the forms of risk of default and bankruptcy in these Sukuk. The same approach will be followed when dealing with the other two cases of defaulled Sukuk.

2.3.2.2. The Issuance structure’s inclusion of SPV

Despite the possibility that it could be the Sukuk issuer, TID preferred to issue them through the SPV. Thus, the process of structuring these Sukuk included the establishment of SPV, which is one of the preventive measures against the bankruptcy of the party that sold its assets for its need for cash - which is immune to bankruptcy in itself. However, this pivotal issue will be discussed further in the next chapter in the course of its assessment and evaluation.

2.3.2.3. Sukuk Returns and the Subscription Proceeds

The returns of this type of Sukuk were supposed to be accrued from the business activities and income-producing assets owned by the partners by virtue of the Musharakah contract, and these were in fact the vehicles, real estate as well as the investors’ funds that will be channeled by TID into the expansion of TID’s typical projects. These projects were assumed to be a joint ownership of TID and the investors, each according to their

213 Gustina, Mateeyoh, Hanis & Suayngam, supra note 147, at 23.
respective share percentage, throughout the sukuk term. At the maturity date, it was assumed that the ownership will be fully transferred to TID by virtue of its promises to purchase the investor's share of the Musharakah assets, and it had committed itself to fulfilling those promises.

2.3.2.4. Privileges of the Musharakah Sukuk accorded to the originator (TID) and their compliance with Islamic Shariah standards

The First Privilege

TID benefited from the sukuk issuance in several ways. First, it will convert - as the assets manager and proxy for the partners, and itself being one of them - the proceeds obtained from the subscribers into assets and investments whose ownership can fully devolve to it at the end of the sukuk term. For, it is bound to purchase the share of the SPV, which represents the sukuk holders’ principal, in the event that the sukuk holders desire to exercise the right of option given to them by virtue of the purchase promise. This option obligates the undertaker, TID, to purchase their units in specific cases, including of the sukuk maturity, in case investors are desirous to do so. As a partner to the Musharakah contract, TID has undertaken to purchase the Musharakah sukuk assets in specific cases, including the already mentioned case, when it is dissolved due to its bankruptcy, when it has breached the terms of the agreement or when it has breached any other promises as stipulated in the agreements.214 TID's purchase of the sukuk holders’ share is in its best interest, as their invested money is assumed to have been invested in projects that are typically related to its activities, or was used in general to expand one of its projects.

The Second Privilege

The purchase of the assets of the Musharakah Sukuk, which is almost similar to the amortization of conventional bonds, is exercised at the end of the Sukuk term. It takes place at either one of different values. It can be made at the market value, fair value, nominal (face or par) value, value initially agreed upon between the two parties - at the time of the promise, or at the value as agreed upon by the two parties when the purchase is exercised.

Fiqh Boards and Shari'ah Committees, such as AAOIFI and IIFA, The Fatwa and Shari'a Supervisory Board (FSSB) of Dubai Financial Market (DFM) as well as the majority of contemporary jurists - who render unilateral promise as legally binding by Shari'ah - ruled that the purchase at the nominal value is forbidden in the event that the promising buyer is a mudarib (profit-sharing agent), shareek (partner) or wakeel bel istithmar (investment proxy) - as is the case with TID being a partner with the investors and a manager of the assets - except when the mudarib or wakeel was proved to be infringing the contract terms or negligent of its duties, but they permitted the purchase at the market value, fair value, or at the value approved by the parties when exercising the purchase promise.\footnote{It can be inferred from the resolutions of the Fiqh councils that the undertaker or promising buyer at nominal value is either one of two cases. The first case is that it is a manager of the Sukuk in its capacity of being a mudarib (agent) or shareek mudeer (a partner manager) or wakeel bel Istithmar (investment agent). This case is prohibited in Islamic Shari’ah according to AAOIFI, IIFA and FSSB. However, some of them made an exception to this prohibition, saying that in the case of infringement or negligence of the manager, it guarantees the nominal value of sukuk, which represents the capital of investors. The second case is when it is not invested with one of the aforementioned capacities, in which case purchase can be made at the nominal value analogous to the lessee who has undertaken to buy the object. In its Standard No. 17 on investment Sukuk, AAOIFI states that: “5/1/8/7 The prospectus must not include any statement to the effect that the issuer of the certificate accepts the liability to compensate the owner of the certificate up to the nominal value of the certificate in situations other than torts and negligence nor that he guarantees a fixed percentage of profit.” AAOIFI, supra note 43, at 477-78. It also states that: “5/2/2 In the case of negotiable Sukuk, it is permissible for the issuer to undertake, through the prospectus of issue, to purchase at market value, after the completion of the process of issue, any certificate that may be offered to him, however, it is not permissible for the issuer to undertake to purchase the Sukuk at their nominal value… 5/2/5 It is permissible for the issuer to redeem, prior to maturity, certificates of ownership of leased assets at the market price or at a rate agreed upon, at the date of redemption, between the certificate holder and the issuer.” Id. at 479. In its Standard No. 44, relative to Obtaining and Deploying Liquidity, AAOIFI lists the Shari’ah formulas of liquidity collection, which include: “4.2.2 Issuing investment Sukuk to expand the institution's activities.” Id. At 1090. Regarding this, it states: “[t]his involves issuing the types of investment Sukuk explained in Shari’ah Standard No. (17) on Investment Sukuk in order to obtain funds from Sukuk investors and undertake projects required of the institution. The institution may securitise some of its assets by selling them to Sukuk subscribers, managing the assets on their behalf and promising to purchase them at the market price or at a price to be agreed. If the institution is only the lessee and not the manager of the Sukuk assets, it may promise to purchase them at face value.” Id. at 1090. IIFA is inclined to approve these views at its nineteenth conference. In its resolution No. 178 on Islamic Sukuk, the IIFA states that among Sukuk characteristics is "the non-guarantee of the manager (agent, proxy or managing partner)." IIFA, supra note 79, at 413. Regarding to Sukuk provisions, IIFA also states that, "the Sukuk manager is trustee who shall not guarantee the value of Sukuk except in cases of infringement, negligence, breach of the Mudarabah terms, participation or agency in the investment. The Sukuk may not be redeemed at their nominal value, but the redemption shall be at market value or at the value agreed upon upon maturity." Id. at 413. It is understood from the context that prevention of the purchase undertaking at the nominal value applies to promising party if it is a Mudarib, a partner or an agent. This is corroborated by the fact that in its twentieth session, IIFA issued its resolution No. 188 stating that: "[a] Mudarib, a partner or an agent may not give any of the following undertakings: the purchase of sukuk or sukuk assets at their nominal value or at a predetermined value, in such a way as to guarantee the capital or immediate cash sum for higher deferred sum. Exception to this are cases of infringement or negligence that require the guarantee of the rights of the sukuk holders.” Resolution on Completion of the Subject of Islamic Sukuk, (IIFA, Sep 2012). Available from: http://www.ifia-aifi.org/2348.html. (accessed on 29th October 2018). FSSB set forth in its standard No. 2 concerning Sukuk: "6.1.3. It is permitted for the sukuk manager to give an undertaking to buy the Sukuk assets at any value except the face value. This undertaking, however, does not bind the undertaker in cases of full or partial damage. This is because the undertaker is bound by his purchase undertaking only if the assets remain in existence at the time of the purchase execution, while if the assets have been destroyed or damaged then the undertaking is not executable, because selling non-existing assets is invalid.” Fatwa and Shari’ah Supervisory Board, Dubai Financial Market Standards on Shari’a Compliance | Standard No. 21 Issuing, Acquiring and Trading Sukuk 13. (Dubai Financial Market, n.d.). Available from: https://www.dfm.ae/docs/default-source/Sharia/dfm-standard-for-issuing-acquiring-and-trading-sukuk.pdf. (accessed on 29th October 2018). There is a view that distinguishes between the purchase undertaking at nominal terms, since it is permissible, and the conditional guarantee of the capital, which is legally prohibited and is contrary to the view of the majority of contemporary jurists and the Fiqh councils. For a broader discussion of this issue and responses to it, see al-}
financial transaction into *riba*-like business. For example, the liability of the mudarib to capital of the investors—
if it committed itself to recover the investors’ capital in the event of the expiration of the Mudarabah contract
because of one of the reasons leading to that - is considered a form of prohibited *riba* (usury) in Islamic Shari’ah.

With regard to the purchase promise in the case of TID sukuk, due to the inability to obtain all relevant legal
documents and the Prospectus, the present researcher relied mainly on the secondary literature of other researchers
who differed regarding the determination of a specific value that should be adopted in these sukuk if the investors
desire to sell their shares for reasons necessitating that. Some viewed that the purchase price of the sukuk holders’
share is subject to a variable accounting formula based on market conditions, and, therefore, there would be no
guarantee for investors’ capital through purchase at the nominal value. Some stated that the promise to purchase
those Sukuk was made at the nominal value. Should this be the case, the entire financial transaction would not
be compliant with the requirements of three prominent Fiqh Boards and Councils in the Islamic world, exposing
the transaction to the risk of non-compliance with Islamic Shari’ah. In other words, the sukuk can be rendered as
void, and each party will have to regain its contribution and investors will not be entitled to any returns. The
privilege accorded to the originator would emerge if the purchase was made at the nominal value, when the market
value of the assets of the Musharakah contract is higher than the value set at the outset of the Sukuk term. In
addition, the originator, who used the Musharakah contract as a means of financing one of its future activities or
projects, has now fully acquired the Sukuk assets. It is true that this would typically happen if the originator had
used one of the other financing tools. But, the difference between the two situations is that the returns of the
Musharakah sukuk are variable, and in this type of sukuk the originator is not bound to pay a fixed sum, but it
relies on the performance of the assets of the Musharakah contract, though he is committed to purchase the
investors’ shares in specific cases.

The Third Privilege

Morshedi, *supra* note 106, at 89-98, 179-83; see also Dr. Abdulsattar Abu Ghuddah, *Altaeahudat Alssadirat Min Masdar Alsukuk Lihamilihā [Undertakings of the Sukuk Managers to their Holders]* 81-87 [A paper presented to the Fourth Seminar of Future of Islamic Banking, held in Jeddah, Saudu Arabia, Muharram 18-19, 1433 AH].


217 See Gustina, Mateeyoh, Hanis & Suayngam, *supra* note 147, at 22.
By virtue of the management agreement, TID will first receive US $ 100, which means nothing in the financial world, in return for managing the assets of the Musharakah contract. But, the fact that one of the partners gets a lump sum in return for its work is something forbidden in Islamic Shari’ah. The prominent jurist, Ibn Munther, reported the jurists’ consensus on “the invalidation of the Alqarad [Mudharabah/profit-sharing] contract wherein one [the agent or the capital provider] or both partners specify a fixed lump sum [of the profits].”

This image, in fact, exists in the TID sukuk. AAOIFI prohibited the allocation of a specific wage to one of the partners in consideration for its administrative work or other tasks, but it permitted that a partner receives an extra share of the profits, and it excluded from the prohibition the case of commissioning one of the partners with assigned tasks under a contract separate from the Musharakah contract and on specific terms. The most important privilege under the management contract is that in case the ratio of the actual earnings to the capital is higher than the expected one, which is linked to the LIBOR rate plus the specified margin, the difference between actual earnings and expected earnings becomes the manager’s right as a bonus and incentive, in addition its 20% share of the profits as a partner.

These clauses are one of the endeavors to make sukuk analogous to conventional fixed-interest bonds. However, it is important to note that reference to profit ratio as the LIBOR is based on the assumption that the Prospectus stated that it is by way of anticipation rather than an assertion, since it is not permissible in view of Islamic Shari’ah to pre-set a specific ratio of profits to capital or to set a lump sum.

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219 AAOIFI states in its Shari’ah standard No.12 related to Sharikah (Musharakah), a and Modern Corporations: "3/1/3/4 It is not permitted, in a Sharikah contract, to specify a fixed remuneration for a partner who contributes in managing the Sharikah funds or provides some form of other services, such as accounting. However, it is permissible to give him a greater share of profit than he would receive solely on the basis of his share in the partnership capital. 3/1/3/5 It is permissible that one of the partners be appointed to provide services that are mentioned in item 3/1/3/4 provided that the appointment is based on an independent contract from the Sharikah contract so that he may be dismissed as a manager at any point of time without the need to amend or to terminate the Sharikah contract. In this case, the appointed partner may earn a specific remuneration." AAOIFI, supra note 43, at 330-31.

220 For example, if the profits accrued from the Musharakah contract activities are US $ 50 million, the profit ratio to the capital of the Musharakah contract – which is US $ 307 million - will be circa 16.25%. Assuming that the six-month LIBOR rate is 5% and the additional margin is 1.25% basis points, the sukuk holders’ share will be 5% + 1.25%, = 6.25%, which amounts to approximately US $ 19 million. For, the sukuk holders’ share is the outcome of the division of the capital by a hundred multiplied by 6.25, and the rest will be for the manager, which amounts to approximately US $ 31 million. If the ratio of the actual earnings to the capital is lower than the LIBOR rate, investors will receive a lower return than expected, and, therefore, the manager/TID will not receive additional profits and should not guarantee the difference between actual earnings and expected earnings from the Islamic Shari’ah perspective.

221 AAOIFI states in its standard No.12 related to Sharikah (Musharakah), a and Modern Corporations: "3/1/5/1 The Sharikah contract should incorporate a provision specifying the manner of sharing profits between the parties. The allocation of profits must be made in a manner that gives each partner an undivided percentage of profit, not a sum of money or a percentage of the capital." AAOIFI, supra note 43, at 332.
case the Prospectus stated that, this condition would be null and void. It may also invalidate the Musharakah contract underlying the sukuk, in view of those who regard that the invalid condition undermines the contract, as stated above when discussing the risk of non-compliance with Islamic Shari’ah. Those who dealt with TID sukuk differed as to whether those sukuk included the obligation to pay periodic profits equivalent to the LIBOR plus Margin rate, or they only mentioned the LIBOR plus Margin rate as expected profits without imposing that Shari’ah non-compliant obligation that might invalidate the contract. Some of their views implicitly mean that those sukuk included the phrase "anticipated profits" and "actual earnings", and that any excess beyond the anticipated profits would be the right of TID in return for its management work. Others said that the Prospectus provided for distribution of periodic dividends equivalent to LIBOR plus Margin and that this is contrary to the provisions of Islamic Shari’ah. It is worth mentioning that among the characteristics of the Musharakah contract is that they are of variable income, since the outcome of their investment is presumably unknown. However, to some extent, the manager can give an initial anticipatory estimation of the profits, such as when the assets are leased or promised to be purchased on a Murabahah or forward sale contract. In all cases, fixed returns should not be pre-assigned, but only the percentage of the profits, if any, allocated to each party may be determined beforehand. What is likely to be challenged in these Sukuk from the Shari’ah perspective is its inclusion of a stipulation that any excess of the expected returns linked to the LIBOR will be for the TID as manager. The objection that may arise in this case is that the earning percentages allocated to the mudarib and the capital provider will not be known at the time of the contract, since the LIBOR benchmark is variable in nature and therefore the profit rate of each party – the mudarib and investors - is unknown. The profit rate of the mudarib is linked to an index rather than a specific percentage of the accrued profits. For instance, if the LIBOR rate is 5%, the actual earnings may be less than that and the manager will not be entitled to a higher rate or any sum beyond

222 AAOIFI states in its standard No.12 related to Sharikah (Musharakah), a and Modern Corporations: "It is not permitted that the conditions or modes of profit allocation in a Sharikah contract include any clause or condition that may result in the probable violation of the principle of sharing profit. For example, if a predetermined amount of profit or a specific percentage of capital is assigned to one of the partners, this assignment will be rendered void. If the assignment is amended before profit comes forth, profit shall be divided in accordance with what partners agreed on as to amendment. Otherwise, profit shall be divided based on each partner’s respective share in capital." AAOIFI, supra note 43, at 333-34.
223 See Gustina, Mateeyoh, Hanis & Suayngam, supra note 147, at 7, 17-8.
224 See Wijnbergen & Zaheer, supra note 146, at 21.
the specified margin and rate, and it will have any the excess. The knowledge of the earning percentages allocated to the mudarib and the capital provider is one of the conditions of the Mudarabah contract. Any obscurity in this matter may expose these Sukuk to risks of non-compliance with Islamic Shari’ah.

The Fourth Privilege

Despite that there is no corresponding proportionality between the capital provided by the two parties and the profits percentage assigned to each one of them, since the legal documents stated that TID as a partner is entitled to only 20% of the profits distributed among the investors, though it contributed assets slightly worth more than the contribution of the sukuk holders, TID has reserved the legal ownership of the assets it contributed to the Musharakah contract in addition to those contributed by investors, in its name. That would realistically mean Sukuk holders are denied the right of recourse to the assets of Musharakah contract in case TID does not meet its obligations. This situation and its relevant risks and ensuing debate, particularly in case of bankruptcy, will be discussed when talking about guarantees in the next chapter.

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225 AAOIFI states in its standard No.13 related to Mudarabah: "8/1 It is a requirement that the mechanism for distributing profit must be clearly known in a manner that eliminates uncertainty and any possibility of dispute. The distribution of profit must be on the basis of an agreed percentage of the profit and not on the basis of a lump sum or a percentage of the capital. 8/2 In principle, it is not permissible to earn a share of profit in addition to a fee in a Mudarabah contract. However, it is permissible for the two parties to construct a separate agreement independent of the Mudarabah contract assigning one party to perform, for a fee, a business activity that is not by custom part of Mudarabah operations. The independence of this separate agreement means that if the contract of providing this activity is terminated, this will not affect the contract of Mudarabah. 8/3 The parties shall agree on the ratio of profit distribution when the contract is concluded. It is also permissible for the parties to change the ratio of distribution of profit at any time and to define the duration for which the agreement will remain valid. 8/4 If the parties did not stipulate the ratio of profit distribution, then they shall refer to customary practice, if any, to determine the shares of profit. If the customary practice is that the profit is distributed equally, then this will be applied as such. If there is no customary practice in this regard, the Mudarabah contract is regarded void ab initio, and the party who acts as the Mudarib should receive a common market price for the kind and amount of services that he provided as Mudarib. 8/5 If one of the parties stipulates that he should receive a lump sum of money, the Mudarabah contract shall be void. This rule does not apply to a situation where the parties agree that if the profit is over a particular ceiling then one of the parties will take the additional profit and if the profit is below or equal to the amount of the ceiling the distribution of profit will be in accordance with their agreement." AAOIFI, supra note 43, at 373-74.

226 AAOIFI states in its standard No.12 related to Sharikah (Musharakah), a and Modern Corporations: "3/1/5/5 It is permissible for the partners to agree on the adoption of any method of allocation of profit, either permanent or variable, for example, by agreeing that the percentages of profit shares in the first period are one set of percentages and in the second period are another set of percentages, depending on the disparity of the two periods or the magnitude of the realised profit. This is allowed provided that using such a method does not lead to the likelihood of a partner being precluded from participation in profit." Id. at 333. It also states in its standard No.8 related to Murabahah: "4/6 It is an obligation that both the price of the item and the Institution’s profit on the Murabahah transaction be fixed and known to both parties on the signature of the contract of sale. It is not permitted under any circumstances to subject the determination of the price or the profit to unknown variations or variations that are determinable in the future, such as by concluding the sale and making the profit dependent on the rate of LIBOR that will prevail in the future. There is no objection to referring to any other known indicators during the promise stage as a comfort indicator to determine the rate of profit, provided that the determination of the Institution’s profit at the time of concluding the Murabahah is based on a certain percentage of the cost and is not tied up with LIBOR or a time factor." Id. at 211.
2.3.2.5. Privileges accorded to Sukukholders in this Musharakah Contract

The First Privilege

This contract has given investors a real advantage as they are entitled to 80% of the dividends. It should be noted that the disparity in the earnings distribution between TID and investors disproportionate to the contributed capital is one of the debated issues among jurists, though they agreed that any loss in the partnership must be borne by all partners each according to its share of the capital.\textsuperscript{227} AAOIFI has consented the disproportion in the earnings allocated to the partners, even if their dividends are incommensurate with their respective shares in the capital, provided that those receiving the additional percentage of profits did not stipulate to be sleeping partners.\textsuperscript{228} According to the available documents of those sukuk, investors did not stipulate to be sleeping partners, though they typically have no work obligations, and they did not stipulate the additional earnings share but they were offered it.

The Second Privilege

One of the advantages that investors can gain - if TID’s purchase promise is exercised in the nominal value - is that the assets’ market value may rise higher than the nominal value. It is in the investors’ best interest not to exercise their right to choose to fulfil TID’s promise to buy their share and to rather sell it in the market. If they were allowed to do so without restrictions, such securitization would typically qualify to the so-called ‘asset-backed Sukuk’ and would not be an ‘asset-based sukuk’ structure. However, the question of whether there are restrictions on investors’ selling of their assets represented in the Sukuk will be discussed in the next chapter. Investors, especially at the theoretical level, can also choose not to sell their share of assets to the originator or any other party by dint of their returns and desire of investors for a stable income. However, the Prospectus did not specify the mechanism of action after the maturity of the Sukuk.

\textsuperscript{227} See al-Enzi, supra note 174, at 12-4.

\textsuperscript{228} AAOIFI states in its standard No.12 related to Sharikah (Musharakah), a and Modern Corporations: "3/1/5/3 In principle, the shares of profit may be in proportion to the percentage of each partner’s contribution to the Sharikah capital. Nevertheless, the partners may agree to make profit-sharing not proportionate to their contributions to capital, provided the additional percentage of profit over the percentage of contribution to the capital is not in favour of a sleeping partner. If a partner did not stipulate a condition that he be a sleeping partner, then he is entitled to stipulate an additional profit share over his percentage of contribution to the capital even if he did not work … 3/1/5/8 Taking into account the provisions of item 3/1/5/3, it is permissible to agree that if the profit realised is above a certain ceiling, the profit in excess of such a ceiling belongs to a particular partner. The parties may also agree that if the profit is not over the ceiling or is below the ceiling, the distribution will be in accordance with their agreement.” AAOIFI, supra note 43, at 332.
2.3.2.6. How the risk of default arises, the relationship between sukuk holders and TID company, and conditions of sukuk circulation

The relationship between Sukuk holders and TID can be legally characterized as a relationship between two partners, or a client and an agent or a manager throughout the sukuk term. As such, these Sukuk can not be guaranteed to yield fixed returns. If the Musarakah contract assets did not generate profits or incurred losses, it is established that this contract by its nature does not guarantee any compensation if there is no infringement or negligence. The agent’s obligations over the sukuk term are the management of the business activities of the partners' assets and the distribution of profits generated by them in accordance with the terms of the contract agreed between the parties concerned. In some stages of these Sukuk and Musharakah contract, however, a seller-buyer relationship may arise in certain circumstances or times. For example, TID promised - during the sukuk term, to purchase a certain amount of the Sukuk holders’ shares, and to purchase the rest upon maturity, if the Sukuk holders accepted to sell their shares to their partner (TID). For, Sukuk holders alone have the right to exercise the option of selling, and any delay in proceeding the sale and paying the consideration by TID creates a creditor-debtor relationship between sukuk holders and TID. In this aspect, holders of the Sukuk issued on the basis of the Musharakah contract may face the risk of default.\(^{229}\) Default on the periodic payment of returns - over the period of the Musharakah and Mudarabah Sukuk – can be conceivable when the manager or/and partner, for various reasons, holds the income and profits generated from the Musharakah and Mudarabah contracts assets without transferring them to the issuer – the SPV - that is commissioned to distribute the returns among investors. Among these reasons is that when the manager is indebted to other parties, and it may give priority to paying off those debts over distributing the returns among the Sukuk holders. This also applies to the case when the issuance of the Musharakah Sukuk was directly made by the entity seeking the financing and not through the SPV.

The relationship between TID, as manager of the Mudarabah contract assets, and the Sukuk holders may end in a debt in case there is the negligence or infringement of the manager. If this the case, the Mudarib becomes liable to the capital of the investors from the perspective of Islamic law and will be indebted until the investors

\(^{229}\) See p. 42-4.
receive their capital. Thus, this contract of Mudarabah may include indebtedness, and thus the default risk may arise.\textsuperscript{230}

These Sukuk represent money throughout the subscription period and prior to the purchase of the assets. Thereupon, when circulation, they must be subject to the money exchange provisions in accordance with Islamic Shari’ah. This means the sale shall be in the nominal value. Once the assets have been purchased, the sukuk represent joint ownership and, accordingly, may be traded up to the maturity date at any value. After the maturity date, the sukuk represent a debt if the parties concerned entered into a repurchase contract, since the company is committed to repurchase the share of investors in the Musharakah assets at the maturity date or the so-called ‘redemption date’ if investors want to exercise their right to the option of sale. The question that arises here is whether those securities represent a debt at the redemption date - without entering into agreements – or when specific cases occur obligating the company to repurchase the sukuk holders’ share - in view of those who approve the validity of such obligations and render the unilateral promises as binding and, therefore, subject to the provisions of debt in accordance with the Islamic Shari’ah, which imposes certain restrictions on sukuk circulation, as discussed before.\textsuperscript{231} It appears that the rule - with one exception by AAOIFI - is that a new contract must be entered into when fulfilling the promises. Accordingly, the Sukuk at the redemption date or when specific cases occur obligating the company to repurchase the sukuk holders’ share do not represent debts except after the conclusion of the new contract, in accordance with the view of AAOIFI and IIFA who see that the unilateral promises is binding.

\textbf{2.3.2.7. How the risk of bankruptcy arises}

Investors in those sukuk can face the risk of bankruptcy from two sides. The first is when TID goes bankrupt and, thus, defaults on fulfilling its financial obligations in cases where repurchase promises are to be honored. The second is when TID goes bankrupt, sukuk holders may face difficulty in having recourse to the assets of the Musharakah contract as partners in a joint ownership, since those assets are registered as the ownership of TID,

\textsuperscript{230} See p. 43.
\textsuperscript{231} See p. 30-1, 35-6.
which means that it is the legal owner of them. As such, the assets are likely to be part of TID’s bankruptcy estate, especially if such assets exist in a State governed by the Common Law and the courts competent to hear the dispute of such Sukuk are governed in accordance with the Common Law. This means that the sukuk investors would likely be in the position of TID’s creditors. But, if such securitized assets are located in a country governed by Islamic law and the jurisdiction over such sukuk is governed by Islamic law, such as Saudi Arabia, the risk of non-recourse to these assets would arise - for example - if domestic laws ban investors or foreign investors from owning these assets.

2.4. A general overview and analysis of Nam Fatt Corporation Berhad (NFCB) Sukuk Case

2.4.1. A general overview of NFCB – at the time -and its Sukuk

2.4.1.1. The background of the issuance

On January 31, 2006, NFCB issued Islamic sukuk worth RM250 million in Malaysian local currency,232 which in the current exchange rate exceed US $ 60 million, but the exchange rate since then should be taken into consideration. In 2006, the company's sukuk gained an A+ credit rating from the Malaysian Rating Corporation Berhad (MARC).233 But, in April 2010, the company defaulted on meeting its debt obligations payable to the sukuk holders, and, accordingly, its credit rating was downgraded to D.234

2.4.1.2. General information about the defaulted company – at the time -, particularly over the period of the sukuk issuance

In 1966, NFCB was established in Malaysia under the name ‘Nam Fatt Engineering’ as a private limited company, and in 1990, it became a public company named ‘Nam Fatt Berhad’, and it finally came to be known as ‘Fatt Corporation Berhad.’235 The company’s business diversified into a number of major activities, such as the construction of bridges, roads and factories.236 The company was listed in the Main Market of Bursa Malaysia

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232 See Majid, Shahimi & Abdullah, supra note 131, at 12.
233 See id.
234 See id.
236 See id.
Securities Berhad. It is a multinational company, and was employing more than 1,000 people distributed over 31 subsidiaries companies and 4 associated companies.237

2.4.1.3. The structure on which the sukuk were issued and their governing laws

The available documents of those Sukuk and some researches that studied them stated that the Sukuk were based on the Murabahah contract [in its contemporary concept],238 which is considered one of the most important fixed-returns tools of Islamic financing. Pursuant to that contract, investors are to buy an asset and then sell it to the entity seeking the capital for a deferred price agreement - as mentioned above in the chapter on the theoretical aspects. In that issuance, the company desirous to obtain finance had sold a specific asset it owns to the investors for immediate cash, and then bought that asset back for a deferred price as stipulated in the legal documents.239 When discussing the reality of this issuance, it will be realized that that transaction is actually none but a form of Bai’ al-Inah (a sale and buy-back) and not a Murabahah contract. The State whose legal system governs those sukuk is Malaysia.240 It observes the provisions of the English law.241

2.4.1.4. Relevant bank accounts

The available documents stated that the sukuk issuer should open bank accounts compliant with the provisions of Islamic Shari’ah. Pursuant to the available documents too, some of these accounts are managed by the security trustee alone, some are managed by the sukuk issuer (the finance seeker), and others are jointly managed by the trustee and the issuer.242 But, when a default occurs, the accounts managed by the issuer - exclusively or jointly with the trustee - are transferred to the trustee alone.243

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238 See Majid, Shahimi & Abdullah, supra note 131, at 13.
240 See id. at 20.
243 See id.
2.4.1.5. Meaning of the Event of Default according to the transaction’s legal documents

The available documents indicated certain cases that can typically be recognized as Events of Default. In other words, it explained the meaning of the events of default, which include, for example, the issuer’ default on paying any amount of money payable under the Financing Agreement; failure to fulfill the promises or terms of the agreement; providing any plainly misleading or incorrect data; the occurrence of a material adverse change in the financial conditions of the issuing company or its subsidiaries; failure to comply with a legal ruling that, in view of the trustee, would have a material adverse effect on the financial conditions of the issuer or its ability to meet its obligations to the sukuk holders; or the occurrence of circumstances plausible to the trustee that would have material negative implications on the issuer’s ability to comply with the terms of the agreement.244

2.4.1.6. Remedies to the Events of Default

The available documents stated that the Trust Deed described the remedies to be taken in the event of default. Under the Trust Deed Guidelines and the Trustee Act of 1949 issued by the Malaysian Securities Commission [given that the sukuk issuance took place in Malaysia], the Trust Deed signed by the parties concerned must comply with the minimum legal requirements.245 The available documents provided for certain powers for the trustee, such as taking appropriate action against the issuer to enforce such payment of the Notes and the provisions of the Trust Deed,246 pursuant to which all such sukuk are payable, although some of them may have not yet fallen due as, for example when the issuer defaults on the payment. This issue will be elaborated on in the subsequent chapter that deals with the assessment of guarantees and financial hedges provided in the three cases of defaulted Sukuk.

244 See id. at 10-11.
246 See Suruhanjaya Sekuriti Securities Commission Malaysia, NamFatt-Revised PTC, supra note 237, at 11-12.
2.4.1.7. Maturity

The available documents referred to the maturity amount by stating that the nominal value – which is the proceeds of the sukuk that the issuer has used to finance its activities as an alternative to conventional debt instruments - at which investors have subscribed to the sukuk must be redeemed at the maturity date. 247

2.4.1.8. The presence of a Shari’ah adviser and the role of Shari’ah Boards

There is a Shari’ah adviser to those issued sukuk. 248 Also, the assets intended for securitization and included in the purchase and sale process are conditional on their compliance with the requirements of Islamic Shari’ah and some Shari’ah Boards. 249

2.4.2. General Analysis and Discussion of NFCB Sukuk Case

2.4.2.1. Issuance mechanism and Sukuk Structuralization

It is clear from the available documents that those Sukuk did not include the establishment of SPV, but a company was commissioned to act as trustee representing the sukuk holders. As such, the issuer will be the company seeking financing. Perhaps, one of the reasons why an SPV was not established is that the contract underlying those sukuk is one of the least likely types of sukuk that require the SPV and the guarantees it provides, since the ownership of the sukuk assets is transferred to the finance seeker at the early stage of the sukuk term. For, one of the most important advantages of the SPV is immunity to bankruptcy in itself that preserves the assets it owns against third-party claims. However, this advantage is of no use in this case as the assets’ ownership is transferred to the finance seeker. However, the role of the SPV will be explained in more detail in the next chapter when we discuss the guarantees and hedges.

247 See id. at 4.
248 See id. at 3.
249 The available documents states: "[p]rior to each drawdown of the ICP/IMTN [Islamic Commercial Papers / Islamic Medium Term Notes], the assets identified for each sale and purchase transaction will have to comply with the Syariah requirements as well as the “Keputusan Majlis Penasihat Syariah (MPS) Suruhanjaya Sekuriti (SC) Berhubung Kontrak Kerajaan Dan Garis Panduan Penetapan Harga Aset Dalam Penerbitan Bon Islam” dated 31 December 2003 and “Keputusan Majlis Penasihat Syariah (MPS) Suruhanjaya Sekuriti (SC) Berhubung Garis Panduan Penetapan Harga Aset Dalam Penerbitan Bon Islam” dated 30 April 2004 respectively as amended from time to time and any re-enactment thereof." Id. at 8.
2.4.2.2. Type of the contract underlying the sukuk and its compliance with Islamic finance standards

Those Sukuk are a model of fixed income instruments that are based on the Murabahah contract - as alleged - or the sale and buy-back contract - which is the reality. According to the available documents, the Sukuk were issued on the basis of the Murabahah contract, but the most correct and accurate designation of the transaction is that it was a reversed form of Bai’ al-‘Inah (the sale and buy-back). This image as mentioned in the available documents applies to the reversed ‘Inah sale contract, which was defined by the jurist Mansour al-bahouti as: "to first sell the object for immediate cash and then buy it back from the purchaser at a higher price of the same currency for a deferred payment." As such, the transaction comprises two contracts, as the first sale contract is followed by a subsequent repurchase contract. In view of the Hanafi, Maliki and Hanbali jurists [though they differed regarding the details], the ‘Inah and reversed ‘Inah sale contracts are forbidden, while the Shafi‘is approved them. Shari’ah Advisory Council of Bank Negara Malaysia, where the sukuk issuer is based, has approved the ‘Inah sale with various conditions, such as that the transaction does not include any condition for resale or repurchase at the time of concluding the contract. As such, "the stipulation to repurchase the asset in bai‘ ‘inah contract will render the contract as void." But this council did not address the Fiqh ruling on a reversed ‘Inah sale contract.

The fact that Malaysia is a majority Muslim country adopting the Shafi‘i School is perhaps the reason why the Shari‘ah Advisory Council had endorsed the transaction, as the Shafi‘i School approves the ‘Inah sale. However, the available documents did not comply with the Shari‘ah rules it set. The Sukuk included binding promises by the two parties to resell and repurchase the assets, exposing the sukuk to the risk of non-compliance with

253 The available documents states: '[t]he successful TPM [Tender Panel Members] or the Investors shall purchase the Identified Assets at an agreed purchase price (“Purchase Price”). The TPM/Investors shall subsequently thereafter resell the Identified Assets at the selling price (“Selling Price”) which shall be made up of the original Purchase Price and profit margin (imposed by the TPM/Investors).” Suruhanjaya Sekuriti Securities Commission Malaysia, NamFatt-Revised PTC, supra note 237, at 4.
Islamic Shari’ah and accordingly the risk of annulment of the contract if the court competent to consider these sukuk was implementing the provisions of Islamic Shari’ah, or endorse Islamic contracts.

AAOIFI set some conditions when defining the Murabahah contract to prevent such formula on which those Sukuks are based, as mentioned in the Prospectus or the available documents.254

The reversed ‘Inah sale differs from the ‘Inah sale255, Murabahah256 and Monetization (tawarruq).257 This Sukuk also included binding bilateral undertaking which is discussed in detail in the third case study.258

**2.4.2.3. Sukuk returns, proceeds and trading**

As can be gleaned from the information about the maturity amount and describing the resale process of the assets to the issuer at the purchasing price plus a profit margin, investors’ returns or periodic payments in this issuance constitute the difference between the purchasing price that investors had paid for the assets and the deferred price of selling them to the financing seeker. In connection with NFCB, which needed the financing, it received the cash and the capital by selling some of its assets to investors, which it later on bought for a deferred price.

**2.4.2.4. Expanding the meaning of default**

It is worth noting in these sukuk that they have expanded the definition of the event of default beyond the legally and technically recognized scope to apply to other situations. As mentioned above, default is the non-fulfillment of the financial obligations, particularly insolvency or default. However, this securitization, allegedly

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254 AAOIFI states: "[t]he Institution must ensure that the party from which the item is bought is a third party other than customer or his agent. For example, it is not permitted for a customer to sell an ordered item to the Institution and then repurchase it through a Murabahah transaction. Nor may the party that is supplying the item be wholly, or by way of majority - more than 50% -, owned by the customer. If a sale transaction takes place and later on it is discovered that it was carried out through such practices, this would render the transaction void as it is tantamount to 'Inah." AAOIFI, supra note 43, at 201-02

255 The 'Inah sale, according to AAOIFI, "refers to the process of purchasing the commodity for a deferred price, and selling it for a lower spot price to the same party from whom the commodity was purchased." Id. at 758.

256 AAOIFI defines Murabahah transaction as, "selling a commodity as per the purchasing price with a defined and agreed profit mark-up. This mark-up may be a percentage of the selling price or a lump sum. This transaction may be concluded either without a prior promise to buy, in which case it is called an ordinary Murabahah, or with a prior promise to buy submitted by a person interested in acquiring goods through the Institution, in which case it is called a 'banking Murabahah" i.e. Murabahah to the purchase orderer. This transaction is one of the trust-based contracts that depends on transparency as to the actual purchasing price or cost price in addition to common expenses." Id. at 221.

257 Tawarruq (Monetization), according to AAOIFI, "refers to the process of purchasing a commodity for a deferred price determined through Musawamah (Bargaining) or Murabahah (Mark-up Sale), and selling it to a third party for a spot price so as to obtain cash." Id. at 758.

258 See p. 93-7.
compliant with Islamic Shari’ah, has put more constraints on the issuer - NFCB – by adding more situations and circumstances described as defaults, such as when the issuer faces a severe financial crisis.

2.4.2.5. The occurrence of an Event of Default, the relationship between Sukuk holders and the NFCB, and conditions of Sukuk circulation

The nature of Sukuk based on deferred sale contract is that they incur indebtedness against one of the parties at the early stage of the issuance, which is what happened in that issuance. The Sukuk assets ownership was transferred to NFCB that has become indebted to the investors due to the postponement of their receipt of the assets’ sale price. The nature of this type of Sukuk is that the amount of the returns and the payment date are known in advance, and the risk of default occurs when the originator who is the company benefiting from the proceeds of subscription fails to pay the periodic dues (coupons) or the maturity sum. This type of Sukuk, whether Murabahah or reverse ‘Inah sale, in view of those who considered the latter permissible, represents money at the time of collecting the proceeds from investors and before buying the assets. Accordingly, when trading these sukuk, they must comply with the provisions of money exchange in Islamic Shari’ah. Then, it represents assets after purchasing the assets from the proceeds of the subscription and before selling those assets for a deferred price to the company seeking financing through sukuk. Later, it represents debt after selling the assets to the company, and therefore these securities must comply with the provisions of debt in accordance with Islamic Shari’ah. These Sukuk, as stated in the legal documents, will not be listed on the stock exchange market.259 Perhaps, one of the reasons is the Shari’ah restrictions imposed on debt circulation, which exposes this type of Sukuk to more risks than other tradable sukuk and conventional bonds. For, investors face difficulty in getting rid of those sukuk for some reasons, including the appearance of signs and indications foreshadowing a looming financial crisis facing the obligor in Sukuk, or they may have trouble in trading the sukuk off for other purposes, as when banks investing in sukuk need immediate liquidity due to a drop in the deposits.

259 See Suruhanjaya Sekuriti Securities Commission Malaysia, NamFatt-Revised PTC, supra note 237, at 8.
2.4.2.6. How bankruptcy risk occurs

Sukuk holders may face the bankruptcy risk if NFCB goes bankrupt and default on the periodic installments and the maturity amount. They may face bankruptcy too in the ‘Inah sale or the reverse Inah sale in particular and not in the Murabahah transaction, in its proper sense, if the process of transferring the assets from the issuer - the financing seeker – to investors by way of selling involves Shari’ah and legal infringements which would make the sale transaction void, in view of those who see that ‘Inah sale contract and a reverse ‘Inah sale contract are valid. In this case, when the issuer/obligor goes bankrupt, these assets, which are presumed to be owned by the investors prior to reselling them to the issuer, provided this transaction does not include Shari’ah contraventions, may be included within the issuer's/debtor's bankruptcy estate pursuant to a ruling of the competent court. As such, investors will not only lose the assets but they may not be able to regain the capital they paid for the assets, given the issuer’s bankruptcy. However, in the view of the majority of Muslim jurists, the ‘Inah sale contract and a reverse ‘Inah sale contract are void. So, if the Shari'ah courts, such as Saudi Arabian courts, have the jurisdiction over dispute of the Sukuk that are based on one of these contracts, such courts would likely cancel the contract with all the implications of these contracts, especially the Saudi courts. Then, investors may not be able to regain the capital they paid for the assets if the seller/originator/obligor goes bankrupt. This problem, including some suggestions to avoid such risks, will be discussed in the next chapter. The foregoing is a manifestation of the relationship between Shari’ah risk and credit risk.

2.5. A general overview and analysis of Ingress Sukuk Berhad (ISB) Case

2.5.1. A general overview of ISB – at the time - and its Sukuk

2.5.1.1. The background of the issuance

These Sukuk were issued on July 9, 2004. The total value of the issuance amounted to RM160 million in Malaysian local currency,\(^{260}\) which is approximately equivalent to US $ 40 million at the current exchange rate. The issuance was made in three series, with the first group worth RM60 million in the Malaysian currency for a five-year term, and RM50 million in Malaysian currency for each one of the second and third groups for six and

\(^{260}\) See Majid, Shahimi & Abdullah, supra note 131, at 11.
seven years term respectively. The maturity date of the first tranche falling on July 9, 2009 coincided with the issuer’s default on the maturity amount owed to the sukuk holders. Less than a week later, MARC reduced the credit rating of the sukuk to D following the decision to defer paying the amount for six months.

2.5.1.2. General information about the financed company through sukuk – at the time

In May 1991, Ingress Corporation Berhad (ICB) was established, which founded an SPV named ISB for the purpose of issuing the sukuk. The main activities of ICB [in the period between its establishment and the issuance of sukuk] focused on automotive components manufacture to meet the growing demand on auto manufacture in Malaysia and the ASEAN region. In April 2000, ICB was listed on the Main Market of Bursa Malaysia.

2.5.1.3. The structure underlying the sukuk issuance

The available documents stated that the company desired to increase its financial resources through the issuance of sukuk based on the Ijarah contract principles. Pursuant to the available documents, the procedures include that the ICB, prior to sukuk issuance, shall sell the beneficial interest to the Assets to the issuer of the sukuk (ISB) in exchange for the Purchase Price, which is the amount payable by ISB from the proceeds of the subscription of the potential sukuk holders, providing ICB with the capital it needs. Once the above sale transaction has been carried out, the Company/ICB and the Issuer/ISB conclude a contract to lease the assets to the ICB for a period of up to seven years in exchange for rent paid periodically. In addition to that,

Ingress will also provide the Issuer with a Purchase Undertaking (as defined below) and the Issuer will provide Ingress with a Sale Undertaking (as defined below). Both undertakings are exercisable upon the

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262 See Majid, Shahimi & Abdullah, supra note 131, at 15.
263 See id. at 31.
265 See id.
266 See id.
268 See id. at 4, 11.
269 See id. at 4.
occurrence of a Dissolution Event, Event of Default (as defined below) or at the maturity of the Ijarah Agreement.270

Both parties gave a unilateral, irrevocable and unconditional undertaking in relation to ICB’s purchase of the assets and the issuer’s sale of these assets to ICB at the Exercise Price, which is exercised in the event of default, dissolution or upon maturity of the Ijarah Agreement.271 “The Exercise Price, as of any date, amounts to the nominal value of the Sukuk plus the Scheduled Expenses as of such date.”272 The issuance process included entry into the Service Agency Agreement between ISB and ICB, whereby the latter is committed under this contract to provide major asset maintenance services.273

2.5.1.4. Sukuk returns and proceeds

Sukuk returns come in the form of periodical rental payments that sukuk holders receive in proportion to their shares of the sukuk. The available documents stated that the periodical rental payments are semi-annual.274 ICB is obligated to open two Ijarah Service Reserve Accounts (ISRA), one for the Ijarah Rental payments and the other for the Exercise Price, both exclusively managed by the Trustee.275 The available documents stipulated that one of the Ijarah rental payments be deposited in the ISRA at the date of issuance.276 Afterwards, and throughout the term of the Ijarah agreement, the credit balance of the same amount of at least one Ijarah rental instalment payable on the next rental payment date must be deposited and kept at all the times in the ISRA.277 ICB’s purpose in securitizing the assets was to finance its subsidiaries to help them build a new plant, meet their debt obligations to repay part of their loans due to banks, and to purchase certain other assets.278

270 Id.
271 The available documents states: ”25.3 Purchase Undertaking: Ingress will give to the Issuer a unilateral, unconditional and irrevocable undertaking to purchase the Assets from the Issuer at the Exercise Price on the occurrence of an Event of Default, a Dissolution Event or at the expiry of the Ijarah Agreement. 25.4 Sale Undertaking: The Issuer will give a unilateral, unconditional and irrevocable undertaking to sell the Assets to Ingress at the Exercise Price on the occurrence of an Event of Default, a Dissolution Event or at the expiry of the Ijarah Agreement.” Id. at 16.
272 Id. at 11.
273 See id. at 4.
274 See id. at 11.
275 See id. at 17.
276 See id.
277 See id.
278 See id. at 7-8.
2.5.1.5. Meaning of event of default according to the transaction legal documents

The available documents provided some cases of Events of Default. Among these cases are when ICB defaulted on any amount payable under the transaction documents, failed to exercise its undertakings or meet the terms of the agreement, or upon the occurrence of a Dissolution Event.\textsuperscript{279} Events of Default include also when any indebtedness for borrowed moneys or guarantee of Ingress [ICB] has fallen due before its maturity date or was not settled at its due date, and that indebtedness or guarantee exceeds RM1 million; when the security representing that indebtedness is enforceable immediately;\textsuperscript{280} or when a receiver on an essential part of ICB's assets or subsidiaries has been appointed.\textsuperscript{281} Among these Events of Default are also the occurrence of a situation that could have a material adverse effect on ICB or its subsidiaries, or when this situation could be addressed from the trustee's point of view, and yet it was not dealt with by ICB within 30 days of receiving a written notification from the trustee.\textsuperscript{282}

2.5.1.6. Remedy to the Event of Default

The available documents stated that the issuer/ISB has the right to terminate its Ijarah Agreement with ICB, to claim all outstanding sums owed by ICB and to exercise its rights pursuant to the Purchase Undertaking,\textsuperscript{283} which means to obligate ICB to redeem the Sukuk.

2.5.1.7. Maturity

The method of maturity was mentioned earlier when discussing the cases of recourse to the exercise price, which represents the nominal value of the sukuk plus the Scheduled Expenses as of such date, one of whose causes is the maturity of the Ijarah Agreement. However, the available documents clearly stated that the sukuk would mature and be redeemed at the nominal value by means of exercising the Sale and Purchase Undertakings.\textsuperscript{284} This is carried out when the SPV/ISB sells the assets to ICB in return for the equivalent of the nominal value at which the sukuk were issued and which represents the capital of investors.

\textsuperscript{279} See id. at 13-5.
\textsuperscript{280} See id.
\textsuperscript{281} See id.
\textsuperscript{282} See id.
\textsuperscript{283} See id. at 14.
\textsuperscript{284} See id. at 19.
2.5.1.8. Position of the Shari’ah Board

The Sukuk issuing process is monitored by Shari’ah advisors.\textsuperscript{285} In addition, the Shari’ah reference to some aspects of those Sukuk, such as setting the purchase price and making compensation for default is the Shari’ah Advisory Council of the Securities Commission Malaysia, while investing the sums deposited in the Ijarah Service Reserve Account for investors complies with the requirements of this and other recognized Shari’ah Boards according to the transaction documents.\textsuperscript{286}

2.5.2. General Analysis and Discussion of ISB

2.5.2.1. Issuance mechanism and nature of investors’ ownership

The issuance of these Sukuk involved the establishment of an SPV in the form of a trust. Therefore, the Sukuk issuer was ISB and not ICB. Perhaps, one of the reasons for the need to establish the SPV is that the contract on which those Sukuk were based can be regarded as one underlying the Sukuk types that most likely require an SPV, since the ownership of the securitized assets is assumed to be for investors and Sukuk holders throughout the issuance term. Hence, the SPV’s role materializes in being immune to bankruptcy per se in order to protect its assets as well as immune to the bankruptcy of the originator who benefited from the financing through Sukuk. The most paramount characteristic of those Sukuk is that the investors’ ownership of them is a beneficial interest, an issue that will be discussed further in the next chapter, including the importance of the SPV and being a protective hedge against the risk of bankruptcy and the evaluation of applications and practice applied in Islamic securitization of assets through the SPV, especially at the three cases selected.

2.5.2.2. Type of contract underlying the Sukuk

The issuance provided for the transfer of the assets to the Sukuk holders represented by the SPV and, thereafter, the process of renting the assets to ICB. Although the process included a sale transaction, which involves the acquisition of the assets by the buyers, this Sukuk structure is specifically designated as Ijarah Sukuk. In practice, the Sukuk that include the sale of assets to Sukuk holders and, then, are rented out to the assets’ seller are called

\textsuperscript{285} See id. at 4.
\textsuperscript{286} See id. at 11, 18, 20.
Ijarah Sukuk, but these sukuk, in reality, represent the ownership of objects and do not represent a usufruct or Ijarah. They are named as Ijarah sukuk by way of flexibility, predominant norm and by virtue of these objects representing assets rented or promised to be rented. Perhaps, that designation is used considering that the longest stage of those sukuk is based on Ijarah agreement, or by way of using the part as an expression of the whole. In general, these sukuk are characterized by being one of the fixed-income instruments.

2.5.2.2.1. ‘Inah transaction and Ijarah Muntahiah Bittamleek

It should be noted here that this structure - which is based on the finance seeker’s sale of some of its assets to the SPV for a price obtained from the subscription proceeds, provided that it rents out the asset as Ijarah Muntahiah Bittamleek (lease-to-own agreement) – may include the ‘Inah sale, which was previously discussed and its Shari’ah position was clarified in the previous case. In its Resolution No. 188, the IIFA stated that,

No asset may be sold for cash conditional on the seller’ leasing out of that asset and a combined repurchase promise for an aggregate of the total rental payment and a final payment exceeding the cash price, whether this condition is explicit or implicit. For, such transaction would be a form of ‘Inah sale, which is forbidden in view of Islamic Shari’ah. So, it is prohibited to issue Sukuk based on this formula.

This view was debated among jurists, and opinions varied between those who approved it and others who forbade it rendering it as a form of ‘Inah sale.

2.5.2.2.2. Bilateral undertakings/promises and unilateral undertaking/promise

This Sukuk included the binding bilateral undertaking between the parties in the sale transaction of assets from the originator to investors and in the transaction of the Ijarah ending with ownership. The Sukuk in the previous case also included binding bilateral undertaking in the transaction of sale that was executed on the basis that the selling of assets -intended to be securitized – was in cash from the originator who then bought back such assets on credit.

288 See id.
290 See AL-MORSHEDI, supra note 106, at 156-63. For broader information about the Shari'ah ruling on 'Inah sale, see p. 85.
Some researchers state that there is a difference between a binding unilateral promise (or binding bilateral promise) and a non-binding unilateral promise (or non-binding bilateral promise). They see that the parties in a non-binding unilateral promise or a non-binding bilateral promise stipulate that a promise is not binding or stipulate that a non-binding unilateral promise or a non-binding bilateral promise gives the promisor/s the option to not fulfill his promise. One researcher attributes the view that binding bilateral promise and a binding unilateral promise in a commutative contract are prohibited and not legally binding, according to the majority of contemporary Muslim jurist including the Permanent Committee for Scholarly Research and Ifta in Saudi Arabia. But when we returned to the statement and Fatwa of the Permanent Committee, it states that the pre-contract agreement (the bilateral promise or the unilateral promise) is not binding on both parties or even on one party [from Shari’ah perspective]. Also, the Committee does not state that a binding or non-binding promise is prohibited by Shari’ah. The question submitted to the Committee did not mention the issue of whether a stipulation that a bilateral promise (or a unilateral promise) is binding when providing promise is legally and religiously binding.

IIFA and AAOIFI state that a binding bilateral promise is [religiously] permissible and legally binding [from Shari’ah perspective] in specific cases that do not apply neither to this Sukuk nor to Sukuk in the previous case. IIFA and AAOIFI state that a bilateral promise is prohibited (without describing whether they are binding or non-binding, i.e. they do not restrict the phrase by adding the word of "binding") in specific cases, such as a bilateral promise leading to ‘Inah transaction. AAOIFI adds that any promise [which includes a unilateral promise] that

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291 See Ahmed M. al-Rzin, *Hakam Al'iilzam Bialwafa’ Bialwaed [Shari’ah Ruling on Stipulation that the Promise is Binding]*. (Midad, November 8, 2007). Available from: [http://midad.com/article/200238/%D8%AD%D9%83%D9%85-%D8%A7%D9%84%D8%A5%D9%84%D8%B2%D8%A7%D9%85-%D8%A8%D8%A7%D9%84%D9%88%D9%81%D8%A7%D8%A1-%D8%A8%D8%A7%D9%84%D9%88%D8%B9%D8%AF. (accessed on 29th October 2018)](http://midad.com/article/200238/%D8%AD%D9%83%D9%85-%D8%A7%D9%84%D8%A5%D9%84%D8%B2%D8%A7%D9%85-%D8%A8%D8%A7%D9%84%D9%88%D9%81%D8%A7%D8%A1-%D8%A8%D8%A7%D9%84%D9%88%D8%B9%D8%AF).


294 See *id*.


296 See AAOIFI, *supra* note 43, at 1166; see also IIFA, *supra* note 79, at 353.
leads to ‘Inah transaction is forbidden in Shari’ah as well.298 This stands except in cases where a bilateral promise is binding. AAOIFI and IIFA state that bilateral promise is not legally binding [from a Shari’ah perspective].299

Their opinion remains unclear regarding the Shari’ah ruling on providing a bilateral promise and on fulfilling a bilateral promise by parties religiously, among several contracts such as Murabahah and Ijarah. The meaning of "religiously" in this context is that if fulfilling a bilateral promise is a religious obligation, breaking such promise is a sin.

AAOIFI, when addressing the standard related to "Murabahah" and the standard related to "Ijarah and Ijarah Muntahiah Bittamleek," prohibits a binding bilateral promise between parties, which is understood as completely prohibited.300

When addressing the issue of "Discharging of Promise and Murabaha for the Orderer of Purchase," IIFA prohibits a bilateral promise if one or two parties do not have the option of not fulfilling promise, which IIFA called it (i.e. if there is no option) "mutual and binding promise."301

On the other hand, AAOIFI, when addressing the standard related to "Unilateral and Bilateral Promise," states: "[f]ulfilling a bilateral promise to perform an act that is permitted but not binding under the Shari’ah is a religious

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298 See AAOIFI, supra note 43, at 1165.
299 See id. at 1166; see also IIFA, supra note 79, at 353.
300 AAOIFI in the Arabic version, states -when addressing the Murabahah standard - that it is not permissible that the document of promise includes a binding bilateral promise by both parties (the institution and the customer). AAOIFI, supra note 85, at 205. But in the English version, AAOIFI states: "[i]t is not permissible that the document of promise to purchase (signed by the customer) should include a bilateral promise which is binding on both parties (the Institution and the customer)." AAOIFI, supra note 43, at 202. It states elsewhere in the English version - when addressing the Murabahah standard -: "[a] bilateral promise between the customer and the Institution is permissible only if there is an option to cancel the promise which may be exercised either by both promisors or by either one of them." Id. at 203. When addressing the standard related to Ijarah and Ijarah Muntahiah Bittamleek, AAOIFI states, in English version, "8/2 A promise to transfer the ownership by way of one of the methods specified in item 8/1 above is a binding promise by the lessor. However, a binding promise is binding on one party only, while the other party must have the option not to proceed. This is to avoid a bilateral promise by the two parties which is Shari’ah impermissible because it resembles a concluded contract." Id. at 250. But in the Arabic version, it adds the word "binding" before the phrase of "a bilateral promise". Id. at 253-54. When addressing the standard related to Sharikah (Musharakah) and Modern Corporations, AAOIFI states: "[i]t is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value or a price agreed at the time of acquisition. However, it is not permitted to stipulate that the equity share be acquired at their original or face value, as this would constitute a guarantee of the value of the equity shares of one partner (the Institution) by the other partner, which is prohibited by Shari’ah." Id. at 347. There is no difference in meaning between the Arabic and English versions. It may be understood from the permissibility of a binding unilateral undertaking by one of the partners that AAOIFI prohibits a binding bilateral undertaking.
301 IIFA, supra note 83, at 87.
obligation on both parties but is not legally binding except in situations..." The view of IIFA, when addressing "Bilateral Promise and Collusion in Contracts," is almost the same as the view of AAOIFI.

The question that arises, since entering into Islamic contracts such as Murabahah or Ijarah contract is an act that is permissible by Shari’ah, is a bilateral promise - concerning the entering into such contracts in the future and concerning fulfilling this bilateral promise – religiously prohibited or required?

IIFA and AAOIFI are more likely to consider a bilateral promise to enter into such contracts as religiously required if a bilateral promise is based on non-binding bilateral promise. They are more likely to see that a bilateral promise should be religiously fulfilled if a bilateral promise is based on a non-binding bilateral promise, namely that the parties do not stipulate that their promise is binding or the parties stipulate that each party has the option to not fulfill the promise.

Our conclusion is the result of the fact that in many places they add the word "binding" before the phrase of "bilateral promise" when they prohibit financial transactions involving such a bilateral promise such as Murabahah and Ijarah and when they see such promises as not legally binding.

The conclusion is supported by stating the phrase "bilateral promise" without adding the word of "binding" when they declare that a bilateral promise to perform an act that is permitted but not binding under the Shari’ah should be religiously fulfilled. Perhaps they mean that a bilateral promise is permitted and should be fulfilled religiously if each party has the option or if the parties do not stipulate that a bilateral promise is binding.

As to the issue concerning when a unilateral promise is religiously and legally binding from AAOIFI's perspective, it also remains unclear. For example, AAOIFI states, in its book of Shari’ah Standards, that a promise [i.e. a unilateral promise] to perform an action or a financial transaction that is permissible in Shari'ah must be religiously fulfilled except if there is an excuse. It also states that the fulfillment of a promise [i.e. a unilateral promise] is not legally obligated "except when there is a real need for it to be enforced, such as when the promisor causes the promisee to incur a liability as a result of the promise." But AAOIFI states, elsewhere in its book of

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302 AAOIFI, supra note 43, at 1166.
303 See IIFA, supra note 79, at 353.
304 See AAOIFI, supra note 43, at 1165.
305 Id.
Shari’ah Standards, that a unilateral promise [AAOIFI does not add the word "binding" before "a unilateral promise"] in transactions of Murabahah, Ijarah and diminishing Musharakah is legally binding. Elsewhere, it states that a "binding" unilateral promise is legally binding. Based on the above, the provisions made by AAOIFI should be more consistent, and there should also be consistency between the Arabic and English versions.

As to IIFA's opinion on a unilateral promise, it states: "[a]ccording to Shari’a, a promise (made unilaterally by the purchase orderer or the seller), is morally binding on the promisor, unless there is a valid excuse. It is however legally binding if made conditional upon the fulfillment of an obligation, and the promisee has already incurred expenses on the basis of such a promise."

2.5.2.2.3. Shari’ah risk

Based on the view of the majority of Muslim jurists including IIFA and AAOIFI on impermissibility of binding bilateral promise and 'Inah transaction, the risk of non-compliance with Islamic Shari’ah arises, which may adversely affect the validity of the contract underlying Sukuk, especially if competent courts or arbitrators abide by the provisions of Islamic Shari’ah. One of the judicial principles in the Saudi Arabian judicial system is that a promise [whether a bilateral promise or a unilateral promise and whether a binding bilateral promise or a binding unilateral promise] is not legally binding. Based on the available information, we did not find a Saudi Arabian court judgment on whether the contract arising from a binding bilateral promise or a non-binding bilateral promise is valid or void.

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306 AAOIFI states: "[t]he promise given by the client in the Murabahah transactions conducted by institutions is legally binding by virtue of item 3/5 of this Standard. [see Shari’ah Standard No. (8) on Murabahah] ... The promise given by the institution in Ijarah Muntahia Bittamleek transactions to grant the leased asset to the lessee as a gift conditional on that he pays all the lease installments is legally binding as in item 3/6 of this Standard. [see Shari’ah Standard (9) on Ijarah Muntahia Bittamleek] ... The promise given by the institution in diminishing Musharakah transactions that it will lease its share of the asset to the other coowner is legally binding and the promise given by the client that he will buy units of the institution’s share at stipulated intervals are legally binding by virtue of item 3/5 of this Standard. [see para 5 of Shari’ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]" Id. at 1168.

307 For example, AAOIFI states: "[i]t is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value or a price agreed at the time of acquisition. However, it is not permitted to stipulate that the equity share be acquired at their original or face value, as this would constitute a guarantee of the value of the equity shares of one partner (the Institution) by the other partner, which is prohibited by Shari’ah." Id. At 348. Another example that AAOIFI states: "[i]t is permissible for the Institution, in the case of a binding promise by the customer, to take a sum of money as Hamish Jiddiyah (security deposit). This is to be paid by the customer at the request of the Institution, both as an indication of the financial capacity of the customer and to ensure the compensation of any damage to the Institution arising from a breach by the customer of his binding promise." Id. at 205.

308 In its Arabic version, IIFA uses the word "religiously" instead of "morally." See IIFA, supra note 79, at 81.

309 IIFA, supra note 83, at 86.

310 See p. 35, 93-4.
2.5.2.3. Expanding the meaning of Event of Default

The case of these defaulted sukuk is similar to that of previous Sukuk in terms of expanding the meaning of Events of Default from the legal perspective. The scope of its meaning expanded from that of non-fulfillment of financial obligations, such as cessation or delay of payment, to include many other events, such as the occurrence of a financial crisis to ICB or the appointment of a receiver to a material part of its assets.

2.5.2.4. Default, nature of the relationship between the sukuk holders and ICB, and conditions of Sukuk circulation

The relationship between the investors or their representative (ISB) and the ICB is that of a lessee-lessee relationship subsequent to leasing the assets at the early stage of those sukuk, and it will later turn into a creditor-debtor relationship. Indebtedness relationship would also occur in this transaction in the event of the fulfillment of binding bilateral undertaking to sell Sukuk assets owned by the investors/lessors at the end of lease period. It is important to note that the fulfillment of undertakings/promises must be through entering into a sale and purchase agreement in view of AAOIFI and IIFA. But they see that a binding bilateral promise is not legally binding and is prohibited by Shari’ah as discussed above. Under the contract of sale in this Sukuk, the assets will be transferred back to the original seller which is ICB (the originator) in exchange for the consideration which is usually equal to their capital (face value) such as this case study. The correct legal characterization of the contract underlying this Sukuk is that it is Ijara Muntahiah Bittamleek contract (lease-to-own agreement). Perhaps, it could be also described as ‘Inah contract. Default can occur on making the periodic rental payments. It may also occur when one of the causes requiring the exercise of the above-mentioned purchase and sale undertakings takes place, including the falling due of the maturity date, which is concurrent with the maturity of the Ijarah Agreement. This type of sukuk represents money in the beginning at the time of collecting the proceeds from investors and prior to buying the assets. Therefore, when trading the sukuk, they must comply with the provisions of money exchange in Islamic Shari’ah. Thereafter, they represent assets after the investors purchase the assets - promised to be leased - through the proceeds of the subscription, whereupon they may be traded without Shari’ah

311 See p. 36.
restrictions. Afterwards, the Sukuk represent a debt post the occurrence of events under which the exercise of the Purchase and Sale Undertakings can be embarked on after entering into an agreement between the two parties. Accordingly, these securities must comply with the provisions of debt in Islamic law, as we established above.\textsuperscript{312}

\textbf{2.5.2.5. Bankruptcy}

Investors in these Sukuk are susceptible to the risk of bankruptcy in this structure of sukuk in many respects. For example, this risk would arise if the ICB/lessee/originator went bankrupt or became insolvent and is unable to pay the periodic installments and the maturity amount. They may also face bankruptcy in other cases, such as if the company/ICB went bankrupt and the court has ruled that the securitized assets - which are supposed to be the investors’ property - be included to ICB’s/originator’s bankruptcy estate; if there are defects in the sale transaction of the assets to investors and non-compliance with the legal requirements of the transfer of ownership; if the contract was rendered as void as it involves the ‘Inah transaction and the binding bilateral undertaking; or if there was no legal separation between the SPV/issuer and the ICB. Further, if the contract was qualified as ‘Inah sale, they may face the risk of bankruptcy by the way as explained in the former Sukuk case.

\textsuperscript{312} See p. 30-1, 34.
Chapter 3: The Evaluation and Development of the most Prominent Guarantees and Preventive Measures of Default and Bankruptcy Risks Included in the three Defaulted Sukuk

3.1. Introduction

Like many other investment instruments, Sukuk can involve a variety of risks, the most prominent of which are those relative to investors’ returns and capital, which might dishearten potential investors to invest in them. In response to investors’ concerns about the risk of default, the issuance procedures of the three defaulted Sukuk cases in question included some terms to reassure investors and encourage them to subscribe in Sukuk. Whereas the three issuances included some common hedges, each one of them strove individually to provide all necessary measures to avoid or reduce credit and bankruptcy risks. Apparently, two of those issuances incorporated a number of approximately shared hedges. This chapter is intended to discuss the preventive measures and guarantees provided, analyze their points of strength and weakness in the Sukuk markets, attempting to enhance and rectify them, when necessary, and to emphasize some of their aspects.

Prudential and protective options included the following: credit rating agencies; special purpose vehicle and investors’ ownership of securitized assets; and, expanding the concept of event of default to include premature exercise of repurchase promise (at redemption date) assumed to take place at the maturity date of the Sukuk that involve such promise, as is the case with Ijarah and Musharakah Sukuk, as well as to include the early repayment of the deferred amounts payable on the maturity date of the Sukuk devoid of repurchase promise on account of their nature that requires the transfer of assets from investors to the entity desirous to obtain financing, as is the case with Murabahah Sukuk.

3.2. The Evaluation and development of Credit Rating Agencies (CRAs)

3.2.1. Introduction

One of the most prominent financial traditions that is typically in the interest of creditors and investors in debt and bond markets is to obtain a credit rating for corporate and government bonds from competent credit agencies specialized in assessing the ability of debt instrument issuers to meet their financial obligations and scrutinizing their creditworthiness. To mitigate potential Sukuk and bonds holders’ concerns of risk of default and financial
insolvency, credit rating has become an essential factor in achieving this goal, as emphasized by Mohd Faizal Kamarudin, Norlela Kamaluddin, Siti Khadijah Ab. Manan, and Gairuzazmi Mat Ghani.\textsuperscript{313} This consideration has been reinforced by the change in Basel II legislations relative to requirements of banks’ capital, as underlined by Marwan Elkhoury.\textsuperscript{314}

The CRAs’ influential role is manifested in the pricing of interest rate in bonds, profit margins and returns on Sukuk. The higher the rating scales, the lower the interest, debt and returns rates. CRAs’ importance to securities appears not only in primary markets but also when trading them in the secondary market. Therefore, CRAs regularly check these securities throughout their term and up to the maturity dates, and thus they play a crucial role in investors' decisions to purchase them, if the Sukuk are permissibly traded in accordance with Shari’ah provisions. CRAs also play a vital role when assessing the debt instruments of corporates and governments, as many legislations require some investment institutions to avoid investing in speculative [or non-investment] grade securities.\textsuperscript{315} The Sukuks have followed in the steps of conventional debt and capital markets in this regard. This section focuses on the explanation of the meaning and mature of credit rating agencies, the extent of their recognition, their role and relationship to Sukuk, the evaluation of their work and investigation of their shortcomings, the assessment of their effectiveness and suggestion of possible remedies and the reality of credit rating in Saudi Arabia and its feasibility as adequate guarantee alone.

3.2.2. Meaning of credit rating, its recognized categories, and significance of degrees granted and their impact on interest rate

An international credit rating agency is defined as a company that assigns credit ratings for issuers of certain types of financial instruments and the debt instruments themselves, taking into consideration the issuer's credit

\textsuperscript{313} Kamarudin, Kamaluddin, Manan & Ghani, supra note 127, at 279.

\textsuperscript{314} In his research, Marwan Elkhoury states: "[r]egulatory changes in banks’ capital requirements under Basel II have resulted in a new role to credit ratings. Ratings can be used to assign the risk weights determining minimum capital charges for different categories of borrower. Under the Standardized Approach to credit risk, Basel II establishes credit risk weights for each supervisory category which rely on "external credit assessments" (see box 1). Moreover, credit ratings are also used for assessing risks in some of the other rules of Basel II." Marwan Elkhoury, Credit Rating Agencies and their Potential Impact on Developing Countries 2 [A paper (No. 186) presented to United Nations Conference on Trade and Development, January 2008]. Available from: https://unctad.org/en/docs/osgdp20081_en.pdf (accessed on 29th October 2018).

\textsuperscript{315} See id. at 1.
worthiness whether the company has its ability to pay back a loan. The issuers of bonds could be companies, governments, non-profit organizations, and special purpose vehicle. Various studies comparing Moody's and Standard and Poor's ratings have found a great similarity for assigning of investment grade although credit rating agencies have different standards and measurements for the likelihood of default.

3.2.2.1. CRAs’ recognized categories

CRAs are divided into two main categories. The first category is recognized by officials of financial policies of each country. In the United States, only five CRAs are recognized by the Securities and Exchange Commission (SEC), such as Moody's and Standard and Poor's (S&P). The second category is not recognized, and this category includes the majority of CRAs, such as the Economist Intelligence Unit (EIU), Institutional Investor (II), and Euromoney.

3.2.2.2. Ranks granted by CRAs and their variant ratings

Many CRAs like Moody's and Standard and Poor's (S&P) and Fitch, which are the three most influential rating agencies globally, use similar symbols (A, B, C, D) in describing the financial conditions of debt securities issuers. These alphabetical symbols are benchmarks of the credit rating quality. Ratings "are commonly classified into four categories, namely Investment Grade (Grade AAA to BBB-), Speculative Grade (Grade BB + to B-), Substantial Risk (Grade C), and in Default (Grade D)."

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317 See id.
318 See id.
319 See Elkhoury, supra note 314, at 7.
320 See id. at 1.
321 See id.
322 See Alen Host, Igor Cvečić & Vinko Zaninović state: "[i]n 1975, when the NRSRO [National Recognized Statistical Ratings Organization] was established by SEC, only these three agencies [Standard & Poor's, Moody's Investors and Fitch] had the right to assign credit ratings; starting with 2011, 10 CRAs have been approved by NRSRO." Alen Host, Igor Cvečić & Vinko Zaninović. Credit Rating Agencies and their Impact on Spreading the Financial Crisis on the Eurozone 640 n.1 (Ekonomiska Misao i Praksa, Vol. 21 Issue No. 2, pages: 639-662, 2012).
323 See id.
324 See Elkhoury, supra note 314, at 1.
325 See Choy, supra note 316, at 42.
327 Choy, supra note 316, at 42.
investment grade and non-investment grade. To indicate the creditworthiness of each rating given, CRAs differ in relation with the signs or numbers existing to the right of the rating.\textsuperscript{326}

With regard to the variant CRAs ratings, research studies have shown a significant conclusion that points out a variation between CRAs in general in rating the same issuer. Generally speaking, as understood from some sources, CRAs are different in the rating scales whether for investment grade or speculative-grade, including variation in rating both sovereign and corporations bonds.\textsuperscript{327} Exception to these agencies are Moody's and Standard and Poor's which research has shown similarity in their ratings of investment grade issuances, both for sovereign and corporate bonds, as can be inferred from some sources.\textsuperscript{328} But, with regard to speculative-grade, they differ in relation with sovereign bonds rather than corporate bonds.\textsuperscript{329}

3.2.3. The relationship of Sukuk, including selected cases, to credit rating and the need for it

To understand the relationship of Sukuk to credit ratings, it has been mentioned above that some see the process of Sukuk issuing as divided into two categories. The first category is the real need for investment. For example, in Musharakah Sukuk, the returns are assumed to be generated from an existing business activity or enterprise wherein the Sukuk holders have contributed their capital and the finance seeker has contributed some of its assets, a monetary contribution or both of them, with the aim to expand the latter’s business activities or establish a new project. The second category is solely for obtaining financing. But, in practice, these two categories of Sukuk issuing are often intended to be parallel to bonds structure with regard to certain issues, such as periodic payment, maturity and redemption.

In TID Sukuk, although they are allegedly based on the Musharakah contract, the company desirous to obtain financing through the proceeds of Sukuk promised to pay periodic returns in a process analogous to that of bonds to some extent. It had an expectation that the returns would be similar to the LIBOR rate. Some researchers

\textsuperscript{326} See Ahmed, supra note 324, at 55.
\textsuperscript{327} See Elkhoury, supra note 314, at 7.
\textsuperscript{328} See id.
\textsuperscript{329} Marwan Elkhoury states: "[a]lthough CRAs have different concepts and measurements of the probability of default, various studies which have compared Moody's and Standard and Poor's ratings, have found a great similarity for investment grade ratings (Cantor and Packer, 1996; Ammer and Packer, 2000). In the case of speculative-grade issues, Moody's and Standard and Poor's assign divergent ratings much more frequently to sovereign bonds than to corporate bonds. The literature also finds clear evidence of differences in rating scales once we move beyond the two largest agencies. For example, ratings for the same issuer tend to be lower for the two largest agencies than for other agencies such as Fitch, Duff and Phelps." Id.
claimed that it assigned a specific returns rate, as already indicated, in which case the Sukuk would be very close to conventional bonds structure. In addition, TID had undertaken to buy the securitized assets in specific events, including the maturity date. There are also views that hold the Sukuk manager –be it a partner, a mudarib or an investment proxy– bound to guarantee the nominal value of Sukuk, which represent the capital of subscribers/investors, as well as the earnings achieved, if it has provided a feasibility study proving the success and profitability of the project, yet the reality is otherwise. There are also other views that approved of the Sukuk Manager offering Sukuk holders an interest-free loan when no profit is achieved or lower returns than expected are generated in order to ensure the distribution of assigned returns at their due times. Here appears the significant role of CRAs. For, as long as there is a binding promise by TID to repurchase the securitized assets in certain events, the need for credit rating becomes evident in order to assess TID’s ability to meet its obligations in full at the specified times.

In NFCB Sukuk, the case is clear, as the issuer/NFCB is committed to make periodic payments plus a final installment at the maturity date. This type, like many other types of Sukuk, involves credit risk as in conventional bonds, which are normally subject to CRAs’ evaluation and ratings.

As to ISB, whereby the originator who is the lessee of the securitized assets is committed to pay the Sukuk returns in the form of periodic rentals in addition to the nominal value of the Sukuk at the maturity date to recover the assets, fulfilling the financial obligations to Sukuk holders depends on the financial condition of the originator/ICB then the issuer/ISB. The reason for putting the originator before the issuer here is that if the earlier has defaulted on payment, this will be followed by the issuer’s default, since the latter has no real activities or income-generating sources other than the assets leased to the originator. Whereas, if the originator has fulfilled its obligations, the issuer is not likely to default because the special purpose vehicles are typically invested with inherent protective measures against financial difficulties, and their activities are restricted to the purpose for which they were established, as will be discussed in the following section.

330 See AL-MORSHEDI, supra note 106, at 90.
331 See id. at 109
In light of the above account, the significance of credit rating, the Sukuk relationship to it and the need for it unfold. These Sukuk, like all other issuances, incorporate binding promises made by originators/sponsors of Sukuk, such as redemption of Sukuk through repurchasing them, as is the case with many applications of Musharakah and Ijarah Sukuk, or include other financial obligations, such as paying the instalments of a deferred sale object, as is the case with Murabahah and Ijarah Sukuk. As such, the CRAs assess the financial position of Sukuk issuing corporations and determine the potentiality of the risk of default.

This confirms the nature of Islamic financial transactions that not all of them are based on the Musharakah contract -in its conventional juristic characterization- and the Mudarabah contract or the principle of sharing the profits and losses, as is mistakenly perceived by many of those interested in this area. To corroborate this point, Kamarudin, Kamaluddin, Manan, and Ghani state: "[h]owever, it is self-fallacy to assume that sukuk is debt-free compared to bond as it is based on Shari'ah principles."332

It is worth noting that these three types of Sukuk, each is based on a contract different from the other, had turned into a creditor-debtor relationship. In some of them, this relation appeared at an early stage of the Sukuk issuance as in Murabahah Sukuk, while in others it appeared at different periods, such as the maturity date, which means the repurchase of assets from Sukuk holders. However, the debt relationship diminishes in the Sukuk that are based on the view of those who do not see the repurchase promise as binding to exercise, for example, on the maturity date, as is the case with Musharakah and Ijarah Muntahia Beltamleek Sukuk.

3.2.4. Assessing CRAs role in general and in the defaulted Sukuk in particular

Despite the long history of CRAs and rhetoric about its significance, after they had acted suspiciously in some aspects, particularly in relation to the political dimension in their ratings and the conflict of interest, and in the aftermath of several global financial crises, controversy has sparked over the reliability of their predictions, impartiality and integrity. There has also been growing criticism regarding their working mechanism and scope of their assessment in the Sukuk area.

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332 Kamarudin, Kamaluddin, Manan & Ghani, supra note 127, at 284.
3.2.4.1. CRAs’ role in the global financial crises

CRAs’ performance came under severe criticism for their role in causing some financial crises at different times. Between 1997-2002, their performance and effectiveness were brought into discussion not only on account of their failure to foresee the potentiality of financial chaos in the emerging countries and giving their economies higher ratings than what they actually deserved, but also for their policies in the post-crisis era, as they downgraded these countries’ credit ratings.\textsuperscript{333} Resultant from that was an increase in the cost of financing necessary for the process of reforming the economic structure of these countries.\textsuperscript{334} In addition to their failure to anticipate China’s financial crisis between 1997 and 1998, CRAs failed to predict the recent bankruptcy of some companies such as Enron, WorldCom and Parmalat.\textsuperscript{335} The 2008 financial crisis contributed to corroborate the negative image of the CRAs’ role. US mortgage-backed securities in the run-up to the financial crisis were given AAA rating, increasing the demand on them and generating substantial revenues for CRAs.\textsuperscript{336} Further, some companies have either obtained a high credit rating and were listed among the Investment Grade categories and some were still classified as such one day prior to their bankruptcy or bailout.\textsuperscript{337} A report by Ernest & Young showed that CRAs ranked 10th among other factors, such as the mortgage crisis and the downfall of financial institutions, that have contributed to the financial crisis.\textsuperscript{338} According to the report, CRAs’ reputation has exceeded its real size and has become open to those who pay more.\textsuperscript{339} In the aftermath of the financial crisis and given that CRAs charges fees from companies and financial institutions desirous to issue debt securities, questions of conflict of interest were raised.

\textsuperscript{333} See Ahmed, supra note 324, at 58.
\textsuperscript{334} See id.
\textsuperscript{335} See Elkhoury, supra note 314, at 2.
\textsuperscript{336} See Ahmed, supra note 324, at 58.
\textsuperscript{337} See id.
\textsuperscript{339} See id.
3.2.4.2. Conflict of interest

With regard to CRAs, conflict of interest appears in several forms. First, a corporate seeking to obtain credit rating pays fees to a credit rating agency to obtain an evaluating after providing the agency with all required information, some of which may not be available to the public. The second form clearly appears when some CRAs initially give the debt instruments a low rating, even if the corporate has not entered into a contract them, based on the company’s information available to the public, prompting issuers to cooperate with these CRAs for fear of getting low evaluation. According to Marwan Elkhoury, both Fitch and the Egan-Jones Rating claimed that Moody's and Standard and Poor's agencies routinely give a lower rating to the structured debt if they were not contracted to rate those securities, practicing what is called "notching". Moody's responded by saying that this unsolicited rating is usually low due to lack of information or the use of different methods to determine the probability of default. Marwan Elkhoury believes that "unsolicited ratings raise potential conflict of interests." Moody's and Standard and Poor's, in turn, replied that, whether or not the issuer has requested the rating, they have the right to rate and evaluate corporate debt securities registered with the US SEC. Information available to the public would be the basis for the rating in case the issuer did not request it. In case the issuer has requested the rating, it is required to provide the CRA with the necessary information and pay the fees. To gain credibility and creditworthiness in the market, many of the new CRAs in the market give unsolicited ratings. But, some issuers have accused CRAs of using this approach and threatening a low rating to drive issuers to a request the rating and pay the solicited ratings fees. Confirming that conflict of interest is likely to exist, US President Barack Obama has presented a proposal to the Congress in relation with the rating agencies.

340 See Elkhoury, supra note 314, at 7.
341 See id.
342 Id.
343 See id.
344 See id.
345 See id.
346 See id.
347 See id. at 7-8. Elkhoury adds: "[s]ince 2001, Moody's claims that it has not done any unsolicited rating in Europe. Standard and Poor's also claims not to do any unsolicited rating outside the United States. As unsolicited ratings are based on public information and thus lack issuer input, the issue of unsolicited ratings could be addressed by requiring CRAs to disclose whether it has been solicited or not. Both Moody's and Standard and Poor's already specify in their ratings whether the ratings have been solicited and give issuers the opportunity to participate at any stage of the process, if they wish." Id. at 8.
seeking to address the issue of conflict of interest and lack of transparency, to which MPs responded favorably by imposing new standards on transparency and disclosure of information underlying the rating.\(^{348}\)

### 3.2.4.3. CRAs’ impartiality and integrity

In addition to the shortcomings of CRAs, some of them are also accused of bias and incredibility, which aroused controversy in the economic and political circles. Some States accused some of these agencies of being partial because they are under the sway of the policies of the States in which they are located and can be pressurized to serve their interests. Russia, China and Turkey have accused some of the CRAs that rated them of being politically motivated and their ratings did not reflect reality, while Saudi Arabia has responded to the decision to downgrade its rating by some of these agencies as being hasty and unjustified.\(^{349}\)

The low rating of countries reflects negatively not only on their sovereign bonds but it often affects, for example, corporate bonds as well. The reason is that corporate bonds rarely get a higher rating than sovereign bonds rating of the State where these corporations are located.\(^{350}\) For this reason, some governments of the countries concerned may have to take certain political positions towards the CRAs.

In 2017, Moody's downgraded China's credit rating for the first time since 1989, which was received with severe criticism from China.\(^{351}\) China’s Ministry of Finance said that the decision is based on an inappropriate approach, and it exaggerated the challenges facing the Chinese economy.\(^{352}\) What confirms China's concern is the agency's disregard for the economic recovery recorded by the Chinese economy.\(^{353}\) The Chinese official news agency (Xinhua) has accused major CRAs of using arbitrary standards.\(^{354}\) In Turkey, the response was even sharper. Moody's decisions were accused of being politically oriented after downgrading Turkey's rating to high

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\(^{350}\) See Elkhoury, *supra* note 314, at 2. He adds that: "[r]are exceptions to the principle of the sovereign ceiling – that the debt rating of a company or bank based in a country cannot exceed the country’s sovereign rating – do occur." Id.

\(^{351}\) See Taleb, *supra* note 349.

\(^{352}\) See id.

\(^{353}\) See id.

\(^{354}\) See id.
risk in 2016, which came as a shock to Turkey as it continues to achieve annual economic growth. On the short term, this downgrade would have an impact on some foreign companies operating in the country, while the internal regulations of those companies provide for the cessation of investments in countries that two or more credit agencies have downgraded their credit ratings. In 2015, some credit agencies downgraded Russia's credit rating, which prompted a response from some economists declaring that the downgrade decision was unjustified and politically motivated.

On the other hand, it can be claimed that there is also the possibility that those countries do not want to admit the weakness of their economy, and thus they are trying to find justifications to reassure investors and ensure the flow of foreign investments by accusing the decisions of these agencies as having political motives.

In order to get rid of these concerns, it is appropriate to find trusted rating agencies for these countries. Many attempts have been made to find alternatives to existing CRAs that dominate the market, the latest of which was the BRICS group’s agreement to establish a rating agency, although they have not set a timetable for that. These attempts are positive steps on the way to get out of the sway of rating agencies, some of which are considered to be suspiciously unfair, but they will take a long time to build a broad reputation in the market, thus justifying the compelling need to rely on dubious CRAs, at least in the short and medium term.

3.2.4.4. Insisting on errors for fear of "Deficiency"

Deficiency in rating can be defined as the CRA upgrading or downgrading the credit rating rank of sukuk, for example, three times or more over a 12-month period. There is a possibility that a CRA that gave a corporation two consecutive low ratings in a year will be hesitant to give that corporation or its securities a third downgrade in the same year, despite the justifying reasons. Among these reasons is when an agency finds that the two previous downgrades were insufficient because it, for example, did not appropriately assess the corporation's situation in the first two rankings. Yet, the CRA avoids giving a third downgrade for fear of being accused of

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355 See id.
356 See id.
357 See id.
358 See id.
359 See Ahmed, supra note 324, at 61 n. 15.
deficiency, which may reflect negatively on its reputation and investors’ confidence in it. As it avoids giving a third downgrade, this may enclose the risk of the bond issuing corporation's default on its obligations due to its negative financial situation, which may as well affect the CRA’s reputation.

3.2.5. CRAs Performance in the defaulted Sukuk (concerned in this study)

Despite the fact that the defaulted Sukuk issuances under discussion had obtained high credit ratings, this did not shield the issuing or originating corporation against financial problems that led to defaults on payment at specified times. TID Sukuk had obtained a credit rating of BBB+ in 2007 from Capital Intelligence, and the International Content Rating Association gave it an A- rating. Both ratings fall within the category of Investment Grade, and they came after the issuance of the two Sukuk bundles in 2005 and 2006. Nonetheless, failure to fulfill the financial obligations towards the Sukuk holders in October 2008 occurred.360

As to NFCB Sukuk, this issuance received an A+ credit rating from the Malaysian Rating Corporation Berhad (MARK) in 2006.361 Sukuk continued to enjoy that rating in 2007 and 2008, but in December 2009, the Sukuk rating was downgraded to BBB+,362 which means that they were still in the "Investment Grade" category, less than four months prior to the maturity date. At the time the company was due to pay the maturity amount for the Sukuk holders, the Sukuk received a D rating as a result of the default.363

The ISB received an A+ rating in almost mid-2004, and this rating continued beyond the mid-2007.364 Thereafter, the rating consistently fell down until it reached D following its failure to pay the first tranche in about mid-2009.365

For a broader outlook, many originators and issuers of Sukuk failed to meet their financial obligations to investors, though Islamic debt instruments represent a much lower stake than conventional debt instruments. For example, according to the table adopted by Majid, Shahimi, and Abdullah, the total number of defaulted Sukuk

360 See Wijnbergen & Zaheer, supra note 146, at 23.
361 See Majid, Shahimi & Abdullah, supra note 131, at 33.
362 See id. at 33-4
363 See id. at 37
364 See id. at 27-8.
365 See id. at 31.
in Malaysia amounted to 24 cases between 1997 and 2010, all of which were based on the Murabahah [in its contemporary sense] and Bai’ Bithaman ‘Ajil [deferred payment sale] contracts, [which are relatively close in form] except for one case based on the Ijarah Muntahiah Beltamleek contract. Despite the disparity in their ratings, all given ratings fell under the category of "Investment Grade". Some of them, which were short-term Sukuk that are typically less exposed to credit risk than long-term Sukuk, received the highest rating level. Despite that, the issuer defaulted. However, none of these cases included any long-term Sukuk that have received the highest rating, but some long-term Sukuk, obtained the degree next to the highest one as shown in the table.

3.2.6. Review and discussion of additional shortcomings of CRAs particularly in the Sukuk area

In addition to the above mentioned shortcomings of the CRAs’ performance in Sukuk, which have ramifications on Sukuk, other drawbacks can be added, such as the limitation of those agencies to credit rating alone to the exclusion of Shari'ah rating, as well as their concern with the evaluation of the issuer and not the originator. Here we review some specialists’ views concerning CRAs’ problems in Sukuk with some analysis and discussion.

3.2.6.1. Limitation to credit risk

Many CRAs’ evaluations, particularly those with a global fame, are limited to the financial situation of issuers and their issued securities, including Sukuk. In general, CRAs do not take into consideration the Sukuk compliance to the provisions of Islamic Shari‘ah. As such, Sukuk are treated in the same way as bonds for some reasons cited by Lahim al-Nasser, which do not go without some reservations and discussion.

The first reason he mentions is that CRAs deals with Sukuk as debt instruments while in reality they represent equity interests in the assets, unlike bonds. But, we have already indicated above that this characterization is not accepted. Despite that the Sukuk represent undivided ownership at the time of their issuance and become the

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366 See id. at 11-2
367 See id.
368 See id.
370 See id.
property of investors, some types of them convert into debt at an early stage, such as the Murabahah Sukuk, while most of them turn into debt at the maturity date. The reason is that banks or originating corporations may have made a binding promise on their part such TID case—sometimes the a binding promise is made by both parties such NFCB and ISB cases- to purchase those assets, which in practice can take place at the nominal value such NFCB and ISB cases, or market or fair value or as agreed by the parties, either at the issuance time or at the exercise of the promise. As such, investors can turn into creditors when exercising these promises, in view of those who render those promises compliant with Islamic Shari’ah. Perhaps for this reason, Hafizi Majid, Shahida Shahimi and Mohd Abdullah say: "Sukuk are therefore considered as a financial obligation, whereby the investors are recognized as creditors and rank equally with other conventional creditors."

The Second reason al-Nasser mentions is that these agencies do not have competent experts familiar with the provisions of Islamic Shari’ah, which makes them not concerned with the compliance of Sukuk with the principles of Islamic finance. Yet, even when the CRAs took into consideration Shari’ah requirements— as promised by Standard & Poor’s - achieving this goal would not be as easy as expected. The issue gets more complicated by the juristic differences between contemporary jurists regarding the applications of Sukuk. On what basis will the evaluation of these Sukuk take place, since they often include clauses or provisions that are contested among Shari’ah jurists, in addition to lack of Shari’ah-grounded competent experts conversant with the principles of Islamic financial transactions theoretically and practically?

The third reason is that there are no clear, uniform Shari’ah standards for Sukuk that CRAs can apply. Differences in Shari’ah standards are insurmountable. Any Shari’ah standards established by Shari’ah and Fiqh institutions or scholars specialized in Islamic financial transactions will be binding only on those who set them and some parties that rely and adopt the views of such institutions. However, judges in Shari’ah courts and some other jurists may reject those standards, given their discretionary nature, should these standards were open to contestation in the Shari’ah, and the inappropriateness of driving people to maintain a certain Fiqh opinion, as is

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371 Majid, Shahimi & Abdullah, supra note 131, at 17.
372 See al-Nasser, supra note 369.
373 See id.
typically recognized in Islamic Shari'ah rules. But, we will cover this issue when discussing the challenges facing guarantees in a separate chapter.

However, the reasons as mentioned in the second and third points can be tackled by considering two suggestions. The first is that CRAs should take into consideration the views of Fiqh councils, which would earn their evaluation more authority and credibility, given the members of these councils’ grounding in Islamic Shari’ah, the potentiality of assessing the reality of the markets and making decisions by majority. Among the reasons to emphasize the pivotal role of these councils is that many researchers and contemporary Shari’ah scholars often make reference to the opinions of these councils and Shari'ah bodies in their researches and cite them. This points out that they are highly regarded, especially when they issue a unanimous opinion regarding the permissibility or impermissibility of legal issue in Islamic Shari’ah. The second suggestion is that the Shari’ah-based rating should be classified into variable grades similar to credit rating, with the highest grade given to Sukuk or Islamic products that do not include any terms or clauses controversial among jurists. In this way, the Sukuk rating grade will inversely be proportionate to the number of controversial clauses or high-risk probability of the clauses in relation with its conformity to the view of the Fiqh councils.

The importance of classifying the Shari’ah aspects lies in the existence of the close relationship between the risk of default and the risk of non-compliance with the Shari’ah, since some sukuk may be ruled as invalid on account of non-compliance with Shari’ah provisions or for their inclusion of terms nullifying the contract. Accordingly, some consequences of the contract nullification would arise, including those affecting the returns and income accruing from the Sukuk process. For example, in UAE Dana Gas Sukuk, Dana Gas claimed that its Sukuk are breach of Shari’ah in order to evade some of its financial obligations to Sukuk holders. One of the advantages of Islamic rating is gaining the confidence of investors in the Muslim world and the development of Islamic debt markets. Standard & Poor's said it would take into account Fiqh different views when rating Sukuk, in case these Sukuk are considered before Shari'ah courts. Some countries have supervisory boards to verify

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374 See Alborsaa News, supra note 126.
375 See AL-BAQMI, supra note 96, at 120.
the Sukuk compliance with Shari’ah provisions. This helps to mitigate the concerns about the risk of Shari’ah non-compliance, though at national levels only, and to eliminate the need to extend the scope of CRAs rating to include non-compliance with Shari’ah risks. Majid, Shahimi, and Abdullah state: 

"Another distinguishing factor for the Malaysian Sukuk market is the establishment of a centralised, national level Shari'ah supervisory board, which ensures that every Sukuk is issued in Malaysia, is in full compliance with the Shari'ah. This helps to reduce the chance of any dispute that may arise at national level, if the courts are bound to follow the decisions of their legislative or supervisory bodies. It should also be noted that the judgment of the Sukuk as being compliant with the Shari'ah is made in view of the opinion of the Shari'ah Supervisory Board."

3.2.6.2. The impact of modifying Sukuk rating during its term -from issuance to maturity-

In Sukuk and bonds, rating is usually given periodically to the issued debt securities as well as the issuer to assess the financial status of the issuer. In the event of downgrading the credit rating of conventional bonds to "non-investment" or "speculative grade", some of the holders of such securities may be inclined to dispose of them by selling them to investors who favor high-risk investment. The sale becomes more exigent for some investment entities such as banks and pension funds because they are compelled to liquidate them by binding laws that prohibit investing in high-risk securities. To this effect, Marwan Elkhoury says that in the United Sates "[these [ratings-based] regulations not only affect banks but also insurers, pension funds, mutual funds and brokers by restricting or prohibiting the purchase of bonds with 'low' ratings."

In contrast, the situation in Sukuk is more complex. The circulation of some Sukuk types is subject to Islamic Shari’ah debt restrictions, as has been shown above, when these Sukuk turn into debt as in the case of Murabahah Sukuk, wherein the assets are sold on deferred price to the party desirous to obtain financing. As such, in case the credit rating of those securities has been downgraded, this rating would be no benefit, because the advantage of liquidating those securities would not be taken and used, as long as investors would comply with the provisions of Shari’ah.

376 Majid, Shahimi & Abdullah, supra note 131, at 17-8.
377 Elkhoury, supra note 314, at 3.
378 To make this clear, the demand on purchase is linked to the existence of offer. Since the sale of securities representing debt is restricted by Shari’ah provisions, the volume of offer will be so limited, even when investors desire to dispose of those securities for the
3.2.6.3. **Emphasizing the credit rating of the issuer and not the originator**

The originator and the investors are the two most prominent parties of the Sukuk. The role of the originator in Sukuk is far more important than that of the originator in conventional securitization, as discussed in the course of debating the central issue of the present research. The originator desirous to obtain financing through one of the many applications of Ijarah, Musharakah and Murabahah Sukuk, as in the Sukuk cases selected for this dissertation, enters into an agreement with investors as a forward buyer, a lessee in Ijarah Muntahiah Biltamleek or a partner in Musharakah Muntahia Biltamleek (participate-to own). Credit rating should not be restricted to the issuer alone, which might be represented by an SPV; it must be expanded to include the originator, which has already occurred with the TID case. Rating was given to the NFCB company, as its structure did not include the establishment of an SPV, and as such there was not originator. However, ICB/the originator was not rated and the credit rating was restricted to the ISB that had issued the Sukuk and rented the assets to ICB/the originator, which is the real finance seeker. The Sukuk issuer in such case is less important in terms of rating than the originator, since the former’ payment of the dues of the Sukuk holders is dependent on the commitment of the party with which it entered into the lease contract.

3.2.7. **Dealing with CRAs’ shortcomings**

Some researchers suggested that the viable options for dealing with CRAs’ problems can be divided into two types. First: a reformative/correctional option that will work in the short and medium term and, second, a substitutional option by establishing alternative Islamic rating agencies, which will be useful in the long term.

3.2.7.1. **Reformative option, which can be summarized as follows**

1. The need to establish supervisory bodies that monitor CRAs performance, and to establish rating institutions that rank these agencies.

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379 See Ahmed, supra note 324, at 59.
380 See id.
381 See id. at 59, 61.
2. States should encourage the establishment of more CRAs by easing imposed restrictions on them to allow for fair competition and prevent monopoly.\(^{382}\) For example, out of 150 rating agencies, the U.S. Securities and Exchange Commission (SEC) has recognized five of them only, including Fitch, Moody's and Standard and Poor's.\(^{383}\)

3. Developing some strategies to deal with the issue of conflict of interest with a method that eliminates it.\(^{384}\) One of the methods is to issue professional codes of conduct.\(^{385}\) The International Organization of Securities Commissions (IOSCO) issued regulations that require CRAs not to be influenced by the existing or potential relationships with corporations in giving credit ratings, as mentioned by Medani Ahmed.\(^{386}\) In order to solve this problem too, the CRAs must be required, by means of legislations, to disclose if the issuer has requested the rating, as suggested by Marwan Elkhoury,\(^{387}\) and whether the originator has requested the rating as well. This is what Moody's and Standard and Poor's are doing, and they also give issuers an opportunity to cooperate at any stage of the rating process if they desire to do so.\(^{388}\) But, there must be a law in operation that forces CRAs to commit to this procedure so that it will not be merely selectional or optional step, and to make all CRAs follow suit this approach.

4. Increasing the scope of disclosure and transparency in CRAs ratings. For this reason, IOSCO requested that CRAs must publish the standards and methodology adopted in the rating process to remove the ambiguity enshrouding the rating standards and to realize transparency.\(^{389}\)

5. Governments should promote and encourage the establishment of local CRAs to minimize the potential for any political motivation and to address the issue of lack of information about corporations, particularly if they are operating in countries with no renowned rating agencies and, hence, facing obstacles to access corporates information and their securities.

\(^{382}\) See id. at 59

\(^{383}\) See id. at 61.

\(^{384}\) See id. at 59

\(^{385}\) See id.

\(^{386}\) See id.

\(^{387}\) See Elkhoury, supra note 314, at 8.

\(^{388}\) See id.

\(^{389}\) See Ahmed, supra note 324, at 59.
Countries like Malaysia require companies desirous to obtain finance through Sukuk to be rated by local credit agencies.\textsuperscript{390} Perhaps, among other reasons, this is to counter the potential for the exercise of political influence. However, the problem with international issuances is that international investors will not be inclined to trust local agencies rating in the same way as they trust the widely recognized global CRAs that they highly regard. Giving the possibility of the occurrence of errors and deviations in the assessment of information and rating of countries where the leading CRAs are not operating, this may be the main motivation for Saudi Arabia in establishing the Saudi Credit Bureau (Simah) which the scope of its work covers Saudi Arabia as well as other GCC countries. Some have claimed that the reason for its establishment came in the aftermath of a decision by Standard and Poor's to downgrade Saudi Arabia's credit rating, which was described by Saudi Arabia as hasty and unfounded.\textsuperscript{391}

6. Consideration of the above suggestions when discussing the shortcomings of CRAs, particularly in the area of Sukuk.

\subsection{3.2.7.2. Shari’ah-compliant alternatives through the establishment of Shari’ah rating agencies}

Some researchers emphasize the importance of establishing Islamic CRAs as an alternative to existing conventional agencies to focus on countries interested in investing in Islamic products and whose tasks include, among others, the verification of the compliance of those products with Islamic Shari’ah provisions.\textsuperscript{392} They gave reasons justifying that proposal, which we already discussed in the course of investigating CRAs’ shortcomings in Sukuk rating.\textsuperscript{393} Among the privileges of these Islamic rating agencies, especially if they have managed to achieve their goal in the most appropriate way, is to mitigate Muslim investors’ concerns. According to Dr. Abdulbari Mashal, Islamic rating agencies are a reflection of investors’ interests in two ways.\textsuperscript{394} The first is to

\begin{itemize}
\item Majid, Shahimi & Abdullah, \textit{supra} note 131 at 9.
\item See Talab, \textit{supra} note 349.
\item See Ben Ali & Ahmed, \textit{supra} note 338, at 12-3.
\item Some Islamic agencies have been founded, including The Islamic International Rating Agency (IIRA), established in 2006 in Bahrain as the oldest Islamic agency, with the aim of providing the technical/credit rating and Shari’ah-compliant rating. \textit{See} Ahmed, \textit{supra} note 324, at 60; see also \textit{Corporate Profile}. (The Islamic International Rating Agency, n.d.). Available from: http://iirating.com/corprofile.aspx. (accessed on 13th November 2018). The other Islamic rating agencies are Shari’ah Board for Auditing and Rating, affiliated with The General Council for Islamic Banks and Institution (CIBAFI), the Malaysian Rating Corporation Berhad (MARC), and Al Faruq agency for Conformity and Islamic rating. \textit{See} Ahmed, \textit{supra} note 324, at 60.
\end{itemize}
abide by the Shari’ah standards, since they prefer financial products and investment instruments that are most compliant with Shari’ah provisions. The second is evaluate the financial situation of the second party [originating corporation]. It can not be ruled out that Western and Asian investors, who in principle are not concerned with the financial products’ compliance with Shari’ah, will be inclined to invest in Shari’ah-compliant financial products for the Islamic financing advantages, some of which have been reviewed in this dissertation and others will follow. They may also be driven by the belief that non-compliance with Shari’ah provisions may lead to the default risk, the annulment of the contract and each party’s reclaiming of its contribution provided when entering into the contract, which is probable if the competent courts consider the case under the provisions of Islamic Shari’ah.

Yet, these Islamic agencies are in fact still nascent and need more time to be able to compete with well-known conventional agencies. It is still early to assess and judge with certainty their feasibility and effectiveness in achieving the purpose for which they were established. However, it is possible, for now, to analyze some of their aspects and foresee the potential results they can produce based on their plans and work policy.

3.2.7.3. The scope of Islamic credit rating agencies work and their types based on that scope

Despite the calls by many experts for the pressing need to establishing Islamic CRAs, it must be noted that one of the obvious shortcomings of their operation is that their verification of the Shari’ah-compliance of Islamic products, of which Sukuk is one of the most important applications, is merely consultative and indicative to Islamic companies and banks. Some of these Islamic CRAs are limited in scope. In this regard, Dr. Abdulbari Mashal believes that there is a need to strengthen the relationship between these Islamic agencies and central banks, suggesting that they should enter into mutual agreements so that the directives of those agencies would be a high priority to central banks, though these corporations and banks are not bound follow those directives and instructions. He also pointed out that in its Shari’ah rating of banks and Islamic products, The Islamic International Rating Agency (IIRA), focus on their compliance with the provisions of their Shari’ah bodies,
effectiveness of the Shari'ah control and consideration of administrative requirements, without issuing the Shari’ah ruling on the validity of these products, commenting on the resolutions of those Shari’ah bodies or correcting an issued Fatwa (Shari’ah dictum). Three limited scope of IIRA’s methodology, that does not verify the product’ compliance with Islamic Shari'ah and whether it is contentiously debated among Muslim jurists, is a deficiency that does not lead to achieving the desired goals. As such, investors may lose confidence in those IIRA as well as other Islamic rating agencies that utilize the same measures for various reasons.

The first of these reasons is that there are some reservations over the Shari’ah bodies affiliated with banks or Islamic companies that make it a risk to rely on their provisions. Among these reservations are the irregularities and leniency in permitting the transactions referred to them and the weak Shari’ah qualification of some of these bodies, which results in the failure to take into consideration the established views of contemporary Fiqh and Shari’ah Boards and Councils. For example, the NFCB Sukuk issued in Malaysia, which had a Shari’ah adviser and were based on the reverse ‘Inah sale contract, contained some clauses, such as the binding promises of the two parties to the contract to resell the assets to the original seller. These clauses will annul this contract in view of the Shari'ah Advisory Council of Bank Negara Malaysia - which is the most tolerant Fiqh council regarding this matter – if it considers the reverse ‘Inah sale contract similar to ‘Inah sale contract. Besides, the ‘Inah sale contract is categorically prohibited in view of the large majority of classical scholars and most contemporary Fiqh councils, such as AAOIFI and IIFA. The ‘Inah sale contract is prohibited in view of the large majority of classical scholars and Fiqh schools. Likewise, the TID Sukuk included clauses that are highly controversial among jurists, such as the partner’s commission for managing the Musharakah contract assets. These reservations and examples are in blatant conflict with the most fundamental objectives of establishing Islamic CRAs, such as gaining the confidence of investors desirous to invest in Shari’ah-compliant products and avoid any contra-Shari’ah risk that may imperil their investments, as demonstrated above when discussing the relationship between the risk of non-compliance with Shari’ah and the default risk.

398 See id.
The second reason is that since those Shari’ah bodies are affiliated with the companies or banks dealing in the Islamic products and receive payment from them for the Shari’ah consultation they provide, this raises the suspicion of bias, conflict of interest, motivation to approve the equivocal tendencies of those banks or companies and the possibility of their impartiality.

Shari’ah bodies supposed to act according to their convictions and visions, in accordance with the fatwa, analogy and reasoning methods as acknowledged by Shari'ah scholars, about the products of banks and corporations they work for. But, the suspicion of bias and conflict of interest appears when it is known that the continuity of the work of these bodies and the salaries and wages their members receive for their consultations depend on the financial performance of those companies. In this way, restricting the products and plans of companies may reflect negatively on them, forcing them, for example, to cut down expenses by canceling the Shari’ah body. In addition, there is a possibility that these companies will be inclined to replace some of the existing Shari’ah body members with others known for their leniency in permitting the financial transactions. In either ways, the Shari’ah bodies may be persuaded to resort to lenient policies in passing and authorizing those products. This orientation is corroborated by the fact that some Shari’ah bodies are entitled to a share of the profits engendered from the financial product. However, this issue will be discussed further in the chapter on challenges and obstacles of preventive measures and protective hedges to address the risks of default and bankruptcy.

3.2.8. The reality of credit rating in Saudi Arabia

Saudi Arabia’s debt and Sukuk markets is witnessing a weak performance in many respects as compared to the reality of stock markets. Among the deficiency manifestations of the Saudi debt markets is that up to 2015 there were no local or international credit rating agencies operating in the Saudi Arabia. This could be due to several reasons, including weakness of Sukuk market, especially in the private sector, reluctance of domestic debt-instrument issuing corporations to request credit rating, as well as absence of necessary legislations requiring the rating. Implementing Regulations of Credit Rating Agencies do not stipulate that securities should obtain a credit rating. Meshari al-Khaled, Managing Director for S & P Global Ratings in Saudi Arabia, states:
As Saudi Arabia’s capital markets evolve to match the size of the country’s economy, there is a prime potential for greater debt issuance. Only 15% of listed companies in Saudi Arabia have a credit rating so there is a significant opportunity for S&P Global Ratings to serve investors through our objective evaluation of risk for governments, corporates and financial institutions.\textsuperscript{399}

However, a bundle of positive changes took place since 2014, including giving attention to and recognition of CRAs as being a fundamental and traditional requirement in financial and debt markets. For example, in 2014, the Board of the CMA issued the first regulation organizing the activities of these agencies. In 2015, the CMA granted SIMAH’s Credit Rating Agency a license to conduct credit rating activities as the first Saudi local and Gulf licensed rating agency in Saudi Arabia as a first step.\textsuperscript{400} In 2017, SIMAH received the official letter from CMA to commence work.\textsuperscript{401} In the same year, S & P Global Ratings obtained CMA’s formal approval to operate as the first international credit rating agency in Saudi Arabia.\textsuperscript{402} During this year too, Fitch and Moody's were given pre-approval to operate in the Kingdom.\textsuperscript{403}

The present researcher believes that such developments are of paramount importance to gaining the trust of Saudi and foreign investors and reassuring them of the Sukuk. They will also benefit corporations desirous to issue Islamic debt instruments. For, these rating agencies operating in the Saudi Kingdom will be close to the reality of the Saudi debt market and will be able to access accurate information about issuing corporates and banks.

On the other hand, the existence of such number of agencies will create a competitive atmosphere among them in terms of performance and thorough objective evaluation of issuers, which will eventually be in the investors’ interest. Companies desirous to issue debt instruments will also benefit from these agencies in terms of paying lower fees for these agencies’ services thanks to lack of monopoly. Further, the existence of these agencies will


\textsuperscript{401} See id.

\textsuperscript{402} See Barbuscia, supra note 39.

\textsuperscript{403} See id.
eliminate some of CRAs’ shortcomings referred to earlier, such as those relating to political aspects. But, it is still too early to measure up their performance as they are new to the market. For, judging their performance depends on several factors, including the accuracy of their rating of the issuing corporations, which can only be learned after a period of time coinciding with the announcement of the financial position of these rated corporations, and whether those agencies will begin from where CRAs have left off and abandon those CRAs’ errors.

However, the regulation can be evaluated based on what we have mentioned above about the reality of CRAs. Taking into consideration that this regulation is the first of its kind, the researcher has some reservations over two of its items: the conflict of interests and the scope of credit rating.

Although the regulation stressed in more than one place the importance of taking necessary actions to address conflict of interests, while preventing some behaviors and attitudes that may be included in this sense, it allowed agencies to rate companies or securities without being asked to do so, based on what is conceived from some articles of the regulation. However, this assumption can be contended by the negative aspects we mentioned about this practice. In particular, the agencies typically give these companies a low rating, claiming that their rating was based on the information available to them. As such, those companies would be prompted to gain another rating, which is often higher than the initial one, after providing their information and paying the required fees. The regulation, however, underlined three requisites that would restrain the practice of giving a rating without a request from the company. The first is that the agency must refrain from rating if it is unable to rate the structured product because it is complex or due to lack of accurate data about the assets. However, the different interpretations of the phrase "lack of accurate data" may give way to expand the scope of giving the rating. Second, the agency should disclose its policy on rating issuers or securities issued. Thirdly, if the rating is based on information that is not fully or partially available to the public, the agency must disclose that to the public.

405 See id. § 19 and Annex No (2).
406 See id. § 17.
407 See id. Annex No (2).
408 See id. § 21
As to the second requisite, which the present researcher sees as a flaw and should be avoided, the regulation obliged the agencies to limit their rating to credit rating only.\(^{409}\) This can be imagined in conventional bonds, which are already prohibited by Muslim scholars. But, in structured financial products, such as Sukuk, Shari’ah rating should be taken into consideration, due to the reasons mentioned above. Therefore, this clause of Article (15) should be amended to allow at least interested agencies to rate/evaluate the Shari’ah aspects of Islamic securities, especially if they fall within the jurisdiction of Shari’ah courts.

3.2.9. Evaluation of CRAs and prospect of dispensing with hedges and other guarantees

Despite the aspects of their weaknesses and shortcomings, CRAs’ role can not be denied or disregarded as a means of hedging to protect securities holders from the default risk, especially in the light of their pivotal role demonstrated in many cases and circumstances and given the improvements they are undergoing. With regard to foreseeing financial crises, CRAs were right in downgrading the sovereign debt rating of Greece and some other European countries prior to Greece’s financial crisis emergence.\(^{410}\) Before the 2008 financial crisis, no more than 1\% of the total AAA bonds rated by CRAs, which is the highest rating rank, defaulted.\(^{411}\) In the Malaysian Sukuk market, the default rate was 0.46\% in 2009,\(^{412}\) although the issued Sukuk were rated by the credit rating agencies, since the relevant authorities in Malaysia required the Sukuk to be classified.

Having said that, for several reasons, those CRAs should not be solely relied upon and considered as a sufficient guarantee in their own right for protecting Sukuk investors from the risk of default and bankruptcy. First, as mentioned above, some criticism was levelled against them, and some of their shortcomings have not been yet remedied. This means that CRAs can not be relied upon without supplemental hedges and additional guarantees. Such transaction, i.e. the Sukuk, should include contractual hedges and other preventive measures that protect the Sukuk holders from the potential errors made by these agencies in their ratings and forecasts.

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\(^{409}\) See id. § 15.


\(^{411}\) See id.

\(^{412}\) See Majid, Shahimi & Abdullah, *supra* note 131, at 10.
The maximum benefit those CRAs can offer, despite the improvements in their performance and governance, is that they evaluate the financial position of issuing corporates. This does not necessarily mean that the issuers of the Sukuk who have a low rating would default, or those who have a high rating will automatically fulfill their obligations towards the securities holders. The financial position of an issuing corporation may suddenly deteriorate, for example, due to participation in high-risk investments or due to some internal subsequent administrative and accounting flaws, which CRAs would not have been able to predetermine their occurrence, since, among other reasons, CRAs are not members of those corporations’ boards to control their financial policies and prevent what they deem as a threat to the corporations’ financial position. This is upheld by the fact that some countries already cancelled the requisite that the issuance’s rating must be within the "Investment Grade" category after imposing compulsory rating in conjunction with the development and maturity of their markets. Among the disadvantages of requiring issuers to have an "Investment Grade" rating is that this restricts Sukuk issuances mostly needed by small corporations seeking financing, which could otherwise provide some guarantees to enhance their credit level. In addition, restricting issuances to corporations with an "Investment Grade" rating will place a constraint on the expansion of capital markets.

Further to CRAs shortcomings, there is nothing to oblige issuers/originators or parties desirous to obtain financing through Sukuk to meet their financial obligations to Sukuk holders in particular except the issuers/originators’ concerns about the adverse consequences of their credit rating downgrading, due to their cessation of default on payment, on their reputation in the market, especially when they care about the continuity and development of their corporations.

3.2.10. Conclusion

CRAs received harsh criticism about their role in the global financial crises. This criticism focused on the methodology and procedures adopted by CRAs in evaluating corporations and countries’ financial situation, the

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413 For example, Majid, Shahimi, and Abdullah state: “[b]esides avoiding the risks of currency, maturity and asset-liability mismatches, only debt securities and sukuk that carry investment-grade ratings from the domestic rating agencies had been allowed to be issued in the Malaysian market during the early years. Mandatory rating, together with the requirement for investment-grade ratings (removed as the market matured), had helped boost investor confidence during the domestic debt securities and sukuk market’s nascent phase.” *Id.* at 9.
suspicion raised about conflict of interest and bias in their performance, their use as a political tool to tarnish some countries’ reputation of economy, reluctance to modify their ratings for fear of deficiency stigma and failure to foretell the exact financial position of some Sukuk and bonds.

In addition to the above, particularly in relation to Sukuk, CRAs were not concerned with non-compliance with Shari’ah risk that may be conducive to credit risk. Suggested remedies for CRAs’ shortcomings included the establishment of Islamic agencies concerned with Shari’ah rating to emphasize compliance with Islamic Shari’ah provisions and to reassure Muslim investors who prefer to invest in Islamic financing products for their religious graces as well as other investors who might not be concerned with the compliance of bonds with Shari’ah but they fear the consequences of Shari’ah non-compliance risks on their investments and see that they offer more privileges than conventional products.

Unification of Shari’ah standards, if meant to force people to follow a single juristic view and commitment of the Shari’ah courts to it, is difficult to achieve, as such standards will be binding to their developers and proponents only. But, the consideration of the views of renowned Fiqh councils that offer collective juristic views based on reasoning and the opinions approved by the large majority of Muslim jurists may help to reduce Shari’ah risks, given the high esteem and regard of these councils by Muslim jurists and judges, especially with regard to contemporary issues.

It was evidently found that many Sukuk types in practice and reality involve debts. They can be considered as debt-instruments and not just, as claimed, equity or undivided ownership. For, in practice, they represent equity or undivided ownership that turns into a debt as in the three Sukuk types selected in this dissertation. Therefore, emphasis should be placed on the credit rating alongside with Shari’ah rating.

CRAs’ performance has undergone some improvements in order to reduce the chance of error. But, reform should continue, particularly at the legislative level, to include other measures such as the importance of requiring CRAs, at the time of evaluating the Sukuk issuing corporations, to disclose whether they have been asked to rate those corporations, obliging issuing corporations to request rating and opening subscription to their Sukuk, despite their low rating. In light of the ongoing development of CRAs and their success in some aspects, they must be
encouraged and supported as an essential hedging tool and one of the preventive measures that can help reduce the risk of default and bankruptcy.

In recognition of their role, albeit a late step, Saudi Arabia has recently licensed a local credit rating agency as well as some international agencies, but they lack the necessary legislations. For example, Saudi corporations desirous to issue Islamic debt instruments are not obliged to request rating, as it is optional. However, CRAs should not be relied upon alone in the face of credit and bankruptcy risks without including other supportive guarantees and other protective hedges to Sukuk. The reason for this is the criticism they received concerning their rating policy of corporations or countries issuing debt instruments, the suspicion of conflict of interest and their being exposed to political influence. In addition, practice has shown that the high credit rating that some Sukuk had obtained did not immunize them from default. Vice versa, other Sukuk that had received a low rating did not default.

Even though the policies of these rating agencies might be correct and flawless, the risk of default is still present. Increasing preventive measures against the default and bankruptcy risks, on the one hand, is not only for addressing the shortcomings of those agencies, but also for tightening the precautionary measures to counter any sudden financial deterioration to originators and issuers who might have already obtained an accurate and fair high rating, but it would not be an adequate guarantee against future investment and management errors. For, unexpected financial crises of the originating or issuing corporations are likely to occur at any time. Meanwhile, these agencies are not members of the board of directors of those corporations to ensure that appropriate decisions are taken to immunize those corporations from any violations that cause financial deterioration. On the other hand, such financial measures and guarantees are intended to drive originators/obligors to make their due payments on time. In reality, Sukuk that rely solely on the value of credit rating have no power to spur the originator to meet its financial obligations, and they hardly include any worrying consequences to deter the originator from default, in contrast to conventional bonds that may impose the payment of additional interest when delay or default occur or when restructuring debts.
3.3. The evaluation and development of securitization through SPV as a way to deal with credit and bankruptcy risks

3.3.1. Introduction

In two of the three Sukuk cases under study in this dissertation, namely the Investment Dar Sukuk and the Ingress Sukuk, the issuance process included the founding of a special purpose vehicle (SPV). The reason for including it beside other provided guarantees and hedges is that the SPV is already present in conventional bonds and Sukuk as a precautionary instrument against the originator’s insolvency or bankruptcy, as described below. SPV is also described as the owner of securitized assets and representative of Sukuk holders and their presumed right of recourse to securitized assets in event of the Sukuk originator’s or financing seeker’s default. In Sukuk in particular, the SPV plays a role in the promises made to Sukuk holders to repurchase the Sukuk in specific cases, including the maturity of the Sukuk.

Given the significant interrelation between the purposes of Sukuk structure through the SPV on the one hand and Sukuk holders’ right of recourse to the securitized assets in specific cases or the type of investors' ownership of the assets on the other hand, this section is dedicated to discussing these two issues as inseparable, although the right of recourse to the assets is not contingent on founding the SPV.

To verify the SPV feasibility and effectiveness as a precautionary measure in protecting investors against the risk of bankruptcy and to see whether there is a gap between the Sukuk structure - particularly the three Sukuk cases under discussion - and the findings of research and studies on conventional and Islamic securitization with regard to the adopted standards and procedures observed in Sukuk structure through the SPV, the researcher will briefly investigate the nature and purposes of the SPV in bonds, conventional securitization and Sukuk, given the unique purposes of the SPV in each case, despite the common purposes in Sukuk and conventional securitization. Then, focus will be made on the compliance of the three Sukuk types under discussion, after explaining their reality, with the established standards of Islamic and conventional securitization systems regarding the SPV and securitization; evaluation of the position of the SPV - that represents the investors - and its ownership of the securitized assets of the three cases under study and the reality of the Sukuk holders’ right of recourse to the
securitized assets under specific circumstances, such as in event of the finance seeker’s default or bankruptcy and potential obstacles in this regard; and the evaluation and amendment as needed for the interest of investors. In addition, there will be a critical analysis of some related issues, with some observations and reservations made.

3.3.2. Definition and characteristics of SPV from the conventional and Islamic laws perspectives

After considering many legal definitions of the SPV, it appeared that they have a great conceptual affinity. Other close synonyms to the SPV are a special purpose entity (SPE), and a special purpose trust (SPT), a bankruptcy remote vehicle and an affiliated special purpose corporation (SPC). Gary Gorton and Nicholas Souleles define it as: "[a] legal entity created by a firm, known as the sponsor or originator, by transferring assets to the SPV, to carry out some specific purpose or circumscribed activity, or a series of such transactions." Among the main objectives of securitization through the SPV is that it is bankruptcy proof and costs of bankruptcy. In addition, it is a protection against the risk of financial insolvency of the company desirous to obtaining finance. By transferring the assets to the SPV from a company obtaining finance, the latter’s creditors will not have the right of recourse to those transferred assets by way of sale in the event of its bankruptcy, since the assets are no longer the property of the company.

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414 See JOSEPH, supra note 117, at 5.
415 See FEDERAL RESERVE BANK, supra note 117, at 7.
418 See id.
419 See Gorton & Souleles, supra note 417, at 549-50.
3.3.3. SPV characteristics

SPV exhibits several characteristics. It is thinly capitalized and is not involved in any financial transaction(s) other than those for which it was founded and does not have any employees or independent administration.\(^{420}\) The Trustee in SPV shall perform the administrative functions according to predefined rules regarding the receipt and distribution of cash and does not have the right to make administrative decisions.\(^{421}\) Its structure is [supposed to be] immune to bankruptcy.\(^{423}\) It has no physical location.\(^{424}\)

3.3.4. The legal characterization of SPV

Views of legists and legislators vary in the characterization of the SPV. Gary Gorton and Nicholas Souleles state that the SPV can be characterized as a trust, a corporation, a limited partnership, or a limited liability company.\(^{425}\) It can also take the form of a mutual fund or be structured according to a formula created specifically for it.\(^{426}\)

Jordan has special legislation for a special purpose vehicle, which stipulates that it shall be established in the form of a private shareholding company.\(^{427}\) In Saudi Arabia, it can be formed only pursuant to the *Rules of the Special Purpose Entities* issued by the Capital Market Authority, which (i.e. the Rules) state different formulas for the sponsor according to the nature of the debt instruments to be issued, as will be detailed below.

3.3.5. Steps of conventional securitization and Islamic Sukuk through SPV

Conventional securitization is distinct from Islamic Sukuk in some respects, such as object of securitization and the nature of the parties, as mentioned earlier in the chapter on the research issue. Conventional securitization has some types depending the finance method. One of these types is when a bank sells some of its assets - typically loans - with the possible guarantees to the SPV, which in turn issues bonds in the amount of these assets, and the

\(^{420}\) *See id.*
\(^{421}\) *See id.*
\(^{422}\) *See id.*
\(^{423}\) *See id.*
\(^{424}\) *See id.*
\(^{425}\) *See id.*
\(^{427}\) *See Special Purpose Company Regulation, No (44) JO § 3. (2014).*
The proceeds of the subscription are the price of the assets.\textsuperscript{428} The dates of payment of interest and the capital of loans must correspond with the dates of the returns on bonds and the amortization.\textsuperscript{429} Another type is similar to the previous situation, but paying the purchase price of the sold assets is made through commercial loans borrowed by the SPV and not by issuing debt securities.\textsuperscript{430}

In Sukuk, originators often sell to the SPV in-kind assets, benefits or services or a combination of them, and the sale may include cash and debt as subsidiary but not independent assets. The steps of Islamic securitization and the nature of the parties involved in the process through the SPV depend on the Sukuk type; and in some Sukuk types, there are various applications that involve different securitization procedures and nature of the assets’ seller.

3.3.6. SPV Purposes

Talking about the purposes of the SPV is of high importance given the principles and guiding rules that ensure the protection of investors in conventional and Islamic securitization from the risk of insolvency or bankruptcy of the parties seeking finance through Sukuk – namely, the originator or sponsor - if these purposes have already been confirmed. In addition, this part of the dissertation intends to assess the three defaulted Sukuk cases in question by examining the conformity of their issuance to the relevant purposes. The reason is to verify whether the origin of the SPV concept serves as protection to Sukuk holders and is an effective guarantee, and if the problem lies in the application only. The importance of discussing the purposes of SPV in conventional securitization and Islamic Sukuk markets is to underline the difference - in some of their purposes- between the two markets and to make some observations on and analysis of what some has been written in this connection.

3.3.6.1. It preserves the rights of financiers, investors and potential security holders\textsuperscript{431}

One of the essential purposes of establishing the SPV and the transfer of assets, whether pool of loans, such as in conventional markets, in-kind assets, benefits or services, as in Islamic Sukuk markets, from the ownership of the issuing company, its receivables and records to the SPV is to protect the rights of investors from the


\textsuperscript{429} See id.

\textsuperscript{430} See id.

\textsuperscript{431} See Merah, supra note 426, at 210.
originator’s bankruptcy or insolvency.\textsuperscript{432} As such, investors shall not be affected should the originator go bankrupt or a court order has been issued to liquidate its estate or to appoint a legal trustee for them, in which case, creditors of the originating company will not have the right of recourse to the assets as they are no longer in the name of the originator.\textsuperscript{433} Therefore, the transfer of ownership of the assets from the originator to the SPV must be verified in order to ensure this privilege to the Sukuk holders.\textsuperscript{434}

3.3.6.2. \textit{Management of the assets in accordance with the interests of Sukuk investors} \textsuperscript{435}

SPV is a corporate and independent financial entity entitled to the right ownership and disposition in accordance with the charter and the organizational document of the SPV.\textsuperscript{436} It manages its assets in accordance with the interests of the Sukuk holders.\textsuperscript{437} This is exhibited in the case of conflict of interests and clash of decisions with the interest of the originating company.\textsuperscript{438} To realize this goal, it is important to keep the SPV separate from the originating company with regard to its ownership and administration.\textsuperscript{439}

3.3.6.3. \textit{Financing purposes} \textsuperscript{440}

Dr. Merah – in the course of his account about the purposes of the SPV – quoted some sources saying that some companies seek to securitize some of their assets and transfer their ownership to the SPV as a financing method alternative to traditional financing sources, such as borrowing from banks and financial institutions or increasing their capital by issuing new shares.\textsuperscript{441} He also quoted their observations about the consequent obstacles and restrictions, emphasizing that access to capital markets through securitization and monetization is an effective option that can boost sources of financing while reducing credit risk through transferring the ownership of some assets of the originating company to the SPV and securitizing them in the form of tradable securities.\textsuperscript{442}

\textsuperscript{432} See id.
\textsuperscript{433} See id.
\textsuperscript{434} See id. at 210-11.
\textsuperscript{435} See id. at 211.
\textsuperscript{436} See id.
\textsuperscript{437} See id.
\textsuperscript{438} See id.
\textsuperscript{439} See id. at 212.
\textsuperscript{440} See id. at 215.
\textsuperscript{441} See id.
\textsuperscript{442} See id. But, the account provided by Dr. Merah is more relevant to the purposes of securitization than to the purposes of SPV; since securitization does not require the creation of an SPV. Perhaps, he mentions that as most of securitization processes are carried out through the SPV.
3.3.6.4. Purposes related to credit risk management

Dr. Mohamed Omar stated that securitization of assets helps reduce credit risk, as the company that sold its assets is not responsible for them in relation to securities holders; thus, credit risk is transferred to other parties and is shared by investors. Merah related what Mohamed Omar said about SPV purposes.

3.3.6.5. Accounting purposes

Dr. Omar states that securitization involves deregulation from the Balance Sheet. In accounting, it is known that the value of the securitized assets, which often represent debts in the Balance Sheet and appear when calculating the capital adequacy and measuring the credit risk, is recalculated commensurate to the potential risk of non-repayment of some of them. As such, their calculated value decreases. Since the assets represent the numerator in the capital adequacy equation, the adequacy will be reduced due to the reduction of the value of these assets in proportion to the risk rate. When securitization, the assets will not show in the Balance Sheet as they will be transferred into a securitization company and be replaced by the price paid by the securitization company.

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444 See id.

445 See Merah, supra note 426, at 215. This feature can be conceived without the creation of SPV. It should be noted that the transfer of credit risk in conventional securitization – which is typically the sale of debt or loans of the originator against its customers - differs in some respects from the Sukuk. The relationship between the originator (for example, the lending bank or the company desirous to obtaining finance) and the borrowers ended and is held now between the borrowers and the SPV and the securities holders in conventional securitization. Credit risk faced by investors lies with the borrowers not the originator. However, in Islamic Sukuk, the situation is different in some respects. For example, in some Sukuk types, theoretically and practically, a strong relationship exists between the originator (which can be a bank or a company) - whether the structure involved the sale of some of its in-kind assets or benefits of those assets through Ijarah, as in the three Sukuk cases under study, or the seller was a third party - and the SPV/Sukukholders.

446 See id. at 216.

447 See Omar, supra note 443, at 7.

448 See id.

449 See id.

450 See id.
company. In this way, the value of assets will rise, which increases the capital adequacy ratio. Dr. Mohamed Omar also indicated that the organization that has debts against other parties deducts from its income a certain amount of the debt amount to form a provision fund for potentially dead debts, which reduces its net profit. Through securitization, the allocated provision balance does not show in the Balance Sheet.

3.3.6.6. Legal purposes

The SPV is sometimes founded to deal with certain legal obstacles and restrictions, such as when the law forbids banks in a country from owning, for example, real estate, equities or cars. In such case, the bank resorts to establishing the SPV to own these assets and sell them to its clients as Murabahah sale or rent them as lease-to-buy transaction.

3.3.6.7. Tax purposes

Some areas, such as the Cayman Islands, the Bahamas, the Falkland Islands and the Virgin Islands, are tax havens, attracting some investors and corporations who transfer their assets into SPVs in some of these tax-free or low-tax zones. This is a legal way to avoid paying taxes or reducing them.

3.3.6.8. Obtaining capital at a lower cost than securitization of direct sales and attracting investors

According to what can be gleaned from Thomas Gordon's account, direct securitization of assets, which is made through the direct sale of securities, leads to high transaction costs because of the assessment procedures costs that investors will have to bear. This reflects negatively on the value of those securities as they are classified as less liquidable compared to conventional debt instruments, in addition to investors’ non-habituation

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451 See id.
452 See id.
453 See id. But this accounting purpose can occur without the foundation of the SPV, and therefore it is not a purpose associated with it but with securitization.
454 See Merah, supra note 426, at 218.
455 See id.
456 See id.
457 See id.
458 See id.
459 See id.
460 See id.
461 A transaction cost, according to Thomas Gordon, "is the incidental cost incurred when one enters into an economic transaction. It is independent of the economic values of the goods or services being exchanged." Gordon, supra note 117, at 1323 n.48.
462 See id.
to deal with this type of securitization. Thus, the indirect sale securitization through SPV will be more useful for the originator since it will get higher and better liquidity for investors as it is a conventional debt tool appealing to investors.

3.3.6.9. Compliance with Islamic Shari’ah with respect to undertakings

Some Shari’ah committees considered that in order for the Sukuk structure to include the privileges, facilities and desired terms, a third party, the SPV, should be engaged, otherwise the transaction would involve Shari’ah irregularities if such privileges and practices were found. Among the most important privileges that require the establishment of the SPV is to guarantee investors' capital, to ensure the exercise of the promise of repurchasing the securitized assets [at the maturity time, for example] and to obtain an interest-based loan therewith to finance an investment project through a Shari’ah-compliant channel commensurate to the interest-based loan. The obligation of the securitized assets’ manager or the issuer to guarantee investors’ capital against practices forbidden by many Fiqh bodies [except in the event of infringement and negligence, as indicated above], and as the way out from this prohibition, some Sukuk regulators considered the establishment of the SPV in order to provide such guarantee. With regard to promises of purchasing the securitized assets and as a departure from the Fiqh opinion that forbids the lease of assets to their original seller as a lease-to-own agreement, which is a method of ‘Inah sale and/or forbids the promise to purchase the assets leased to the originator at the Sukuk nominal value, which is a guarantee of investors' capital [as in ICB Sukuk, which was discussed when investigating this case], some Sukuk regulators established the SPV to purchase the assets from the originator/finance seeker and sell them to investors. Then, the originator leases out the assets on a lease-to-own contract or leases out them

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462 See id. at 323. Gordon states: "[c]onceivably, an originator could directly issue securities that are backed only by a specific pool of its assets (a "direct sale"). But such securities would be unconventional debt instruments. Investors would encounter difficulties when trying to value them. Investors are familiar with traditional corporate debt instruments, like corporate bonds and notes, which are backed by the entirety of a company's assets. They know how to buy, sell, trade, rate, and value these instruments since they encounter many every day. With direct sale securities, an investor would incur high transaction costs in determining their value. These transaction costs make direct sale securities effectively worth less than the comparable conventional debt instruments even though they are backed by the same assets. Securities whose values decrease solely because of the transaction costs associated with them are known as "illiquid" securities. One can therefore characterize the direct sale securities as having less liquidity than traditional debt instruments." Id.
463 See Merah, supra note 426, at 214.
464 See id. at 14–6
465 See id. at 14.
466 See id. at 15.
with the promise of purchase at the nominal value.\textsuperscript{467} In such case, the seller of the assets and the obligor to purchase or redeem the assets at the nominal value are not one party.\textsuperscript{468} As for the SPV’s receipt of an interest-based loan - contrary to Shari’ah regulations- and thus financing an Islamic bank to carry out some of its activities, Dr. Merah says he came across one case where an Islamic bank desired to obtain finance in order to enter into a deal.\textsuperscript{469} As it was not possible for the bank to obtain the finance through a Shari’ah-compliant way, it resorted to setting up an SPV (orphan company) not owned by it, whose purpose was to obtain an interest-based loan – in the amount required by the bank - from a conventional bank.\textsuperscript{470} In that case, the Islamic bank became the guarantor of the SPV that created a Shari’ah-compliant agreement to finance the bank’s deal.\textsuperscript{471} It is not intended here to investigate the legitimacy of those applications and practices from a Shari’ah point of view. Rather, the aim is to refer to some of the purposes of founding the SPV by Sukuk regulators, especially with respect to the three cases of Sukuk under consideration.

3.3.7. The reality of the three cases of Sukuk under study and their compliance with conventional and Islamic standards protective against the risk of bankruptcy

Following the practice of conventional capital markets, Islamic Sukuk markets in general used SPVs in the process of assets securitization. Two of the three cases under study had founded SPVs, as previously mentioned. As the purpose of securitization and issuing of Sukuk via the SPV is to protect investors from the risk of the originator’s bankruptcy, and the rule is that the Sukuk represents an equity in in-kind assets or benefits and investors’ right of recourse to such assets, this part of the dissertation will examine and analyze the reality of the existence of this purpose and equity in the three selected Sukuk cases in some respects from the conventional and Islamic standards perspectives.

\textsuperscript{467} See id.
\textsuperscript{468} See id.
\textsuperscript{469} See id. at 15-6
\textsuperscript{470} See id.
\textsuperscript{471} See id.
3.3.7.1. The Investment Dar Sukuk (TID)

Structure of the Issuance

As previously stated, these Sukuk were based on the Musharaka contract structure, which can be represented in several formulas. The formula underlying those Sukuk was that TID had entered into a Musharaka agreement with investors, the latter were represented by SPV. The SPV was responsible for issuing the securities, and the proceeds of subscription represented the equity and contribution of investors in the assets of the Musharaka agreement as a party to this contract. TID’ contribution came in the form of rights and benefits of specific assets, such as rented vehicles and real estate. The liquid assets provided by investors were employed to purchase specific assets similar to the nature of the TID’s activities. The legal documents provided that the ownership of these assets will be transferred to TID by way of diminishing Musharakah, which is presumed to be the owner of the assets of the Musharakah contract at the maturity date, in case the investors desired to exercise the option of obliging the company to fulfill its promises of repurchasing the assets.

Type of Sukuk holders’ ownership of the Musharakah Sukuk assets

The terms of the issuance documents provided that the contribution of the originating company (TID) to the Musharaka contract is done through transferring "all rights, benefits and entitlements to the TID vehicles and property."472 While the Musharakah agreement provided that "registered title to the TID vehicles and property [musharakah assets] is held in the name of 'Investment Dar Company.'"473 In addition to that, “the registration of the property and vehicles will continue with 'Registration of Property Department in the Ministry of Justice' and with 'Traffic Department' in the name of TID company.”474 The agreement referred to the legal nature of the originating company’s retention of the title by stating that TID "shall hold and maintain such registered title as agent for the Musharakah."475 The offering circular (OC) also provided that "[t]he certificates represent entitlements solely to the trust assets [in musharakah proportionally]."476

472 Wijnbergen & Zaheer, supra note 146, at 34.
473 Id.
474 Id.
475 Id.
476 Id.
3.3.7.2. Ingress Sukuk Berhad (ISB)

Structure of the Issuance

The Ijarah Sukuk has several images according to which the process of securitization through the SPV varies. Ingress Corporation Berhad (ICB) adopted one of these images to respond to its need for financing, and it founded an SPV in the name of Ingress Sukuk Berhad (ISB). ICB then sold some of its assets to ISB with a binding promise by the two parties to lease out the assets on a lease-to own-contract. By virtue of that, the ownership of assets intended for securitization were to be transferred to the SPV, which in turn issued securities equivalent to their value. The proceeds of selling those securities to the public belong to those who sold the assets as a price of the assets. Afterwards, the SPV leases the assets to the seller and sells them to it at the end of the lease term.

Type of Sukuk holders' ownership of Ijarah Sukuk assets

This transaction resulted in the beneficial ownership only, while the legal ownership remained in the name of the originator / seller. The documents stated:

Before the Sukuk can be issued, Ingress or its subsidiaries will sell the beneficial interest to the Assets, to the Issuer in exchange for the Purchase Price (as defined below). Immediately after the said sale transaction, Ingress and the Issuer will enter into an Ijarah Agreement for the lease of the Assets to Ingress for a period of up to seven (7) years in consideration of Ijarah Rentals to be paid periodically by Ingress.477

The documents also states: "[e]ach Sak (singular of Sukuk) represents an undivided beneficial ownership of the Trust Assets."478 The documents also states that: "Trust Assets [m]eans (a) the beneficial ownership of the Assets; and (b) the rights, title, interest and benefit, present and future, in, to and under the Transaction Documents (as defined under paragraph 27.11 of the Principal Terms and Conditions) and all proceedings of the foregoing."479

478 Id. at 19
479 Id. at 23.
3.3.7.3. Nam Fatt Corporation Berhad

Structure of the Issuance

In these Sukuk described as Murabahah Sukuk, the company seeking finance sold some of its assets to the SPV with a promise to buy them back on a deferred payment agreement. Under this structure, the assets’ ownership is supposedly transferred to the SPV, which in turn issues Sukuk with the value of the assets. After the public offering ends, the proceeds of the IPO represent the price of these assets. Then, the Sukuk holders, represented by the SPV, sell the assets to the party that had sold them on a deferred payment agreement with a predefined profit margin. However, the reality - as already described in the characterization of this type - is that this represents a form of ‘Inah sale. The proper application of Murabahah Sukuk according to the contemporary concept is that the seller of the assets should be a third party, and the proceeds of the IPO are the price of these assets. Then, the SPV, after the acquisition of those assets, is to sell them to the company desirous to obtain finance on a deferred payment agreement, informing the buyer of the original purchase price. If the purpose of the promise to buy the commodity is to benefit from it without selling it in the market, the transaction is characterized as a Murabahah contract and a credit sale contract. However, if the purpose is that the promising buyer will sell the commodity in the market for cash, the transaction is called Tawarruq (monetization).

Type of Sukuk holders' ownership of Murabahah Sukuk assets

The transaction documents stated that the transfer of NFCB assets to investors is a type of sale based on beneficial ownership. The documents provide that,

The proposed Islamic Commercial Papers/Islamic Medium Term Notes Issue shall be secured by the following: -

1. Assignment of all the Issuer's and/or its Operating Subsidiaries' (as defined in item (z) (iii) below) (as the case may be) contractual rights, interest, titles and benefits in and to the Specific Contracts / Projects (as defined in item (z) (xi) below) including all proceeds arising therefrom and any other amendment (s) or variation (s) thereof and addition (s) thereto or in substitution thereof.480

480 Suruhanjaya Sekuriti Securities Commission Malaysia, Nam Fatt-Revised PTC, supra note 237, at 6.
3.3.7.4. Type of assets investors’ ownership

According to the Common Law governing these Sukuk issued by a company based in Malaysia and following the English Law, and in light of specific terms stated in the Sukuk documents, the Sukuk holders’ ownership of those assets, prior to their selling to the finance seeker - the seller of assets promise to buy them back on a deferred payment agreement - is described as a beneficial ownership. Terms are used to refer to this type of ownership - recognized under Common Law by virtue of ownership rights - such as "benefits". In the next chapter, this issue will be dealt with in depth with reference to the legal and Shari'ah effects of this ownership in terms of its relevance to the protection of investors and the possibility of their right of recourse to the assets.

3.3.8. Standards of conventional securitization through SPV

The importance of talking about conventional securitization standards arises when dealing with Sukuk for two reasons. The first is that Islamic securitization can benefit from the mechanisms of conventional securitization, which emerged first. The second reason is to take into consideration these standards in case the Sukuk were issued in non-Islamic countries and the standards were considered by specialists in conventional securitization in order to ensure the protection of Sukuk holders from the risk of the originator’s bankruptcy.

Many of the conventional securitization processes involve the founding of an SPV to be immune to bankruptcy and plays a vital role in avoiding bankruptcy risk. The SPV is founded to achieve two important objectives. The first is that it is created in a way that makes it immune to bankruptcy. The second is that it protects the asset-backed securities holders from the risk of bankruptcy of the originating party by ensuring the separation of the securitized assets from their seller’s estate, which is realized through the true sale of those assets to the SPV, thus protecting the holders of securities from the claims of the originator’s creditors.

3.3.8.1. Immunity of the SPV from bankruptcy per se

Although the bankruptcy risk of the Sukuk originator can be avoided, investors in the securitized assets may still be exposed to the risk of the bankruptcy of the SPV when it defaults on paying investors’ due, according to

482 See id. at 932.
In order to avoid this risk, the organizational documents of the SPV should provide for provisions and terms that make it almost impossible for the SPV to go bankrupt and restrict its actions that could threaten its bankruptcy remoteness. Among these provisions is to restrict its ability to file a voluntary bankruptcy or insolvency petition. When it intends to file a bankruptcy petition, the SPV’s charter typically requires the unanimous approval of the directors. To ensure the SPV’s prevention from filing a bankruptcy petition, the board of directors should include the independent director(s) whose duties include the interest of investors and not the shareholder (the originator). The director(s) also has the right to veto the actions of the Board of Directors, which include, beside filing a bankruptcy petition, dissolving decisions, consolidation or merging, the sale of all SPV assets and entering into or participating in any business outside of its assigned purposes. In case the SPV is engaged in activities contrary to the purpose for which it was founded, this would increase the likelihood of creditors to it, resulting in higher potentiality of filing an involuntary bankruptcy petition.

3.3.8.1.1. Commitment of the three defaulting Sukuk cases to these standards and procedures

The researcher did not find any indication that the SPV in the TID and ISB Sukuk adopted the above-mentioned protective measures against filing a voluntary or compulsory bankruptcy petition, such as the inclusion of independent members in its Board of Directors or the provisions and terms restricting its actions, such as merging, borrowing or expanding in activities other than the purposes for which it was founded. However, there are promises and provisions relevant to the originators. For example, TID is obliged as the manager of the Musharakah assets to provide the partners with the approved budget of TID, not to act as guarantee to other

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483 See Gordon, supra note 117, at 1324; see also Cohn, supra note 481, at 932.
484 See Gordon, supra note 117, at 1324. Forbidding SPV from merging with any entity that does not adopt the same bankruptcy-avoiding provisions must be provided by the charter in order to protect the SPV from losing its bankruptcy-avoiding status. See id. At 1324-325. In case of correspondence of these provisions, it can be merged with another originator, and this process is called multi-seller securitization conduit (MSC). See id. At 1325. This process is useful, as it contributes to reducing the probability of the SPV being an alter ego for the originator, in which case it will be subject to consolidation with the originator, and thereby it will lose its immunity from bankruptcy of the originator. See id. The other benefit of this structure is that it enables investors to diversify their portfolios, which makes this structure attractive to investors. See id.
485 See Gordon, supra note 117, at 1324; see also Cohn, supra note 481, at 932.
486 See Cohn, supra note 481, at 932.
487 See id.
488 See Gordon, supra note 117, at 1324.
489 See Cohn, supra note 481, at 933. The SPV’s organizational documents may contain specific provisions allowing it to borrow for special purposes, such as when the SPV is structured in a way that requires borrowing to purchase the assets from the originator before issuing its securities. See Gordon, supra note 117, at 1324 n.51.
parties, not to allow TID’ debts to exceed a certain limit therewith it fails to perform its functions, and not to allow
its capital to fall under a certain threshold. All this is to ensure that the manager will be able to return full capital
of investors in the event of its negligence or infringement, as previously stated. The ICB, which originated the
ISB Sukuk, made certain financial promises, such as restrictions on indebtedness and distribution of dividends
among shareholders as well as refraining from pawning its assets.\footnote{See Suruhanjaya Sekuriti Securities Commission Malaysia, Ingress Revised PTC, supra note 261, at 16-7.} In addition to these restrictions and promises, NFCB made other promises, such as non-merging or restructuration as well as providing the trustee with the company's financial statements.\footnote{See Suruhanjaya Sekuriti Securities Commission Malaysia, Nam Fatt Revised PTC, supra note 237, at 13-4}

However, the important issue here is these companies’ commitment to their promises and the guarantee that
they will honour their promises to preserve their financial position, as they are bound by variant financial
obligations in this regard, which explains the investors' request to provide positive and negative promises.

3.3.8.2. Protection of investors from the bankruptcy of the originator\footnote{See Cohn, supra note 481, at 931; see also Gordon, supra note 117, at 1322-323.}

Securitization through the SPV is vital to attracting investors, as the SPV is an important device in dealing
with the potential risk of the originator’s bankruptcy. In conventional capital markets, the goal of structured
financing or securitization through the SPV is to ensure that the securitized receivables are separated from the
originator's assets in the event of its bankruptcy.\footnote{See Cohn, supra note 481, at 931.} However, the foundation of the SPV does not necessarily
mean that the securitized assets transferred to it are safe from third parties' claims. For example, the originator’s
creditors may demand the inclusion of the securitized assets among the originator’s bankruptcy estate, should
these assets prove to be the property of the originator due to defects in the sale process or separation between the
originator and the SPV. To ensure that securitized receivables are not part of the originator's property when it is
under bankruptcy proceedings, two steps must be taken: the sale process is true, and the SPV is separate from the
originator’s property, according to conventional securitization researchers.
Michael Cohn sees that in order to counter the risk of bankruptcy of the originator, the legal characterization of the securitization process of these assets and their transfer to the SPV is done through "true sale". Otherwise, the competent court may characterize the defected sale transaction as a secured loan. This result should worry investors, given the downsides and the potential for negative consequences for their investments. In this regard, Thomas Gordon says: "[e]ven in a regular secured lending arrangement, the lender risks enduring a lengthy and costly bankruptcy process before being able to claim possession of collateral." In addition, the laws of some countries also forbid creditors from possessing mortgages during bankruptcy proceedings. For example, the US Bankruptcy Code provides for automatic stay of "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." The sum of the debtor's bankruptcy estate under the US Bankruptcy Code includes "all legal or equitable interests of the debtor in property as of the commencement of the case," as Thomas Gordon cited. He states that all of the seller's legal and equitable interests in the property are extinguished by a true sale of property, thus, the property [or any asset] is not included in the originator's bankruptcy estate if the property is transferred to an SPV from the originator as a true sale, thus this property is "bankruptcy remote." The second step to be taken to protect investors from the risk of the originator's bankruptcy is what Michael Cohn says that the SPV should be completely separate from the originator by observing all necessary formalities leading to that purpose. With respect to the risk of the originator’s bankruptcy, the securitization process through the SPV faces the separate entity risk and the legal characterization risk. If SPV investors fall victim to one of them, they will be treated in the same way as the other unsecured creditors of the originator during bankruptcy proceedings.

**Separate Entity Risk**

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494 See id. at 931.
495 See id. at 931-32 n.20.
496 Gordon, supra note 117, at 1317.
497 11 USC § 362 (a) (3) (1994).
498 Id. At § 541 (a)(1).
499 See Gordon, supra note 117, at 1325.
500 See Cohn, supra note 481, at 931.
501 See Gordon, supra note 117, at 1325.
502 See id.
503 Id.
The competent court may issue a judgment to include the SPV assets to the total sum of the originator’s bankruptcy estate if they were not legally separate from the originator.\(^504\) An important aspect when considering this separation is whether the SPV is an alter ego for the originator.\(^505\) To determine the alter ego status, the competent court will evaluate the relationship between the originator and the SPV to determine whether they are acting at arms' length, according to Thomas Gordon.\(^506\) In his view, the court [in America by context] could issue a judgment that includes the assets of the SPV among the originator’s bankruptcy estate if two conditions were met.\(^507\) The first is the presence of an alter ego status. \(^508\) The second is that the originator’s creditors "must show that they relied to their detriment upon a belief that the originator and SPV were not separate legal entities."\(^509\) The bankruptcy court will issue an inclusion judgment if the creditors are substantially affected.\(^510\) To ensure that the SPV is a legally separate entity [in America, by context], the originator must comply with specific requirements.\(^511\) To ensure that the SPV is legally separate, the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York provides a list of auxiliary factors that will enable the SPV to play an effective role in separating the assets to be securitized from the originator.\(^512\)

**Legal Characterization Risk**\(^513\)

\(^{504}\) See id.

\(^{505}\) See id. at 1325-326.

\(^{506}\) See id. at 1326. Gordon states: "[i]n New Center Hospital, the court enunciated a seven-part test for determining alter ego status: '(1) presence or absence of consolidated business or financial records; (2) unity of interest and ownership between the debtors; (3) the existence of parent and intercorporate guarantees on loans; (4) degree of difficulty in segregating and ascertaining separate assets and liabilities; (5) existence of transfers of assets without observance of corporate or other legal formalities; (6) commingling of assets and business functions; and (7) the profitability of consolidation at a single principal location.'" Id. at 1326 n.64.

\(^{507}\) See id. at 1326.

\(^{508}\) See id.

\(^{509}\) Id. Gordon states: "[d]etrimental reliance can be shown by demonstrating that the creditors, in extending credit, did not rely on there being separate legal entities. Alternatively, it may be shown by demonstrating that the affairs of the two entities are 'so entangled that consolidation will benefit all creditors.'" Id. at 1326 n.65.

\(^{510}\) See id. at 1326.

\(^{511}\) See id.

\(^{512}\) See id. Gordon attributes to the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York that: "[t]he factors are as follows: (1) The SPV's compliance with its corporate formalities; (2) The separateness of SPV decisionmaking from that of the originator, (3) The separateness of SPV operations from those of the originator; (4) Whether the SPV has actual possession of the securitized assets; (5) The SPV's management of its liabilities; (6) The separateness from the originator of the SPV's offices; (7) The separateness from the originator of the SPV's financial statements; (8) The arms' length nature of the SPV's transactions with the originator and affiliates; (9) The extent of disclosure of the separateness of the SPV and its assets from the originator, and (10) The separateness from the originator of the relationship between the SPV and third parties such as contracting parties, creditors, and certificate holders." Id. at 1326-327 n.67.

\(^{513}\) Id. at 1327.
This means that bankruptcy courts will not consider the process of transferring the assets to the SPV as a true sale, but a secured loan. Therefore, the court will regard the SPV as a lender to the originator, with the securitized assets as collateral, and not a buyer of the assets. Accordingly, the SPV securities holders will be at equal footage with the originator’s creditors in obtaining a share of its assets upon bankruptcy. Such risk should worry investors, as they will be party to the bankruptcy proceedings with the consequent delay in and uncertainty about recovering their capital. In order for the concerned parties to avoid this dilemma, they should be able to foresee the factors that might prompt the court to characterize the process as secured loans.

Thomas Gordon, in his paper published in 2000, says, "[t]he application of bankruptcy case law to securitizations remains unclear, primarily because bankruptcy courts have never considered whether securitizations constitute true sales or secured loans. Practitioners must draw on the bankruptcy law of similar transactions, such as direct sales of accounts receivable, and analogize this to securitizations." In 2008, East Cameron Partners (ECP), a US-based company that originated the Sukuk, filed a bankruptcy protection petition under Chapter 11, requesting the court to consider the Sukuk, which was based on the Musharakah contract, as secured loans and not a true sale. The request was rejected by the court, which issued a judgment entitling the Sukuk holders to possess the securitized assets. This case provides an important basis and precedence for conventional securitization and Islamic Sukuk from the Common Law perspective, especially concerning the factors deciding whether a transaction is a true sale or a secured loan.

514 See id.
515 See id.
516 See id.
517 See id.
518 Id. at 1328.
519 See Wijnbergen & Zaheer, supra note 146, at 12-3, 35. They state: "[t]hen, East Cameron Partners filed a revised lawsuit but, subsequently the stakeholders preferred to resolve the case through negotiations. Finally, the underlying sukuk assets were transferred to the issuer for the benefit of sukuk investors. According to the terms of the sale the assets of East Cameron Partners were sold to the Sukuk investors (Latham and Watkins (2011)). But the originator was given a subordinated ORRI on future production, which would contain some value once the principal amount of sukuk holders have been repaid. In a sense the originator received a call option on its own assets with as strike price the principal amount of the sukuk." Id. at 18.
520 See id.
3.3.8.2.1. Commitment of the three defaulting Sukuk to these standards and procedures

From the perspective of traditional laws governing conventional securitization and according to the above standards, the three Sukuk cases under study are exposed to legal characterization risk at best, if we exclude the separate entity risk between the originator and the SPV. The conducted sale was not done on the basis of true sale, in view of the concept of Common Law; for, the legal ownership remained in the name of the originator, and as such the standards of conventional securitization were not met.

In TID Sukuk, this company, which is a party to the Musharakah contract, transferred the rights and interests of the assets, supposed to be contributed to the Musharakah assets, as the assets remained in the name of TID. Besides, all the Musharakah assets are registered in its name. Accordingly, this transaction is structured in such a way that the SPV does not own any assets; its role is to issue Sukuk, and the subscribers are partners by their funds with TID. Consequently, Sukuk holders will not be immune to the risk of the originator’s bankruptcy, as the company’s creditors may claim such assets. Even if the assets are transferred by way of true sale, the Sukuk holders will be affected by the bankruptcy of TID because it is required to repurchase all the Sukuk - maturity - at the end of the Sukuk term, in case investors desired to exercise their right by virtue of the repurchase promises.

In ISB Sukuk, the transaction did not involve a true sale under the Common Law, since it did not include the transfer of the legal title of the assets, which remained in the name of the originator, thus exposing the Sukuk investors to be in the same situation as the originator’s creditors at the bankruptcy proceedings.

As for NFCB Sukuk that is based on a reverse ‘Inah sale contract, the transaction was not based on true sale because the assets remained in the name of the originator / seller. It is important to point out that the Sukuk based on this structure, even when the sale is true by transferring the ownership of the beneficial and legal ownership, protection of investors from the risk of the originator’s bankruptcy by securitization through the SPV will not apply to Sukuk holders except in only one case. This is because investors or their representative in this structure will sell the assets they bought from the originator back to it at the early stages of the Sukuk. As such, they will not have assets that may be claimed by the originator’s creditors. But, immunity from the originator’s bankruptcy in such structure could apply if, after the true sale of the assets from the originator to the SPV is carried out, the
originator has gone bankrupt before engaging in the assets repurchase contract on a deferred payment agreement. However, in those Sukuk, it is difficult to judge whether the assets before engaging in the assets repurchase contract could be included in this exemption, since the documents provided for a binding promise by the two parties that requires the repurchase of the assets on a deferred payment agreement immediately after the assets have been sold by the originator.

3.3.9. Standards of Islamic securitization

As shown above, researchers in conventional securitization, whom we could find, stated that the purpose of founding the SPV is to be inherently immune to bankruptcy. It is also intended to avoid the risk of bankruptcy of the originator who securitized its assets typically in the form of pool loans or debts owed by the originator’s clients. To ensure the avoidance of the originator’s bankruptcy, its estate must be separate from the SPV and the transfer of the assets must be done through a true sale transaction. In Sukuk, however, the approach of many of researchers to dealing with protection of Sukuk holders from bankruptcy or insolvency of originator the differed from conventional securitization to some extent, though in some other respects the results were close.

3.3.9.1. SPV Immunity

Previous studies on Sukuk that we have come across did not deal with the SPV immunity per se as much as they did with relevant studies on conventional securitization. The reason can be attributed to the absence of problems in this connection that need to be further explained.

3.3.9.2. SPV Immunity against the originator’ bankruptcy, the right of recourse to the assets

We showed earlier that researchers’ approach to Sukuk was different from conventional securitization, but in some respects, the conclusions were almost similar. For example, researchers on Sukuk still focus on issues such as the right of recourse to assets and whether the Sukuk are asset-based or asset-backed. This led to the discussion of some related issues, such as verification of ownership as legal or beneficial, which depends on the type and procedures of the sale, and whether the sale was true or fictitious. It also led to reviewing some of the terms contained in the Sukuk structure jeopardizing the validity of the sale as true and the subordination of the SPV to the influence and control of the originator. Perhaps, the difference between the approaches to the two
securitization forms is due to several reasons previously mentioned in detail when discussing the risk of bankruptcy, such as the difference in the type of the assets, the role of the originator in both forms and the nature of the originator in the contracts underlying the Sukuk, by virtue of which the originator becomes a party in the Sukuk structure after its issuing. The originator may be an agent (ajeer), a deferred-sale buyer, a manager of assets, etc. Further, in most Sukuk in practice, the relationship between the originator and investors or their representative ends with a debt relationship given the promises made by it to buy the securitized assets at the maturity date. The present researcher believes that both approaches to dealing with this issue are valid, as long as the conclusions are almost the same in many important aspects.

3.3.10. Asset-based Sukuk vs. asset-backed Sukuk and the recourse to assets

IFSB classified Sukuk structures into three categories. These are an asset-backed Sukuk structure, an asset-based Sukuk structure with a repurchase undertaking (binding promise), and a so-called "pass-through" asset-based Sukuk structure. Some academics and researchers commented on IFSB’s standards, and some dealt with the distinctions between asset-backed Sukuk and asset-based Sukuk. Almost, all those who have addressed this issue followed the same approach in distinguishing between the two types of Sukuk. Dr. Saeed Bouheraoua, for example, states that IFSB explained that asset-based Sukuk means that in case of default, the Sukuk holders either have the right of recourse to the originator through the promise of repurchase or to the issuer through guaranteeing the repayment of their dues. In connection to his conception of IFSB account, he added that asset-

521 See ISLAMIC FINANCIAL SERVICES BOARD (IFSB), supra note 119, at 3.
522 IFSB states: "[a]n asset-backed sukūk structure that meets the requirements for being an asset backed structure as assessed by a recognized external credit assessment institution (ECAI): this structure would leave the holders of sukūk to bear any losses in case of the impairment of the assets. The applicable risks are those of the underlying assets, and these will in principle be reflected in any credit rating issued by a recognized ECAI." Id.
523 IFSB states: "[a]n asset-based sukūk structure with a repurchase undertaking (binding promise) by the originator: the issuer purchases the assets, leases them on behalf of the investors and issues the sukūk. Normally, the assets are leased back to the originator in a sale-and-leaseback type of transaction. The applicable credit risk is that of the originator, subject to any Sharī‘ah-compliant credit enhancement by the issuer. The recognized ECAI will put weight, in determining the rating, on the payment schedule of the repurchase undertaking and the capability of the originator to make the scheduled payments to the issuer (see paragraph 13). Such structures are sometimes referred to as “pay-through” structures, since the income from the assets is paid to the investors through the issuer." Id. at 4.
524 IFSB states: "[a] so-called “pass-through” asset-based sukūk structure: a separate issuing entity purchases the underlying assets from the originator, packages them into a pool and acts as the issuer of the sukūk. This issuing entity requires the originator to give the holders recourse, but provides Sharī‘ah-compliant credit enhancement by guaranteeing repayment in case of default by the originator." Id.
525 See Dr. Saeed M. Bouheraoua & Dr. Ashraf W. Dasuki, Taqwim Naqdiun Lilqadaya Alshareiat Almutaealiqat Bimalkiat Alsukuk Alqayimat Ealaa Al’usul [Critical Appraisal of Shari’ah Issues Related to Ownership of Asset-Based Sukuk] 112 [A paper presented to
backed Sukuk requires the full transfer of legal ownership of the assets of the contract.\textsuperscript{526} As to asset-based Sukuk, they only require the transfer of beneficial ownership to Sukuk holders and provision of recourse to the originator or the issuer and not the assets.\textsuperscript{527} As such, Sukuk holders would be more concerned with the financial position of the issuer or the originator and its affordability to repay, while the asset-backed Sukuk holders are concerned with the efficiency of the assets to yield profits.\textsuperscript{528}

Tasniaa, Mustaphab and Shakilb say that asset-based Sukuk are: "a securitization of receivable. It involves a beneficial ownership where no right to dispose of the underlying asset."\textsuperscript{529} They add that investors in this type of Sukuk have the right of recourse to the issuer not the assets.\textsuperscript{530} If the issuer defaults, investors “will only have limited right of disposal because they will be required to sell the asset to the issuer.”\textsuperscript{531} In contrast, they see that asset-backed Sukuk means the ownership of the underlying asset is fully transferred.\textsuperscript{532} Asset-backed Sukuk are based on true sale. It is the process of securitization of tangible assets and has a legal ownership right to dispose of the underlying asset.\textsuperscript{533} They refer to IFSB’s statement that holders of this Sukuk type bear losses resultant from the asset impairment, and they have the right of recourse to the assets not the originator.\textsuperscript{534} They analogized asset-backed Sukuk to Musharakah and Mudarabah Sukuk, indicating that investors in them have the right of recourse to assets in the event of default, while they analogized asset-based Sukuk to Murabahah and Ijarah Sukuk, claiming that investors have no right of recourse to the assets.\textsuperscript{535}

\textsuperscript{526} See Bouheraoua & Dasuki, supra note 525, at 112.
\textsuperscript{527} See id.
\textsuperscript{528} See id.
\textsuperscript{529} Mashiyat Tasniaa, Is’haq M. Mustaphab & Mohammad H. Shakilb, \textit{Critical Assessment of the Legal Recourse for the Case of Sukuk Default for the Asset-Backed and Asset-Based Sukuk structures} 3 (European Journal of Islamic Finance, issue No. 7, pages: 1-6, July 2017).
\textsuperscript{530} See id.
\textsuperscript{531} Id.
\textsuperscript{532} See id.
\textsuperscript{533} See id.
\textsuperscript{534} See id. at 3-4.
\textsuperscript{535} See id.
It is not clear whether the characteristics of these two types of Sukuk- or three types according to others - are the correct forms of Sukuk or it is only an extrapolation of the reality. But, it can be surmised from the context that this is an extrapolation of the reality, with an impression that applications and visualization are limited to that.

3.3.10.1. The researcher’s views and reservations on some views and convictions

The present researcher finds that the above categorization as presented by IFSB and the sub-categories and conclusions made by some researchers based on that categorization - which appealed to and were approved by many others - is flawed and needs further consideration. The categorization assumes specific and limited scenarios that can actually occur in the contrary, and some of its details are based on false perceptions and premises. The purpose of criticism here is not to investigate their compliance with Islamic Shari‘ah.

With regard to the three categories mentioned by IFSB, it can be said that there may be a Sukuk structure based on true sale - which in conventional securitization means the transfer of legal and beneficial ownership and was followed by Sukuk researchers we examined their views. Yet, it could include a binding undertaking by the originator to repurchase the assets. This type comprises the first and second categories mentioned by IFSB. The true sale - according to the method adopted by some researchers - will give the Sukuk holders the right of recourse to the assets, even if the assets included a binding repurchase undertaking by the originator. There can also be a type of Sukuk that entitles its holders to beneficial ownership, but its structure does not include a repurchase undertaking. Further, the transfer of beneficial ownership only can take place in Musharakah Sukuk that are based on the principle of profit-and-loss sharing, that include a binding undertaking to repurchase the assets after the expiry of the Sukuk term, or with all of the above as was the case in the TID Sukuk. However, some analogized Musharakah Sukuk to asset-backed Sukuk, assuming that it includes legal and beneficial ownership but not a binding promise by the originator to repurchase the Sukuk holders' share.

As to the first category stated by IFSB, it is possible not only to have recourse to the assets - as mentioned by some researchers - but to the have recourse to the originator as well, even if the Sukuk is asset-backed - in accordance with the characterization of IFSB - as in the event of the issuer’s negligence and infringement in Mudarabah and Musharakah Sukuk, in case it is the manager of the Musharakah assets, as mentioned above.
With regard to the second category, it assumed that this structure relates only to the transaction involving the sale and lease. But, this limitation is questionable, for even the Musharakah Sukuk can include a binding repurchase promise by the originator, which already occurred, for example, in TID Sukuk.

Some Sukuk, such as Murabahah Sukuk, can be conceived of to involve a transaction carried out on the basis of ‘true sale’, which, according to many researchers, involves the transfer of legal and beneficial ownership. However, the Sukuk holders can only have recourse to the securitized assets at a particular stage, i.e., the stage of their possession of the assets prior to selling them as Murabahah or deferred-payment sale to the obligor and the purchase orderer, as in NFCB Sukuk. The reason is that the assets are no longer in their possession, since they have sold them.

A structure of the Ijarah Sukuk can also be conceived of wherein investors have the right of recourse to the assets - even with consideration of IFSB’s categorization and the researchers who followed it. In this structure, the assets are sold - as true sale - from the originator to investors and leased to it, without any repurchase undertakings. It can also be envisaged when investors buy assets from a third party and lease them to the finance seeker, possibly as a lease-to-buy transaction.

Many researchers, including those we referred to above, view that holders of the Sukuk that includes the transfer of beneficial ownership only do not have the right of recourse to assets, and, accordingly, they lose their right to sell them in the market. In this way, such Sukuk comes under what they called as asset-based Sukuk. Based on this view, the holders of TID, NFCB and ISB Sukuk will not have the right of recourse to the assets because the Sukuk holders are not their legal owners.

Transactions of TID and ISB are asset-based securities and are not asset-backed securities. These Sukuk represent beneficial ownership and not legal ownership of the assets. This means that Sukuk holders are not immune to the bankruptcy of the originating company or bank, and they have no right of recourse to the assets in view of the researchers in Sukuk mentioned above.

In conventional and Islamic securitization, protection from bankruptcy, investors’ right of recourse to the assets and ensuring the separation of the assets from the originating company that sold its assets depend on several
essential factors, such as the type of the securities’ holders’ ownership of the assets, whether the legal characterization of securitization is guaranteed loans or real sale transaction, and the legal recognition of the contract formula underlying the securitization process. The presence of SPV is not in itself a guarantee that the Sukuk holders and bondholders will be immune to the risk of bankruptcy, even if measures are taken to avoid the bankruptcy of the SPV, unless many standards - proposed at the end of this section - related to the entire structure, transaction items, legal environment and other aspects are taken into consideration.

3.3.11. The issue of beneficial ownership in Sukuk

In practice, many researchers have argued, as pointed out earlier, that what is transferred in most Sukuk issuances - especially in Sukuk commonly known as assets-based Sukuk - is beneficial ownership only. While other researchers regard that many applications of Sukuk held by investors represent cash flows from those assets rather than from in-kind assets. At the same time, they call the structure the ‘beneficial ownership’. They indicated that such a structure does not provide beneficial owners the right to legal disposition of the assets, because the legal owners of the assets is the originator and not them. This structure, according to many researchers who tackled this issue, is fraught with problems. According to Dr. al-Morshedhi, in the asset-based Sukuk, which represents the vast majority of Sukuk issuances, the holders cannot dispose of the assets because they are not their legal owners. In case of default, they will have recourse to the originator by obliging him to fulfill its repurchase promise or to the issuer by virtue of guaranteeing the payment of their dues. But, in all cases, the holders have no recourse to the assets. Some say that these structures are based on beneficial ownership, and investors have no right to dispose of assets as mentioned above. At the same time, they say investors can only sell the assets to the originator, as we pointed out when explaining the difference between asset-backed and asset-based Sukuk. Some say that the beneficial owner in Britain and America has all the benefits ensuing from ownership except the right to dispose of the assets. As such, immunity from the originator’s bankruptcy will not be realized in this

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536 See AL-MORSHEDI, supra note 106, 82-3.
537 See id. at 83.
538 See id.
539 See id. at 86.
formula because the assets are owned by the originator and not by the Sukuk holders.\textsuperscript{540} Therefore, investors, in case of default, cannot sell those assets\textsuperscript{541} in the market to recover some of their capital and because of the limitation of recourse to the assets, according to some researchers. One can argue that the legal documents and issue brochures of Sukuk that include beneficial ownership may indicate that what is transferred from the originator to the SPV is the cash flows and not the assets. As such, the contracted object would be thought of as cash flows from the assets. These cash flows are considered one of applications of the beneficial ownership. This application (i.e. transferring cash flows) is exercised lawfully and widely in many countries such as Anglo-Saxon countries and is prohibited by Islamic law, as will be discussed later.

Based on many jurists’ perception of beneficial ownership, they stressed several conditions in the sale contract transferring ownership of the assets to the Sukuk holders including, inter alia, separation of the assets from the seller's property and registering them outside its balance and transferring the legal and beneficial ownership to investors. Resorting to Sukuk structures based on beneficial ownership has, among other things, legislative or tax reasons, as will be discussed later. The present researcher notes that some confused many concepts and applications of beneficial ownership. Beneficial ownership does not only mean one party benefiting from assets, while the legal ownership belongs to another party. Rather, it also means benefiting from cash flows arising from the assets. Some researchers deal with beneficial ownership in relation to verifying the satisfaction of Shari’ah requirements of ownership, while elsewhere characterizing it to mean cash flows. Some state that asset-based Sukuk involves beneficial ownership, and, as such, they can only be sold to the originator, whereas elsewhere they claim that such Sukuk represents receivables, as previously indicated.

Here we will look at the Shari’ah perspective and its requirements vis-à-vis beneficial ownership and its concept in Common Law to verify whether the holders of Sukuk based on it are at risk of the originator’s bankruptcy that sold its assets based on this formula. We will also examine whether Sukuk holders have the right to dispose of these structured assets. In addition, we shall tackle this issue with regard to the risk of non-

\textsuperscript{540} See id.
\textsuperscript{541} See id.
compliance with Islamic Shari’ah. To achieve this goal, and because the judgment of a case is part of its conception, it is useful in this section to address some aspects. The first aspect is to define the meaning of ownership in Shari’ah and its implications. The second aspect is the verification of the concept of ownership, especially beneficial ownership, and its implications from the Common Law perspective, therefrom this type of ownership has emerged, in order to arrive at a clear and correct perception that can lead to its Fiqh characterization under which most Sukuk structures are claimed to have been structured. The third aspect is to explain its ruling and characterization in Shari’ah, its compatibility with ownership requirements in the Shari’ah and the ensuing Shari’ah and legal implications. The fourth aspect is to investigate the causes of resorting to beneficial ownership so that it can be possible to deal with and eliminate them. The fifth aspect is to verify whether Sukuk applications - particularly the Sukuk under study - are based on beneficial ownership in view of the Common Law.

Conventional securitization is quite clear in this regard, if the assets are transferred from the originator to the SPV by way of true sale, by virtue of which all rights, including the right to sell the assets to other parties, are transferred. That involves the transfer of both legal and beneficial ownership, making investors immune to the originator’ bankruptcy. In Islamic Shari’ah, the term "true sale" is not typically used. But, whenever the sale contract observes all necessary requirements, the contract effects take effect. For many reasons, most of issued Sukuk were based on beneficial ownership, and, accordingly, this structure was commonly termed as asset-based rather than asset-backed Sukuk.

3.3.12. Ownership from Islamic law, Civil Law, and Common Law perspectives

The importance of talking about ownership, its characteristics and legal implications through these three Laws stems from the fact that Sukuk has become a transcontinental tool. It is not exclusively used in the Islamic World,

542 In theory and practice, sales – and other transactions - are frequently qualified by some descriptions to denote particular senses. A qualifying word or phrase precedes the term ‘sale’ classifying it into specific categories according to some considerations. For example, some jurists divided sale with regard to its senses or effects into "enforceable (nafiz), suspended (mawqif), false (fasid) and invalid (batil). The first establishes immediate ownership; the second results in ownership subject to approval; the third proves ownership upon receipt; and the fourth does not result in ownership. See ABDULRAHMAN M. AL-JAZRI, AL-FIQH ‘ALA AL-MADHABIB AL-ARBA’AH [FIQH ON THE FOUR MADHHABS] vol. 2, p. 135 (Dar al-Kotob al-Ilmiyah: Beirut, Lebanon, 2d ed. 2003). As such, each one of these different senses of sale has a specific juristic ruling in Shari’ah.

543 See AL-MORSHEDI, at 82; see also Abdul Karim Abdullah, Islamic Finance: Legal and Beneficial Ownership 2 (Feb 6, 2018). Available from: https://www.researchgate.net/publication/322958854_Legal_and_beneficial_ownership (accessed on 5th July 2018); see also Bouheraoua & Dasuki, supra note 525, at 111.
some of whose countries are governed by the Common Law such as Malaysia, while others follow the Civil or French Laws or are highly affected by them, as in the case of most Arab countries. Still some Islamic countries, such as Saudi Arabia, rely only on Islamic Shari’ah. The distinction between the three Laws Takes on an added importance also in connection with arbitration. The arbitrator must be fully conversant with the difference between their characteristics and implications and must not analogize the legal concepts of a particular region to another a legal concept of the same name, whereas, in practice, they are completely different, though their apparent nominal similarity. Realizing the distinction between the concept of ownership in the three Laws would hold the arbitrator from generalizing his perception of ownership in one of the three laws to all of them. In addition, as noted earlier, the definition of ownership and its effects in Shari’ah will help learn the Shari’ah designation, fiqh characterization and effects of beneficial ownership.

Here, we will briefly refer to some essential questions related to ownership in Shari’ah and Civil Law in order to provide a general perception about it in as much to verify whether the Sukuk based on beneficial ownership protects its holders from the bankruptcy of the originator, which sold the assets on that basis. Elaboration on that matter will cause a digression from achieving the dissertation objectives.

**3.3.12.1. Ownership in Shari’ah**

Fiqh councils and Shari’ah bodies do not deal with the concept of ownership in Islamic Shari’ah and do not set specific standards for it. Besides, traditional Fiqh Schools did not tackle the issue of ownership in the same way and approach as that of some contemporary Shari’ah jurists in terms of dedicating researches to it and highlighting its elements, characteristics and effects in a manner close to the Civil Law approach in form but not in content. What some contemporary jurists say about ownership is pure extrapolation, ratiocination and refinement of the literature already available in Islamic Fiqh and not a breakthrough. The gist of jurists’ statements about this matter in the past and at present is one and the same, but the difference is only in the wording.\(^\text{544}\)

\(^{544}\) It should be noted here that courts of Saudi Arabia judge ownership in view of Islamic Shari’ah perspective, although Shari’ah Colleges there, where judges are exclusively graduated, do not consider ownership as an independent subject. Rather, students presumably deal with it as part of their study of financial transactions, such as sale and lease. In contrast, in Colleges of Law in Saudi Arabia, students study ownership from the Civil Law perspective, which may cause some confusion and misunderstanding to students of Law Colleges on account of the difference between these curricula and the judicial judgements based on Islamic Shari’ah, although there are some commonalities between the Civil Law and Islamic Law.
Law and Civil Law jurists do not classify ownership into legal ownership and beneficial ownership, as they do not recognize the distinction between them in the sense as seen in Common Law, as will be explained later.

### 3.3.12.1.1. Definition of ownership in Islamic Shari’ah

The jurisprudent Mustafa al-Zarqa defined ownership as: "a legally exclusive right entitling its owner only to the right of disposition of something, except for an impediment." The meaning of being “exclusive” is that individuals other than the owner are prevented from disposing of and using that right without the owner’s permission. As to “impediment” – though it may be temporary and not inconsistent with ownership - that restricts the owner’s right of disposition, it includes two cases: (1) lack of capacity, e.g., a minor, whose guardian acts on his behalf, and (2) encroaching on the right of others, e.g., a joint or pawned property, where participants’ and pawner’s acts are restricted, despite their right of ownership. Al-Zarqa and Ali al-Khafif related ownership warrants and counted among them possession of permissible items, contracts and the yield of property. Contracts include, inter alia, sale and lease, which are involved in most of Sukuk applications. In terms of the owned object, ownership is divided into three categories: ownership of an object or a slave, ownership of a benefit and ownership of a debt. As to objects and benefits, ownership is divided into two subdivisions: the first is perfect/full ownership, namely that a person owns the object and its benefit together, and the second is imperfect ownership, and it has two forms. The first is that a person owns the benefits of an object but not the

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546 See id. at vol. 1, p. 334.
547 See id. The jurist al-khafif defined ownership as “the possession of something in a way that warrants its owner the right to exclusive disposition of it, except for a Shari’ah impediment forbidding him to do so.” Ali M. Al-Khafif, Ahkam Al-Mu’Aamalat Al-Shari’iyah [Rulings of Shari’ah Transactions] 42 (Dar Al-Fikr Al-‘Arabi, 2008). He also says, "Al-Kamal bin al-Hammam defined it as: 'the capacity to act a priori, except for an impediment.' ‘Capacity’ here stands for the legal capacity as granted by the Lawgiver to the owner of the object. As such, he has the right to dispose of it by himself, not on behalf of others, except for an impediment restricting his eligibility. Accordingly, neither the proxy, guardian, trustee nor administrator of endowments (waqf) are considered owners of the property, since they are not acting by virtue of their own will, but they act on behalf of others. Minors, the insane and the Incompetent can be owners, because they have the right of disposition, but for their temporary impediments. This is evident by the fact that they can assume the right of disposition when the impediment is removed. Id. at 43. In clarification of the meaning of 'the capacity to act a priori', he says: "it is the legal capacity to carry out an act initiated by the executive and assumes it by himself not through others. Hence, the act of a proxy, for example, is not an initiated act, but he derived his power from the client." Id. at 43 n.4.
548 See Al-Zarqa, supra note 545, at vol. 1, p. 335; see also Al-Khafif, supra note 547, at 84.
549 See Al-Zarqa, supra note 545, at vol. 1, p. 348.
550 See id. at vol. 1, p. 349.
551 See id.
object itself, and this represents most cases of imperfect ownership. \textsuperscript{552} Ownership of the benefits alone is gained via one of the four ways: leasing, loaning, endowing and bequeathing the usufruct of a property to an individual, such as using a house for dwelling. \textsuperscript{553} The second form is that a person owns the object but not its benefits, and this is rare and contrary to the norm and can only be possible by way of a will. \textsuperscript{554}

\textbf{3.3.12.1.2. Characteristics of ownership in Islamic Shari’ah}

In Islamic Shari’ah, ownership has several types that feature distinct characteristics and effects. Here, we will briefly focus on the most important characteristics of ownership as related to the research focus. The jurist al-Zarqa says that among the characteristics of ownership is that

The ownership of the property entails the ownership of its benefit, whether immediately or subsequently, but not vice versa. Ownership of the benefit does not necessarily mean ownership of the object. As such, ownership of the benefits of the property without owning the property itself is possible, as in cases of lease (\textit{ijarah}) and loan (\textit{i’arah}). \textsuperscript{555}

In this regard, he adds:

The ownership of objects is not intended for their own sake, but for their benefits. Without the desired benefit, ownership of a thing is of no avail. In fact, the lawgiver recognized the idea of ownership of a bondsman as a title for the service and lawful disposition, even by way of utilization. It is absurd to imagine that the legislation system would recognize the separation between the ownership of a bondsman and the permanent title to his services, except in temporary cases, wherein the benefits are finally related to the property. \textsuperscript{556}

In the context of discussing the characteristics of ownership, he adds that the rule in the ownership of the benefit is temporality, whereas the ownership of the object is not subject to temporality. \textsuperscript{557} As such, the ownership of the object, which is substantiated by one of its legal warrants, is permanent, unless there is a reason justifying

\textsuperscript{552} See \textit{id}. at vol. 1, p. 349-50.
\textsuperscript{553} See \textit{id}.
\textsuperscript{554} See \textit{id}. at vol. 1, p. 350.
\textsuperscript{555} \textit{Id}. at vol. 1, p. 359.
\textsuperscript{556} \textit{Id}. at vol. 1, p. 359-60.
\textsuperscript{557} See \textit{id}. at vol. 1, p. 362.
its transfer to others, such as a new contract.\footnote{See id. at vol. 1, p. 362-63} Based on this principle, jurists concluded that one of the conditions for the validity of the sale contract is permanence.\footnote{See id. at vol. 1, p. 363.} As to ownership of the benefits without the property, the rule is temporality, such as leasing and loaning.\footnote{See id.} Al-Khafif, after stating the two types of ownership, i.e., perfect/full and imperfect, said that one of the characteristics of perfect/full ownership is the owner’s capacity to dispose of the object by all types of actions legalized by Islamic law, such as sale, gift and endowment, and the capacity of the owner to benefit from the property in any way of legitimate use, such as lease, loan and cultivation, without any restriction by time or place.\footnote{See AL-KHAFIF, supra note 547, at 45.} So, ownership is permanent and ends only by the death of the owner, termination of its ownership by endowment or transferring ownership to another by virtue of one of the legal warrants justifying that.\footnote{See id.} A full owner of property is not legally liable to it if he deliberately damaged it, for compensation is the right of the owner, and it is not conceivable that a man is indebted to himself.\footnote{See id.}

3.3.12.1.3. The difference between beneficial ownership and usufruct in Islamic Shari’ah

Before considering the Fiqh characterization of the concept of beneficial ownership, an important issue related to the linguistic and translational aspect should be underlined. The translation of the phrase "beneficial ownership" into Arabic is pronounced as ‘almilikiyyah alnafyiah”, which is close to the phonation of the two terms “usufruct” (Ar. Haqq alintifa) - a phrase widely used in Arab countries adopting the Civil Law - and “ownership of benefit” (Ar. milk almanfaah) - a phrase frequently used in Islamic Law. Both Arabic phrases are typically translated as “usufruct”. Some Fiqh councils, such as stated by AAOIFI in its book of “Shari’ah Standards”,\footnote{See AAOIFI, supra note 43, at 266, 468-69.} used ‘usufruct’ to stand for milk almanfaah, one of its most important applications is asset leasing Sukuk. The term "usufruct" is defined as: "[a] right for a certain period to use and enjoy the fruits of another's property without damaging or diminishing it, but allowing for any natural deterioration in the property over time."\footnote{BLACK’S LAW DICTIONARY, 1684. Editor in chief: Bryan A. Garner. (Thomson Reuters, 9th ed. 2009).}
**Haqq alintifa** is defined from the perspective of the Civil Law as: "a time-bound, original in-kind right to a movable or immovable property that entitles the owner to use and exploit something owned by others." Some said that Shari’ah jurists render this phrase as "milk almanfaah," meaning they are synonymous, but this is not accurate. Perhaps, jurists’ confusion between them, in addition to phonation similarity, is created by the correspondence between them in some characteristics and provisions, or arises from the non-distinction between them by the Hanafi jurists, as will be shown later, although in many respects they intended by **Haqq alintifa** something different from that phrase as used in the Civil Law. **Milk almanfaah** in Shari’ah is defined as:

The temporary benefit derived from the utilization of objects, such as dwelling in a house, riding a car, wearing a garment, benefiting from the labour of a worker, and this does not include the material benefits, such as the milk of an animal or the fruit of a tree, because this is called a ‘yield’ (ghalla).

**Haqq alintifaa** in Shari’ah is defined as:

Authorizing a person or permitting him personally to benefit from something, such as permission to use a school as accommodation. In such case, whoever is authorized to do so shall solely benefit from that right and is not allowed to transfer it to another person, with or without a compensation.

Jurists of positive law hold the right [or title] to benefit (**haqq alintifa**) as a right in rem [which means a complete and perfect right to a thing], while Ijarah (leasing) [which is one of the most important applications of **milk almanfaah** according to Shari’ah jurists] is a right in personam [which means a right to enforce a legal duty of a particular person]. Jurists of [positive] law do not distinguish between the **haqq alintifa** and **milk almanfaah**. Also - according to some - the Hanafi scholars did not differentiate between the two phrases,

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567 *Id.* at 17.

568 *Id.* at 16.

569 *See Id.* at 15.

570 *See AL-ZARQA, supra* note 545, at vol. 1, p. 374.
contrary to the majority of jurists. The classical Shari'ah jurists differentiated between the phrase "milk almanfaah" and "Haqq-alintifa" [or “milk alintifa”] according to Mustafa al-Zarqa. By the latter, they intended a meaning or application distinct in some aspects from the applications of the usufruct (haqq alintifa) in the Civil Law. Differences appear, for example, in issues such as reasons for their emergence and the causes of their expiration and the ensuing consequences. Abdur Rahman al-Suyuti - one of the late classical Muslim scholars - says:

An individual can have the right to personally benefit from a thing “iintifa” without the right to own it (almanfaa), such as the borrower who is permitted to use a thing without owning it … As such, whoever owns the object (almanfaa) has the right to lease or loan it to others (i’arah). But, whoever has the right to benefit (owns iintifa) from a thing is not definitely permitted to lease it to others not to loan (i’arah) it to them, based on the most accurate view.

Al-Zarqa states that both phrases are not similar in meaning. The ownership of the benefit (milk almanfaa) is an exclusive right preventing others, as mentioned earlier in the definition of ownership, such as the right of the lessee to the benefits of the leased object, whereas the right to the benefit (intifaa) involves the authorization to personal use of the property without owning it, such as the right to occupy a spot in the market, to use roads and rivers without causing harm to the public or to eat a meal as permitted by its provider. Therefore, the ownership of the benefit is much stronger and exclusive, as it involves benefiting as well as additional privileges.

Al-Zarqa points out that the two phrases also differ in terms of their origin. Ownership of the benefit (milk almanfaa) arises from the contract of ownership. This ownership is effected by virtue of one of four contracts:

573 See id. at 374-75.
575 See AL-ZARQA, supra note 545, at vol. 1, p. 374-75.
576 See id. at 375.
577 See id.
lease, loan, bequest of a benefit and endowment. As for usufruct (Haqq alintifa), its cases are more general. It is proven by ownership of the benefit via one of these contracts as well as by virtue of two warrants not entitling ownership, namely, permission to benefit from an object as authorized by an owner, and the benefit from objects intended for the public or for a group of people without being owned by any of them, such as public roads and hospitals.

The two phrases also differ in terms of the ensuing effects. Ownership of the benefit warrants its owner to dispose of it within the limits as specified by the contract. So, he can sell the right to that benefit to others, so the lessee, for instance, can sublease the property to others. while a benefit holder (malik alintifa) has the right to personally use it without hiring or giving access to it to others. Close to these distinctions, Ali al-Khafif classifies defective ownership (milk naqis) into three types: ownership of the property only, ownership of the benefit, where the right to the benefit is personal (shakhsi), and ownership of the property, where the right to the benefit is corporeal (‘aini). Jurists have mentioned further provisions and details that are not relevant to the focus of the present research.

Therefore, the present researcher deems it more accurate to rely on the Arabic pronunciation when referring to both phrases, i.e., milk almanfaa and haqq alintifa, because the term ‘usufruct’ is employed to stand for a specific meaning in the Civil Law that has no exact equivalent in Islamic Shari’ah. Due to many differences between ownership of a benefit and right to a benefit in Islamic Shari’ah, as well as differences between these terms in Shari’ah and the Civil Law, which may cause ambiguity and confusion leading to generalization of the meaning of one of the two systems on the other, on account of phonation similarity and resemblance in some provisions and applications, errors in the legal conception and characterization have already occurred when some have characterized beneficial ownership as leasing.

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578 See id.
579 See id.
580 See id.
581 See id. at 375-76.
582 See id. at 376.
583 See AL-KHAFIF, supra note 547, at 46.
3.3.12.2. Concept of ownership in the Civil Law

Dr. al-Enzi quotes the definition of ownership in the [Civil] Law as "the power that entitles the owner to obtain all benefits derived from the owned object, and thus all powers that can be exercised on the object are established to the owner." This definition includes the three rights of employment, exploitation, and disposition, both physical and legal. Abd al-Razzaq al-Sanhuri, an expert in Civil Law, was quoted as saying that the right to the usufruct of the property and benefit from the yields and fruits, i.e., the right to exploitation and disposition of the property, are basic elements of the right of ownership in Islamic Jurisprudence as well as in Western Jurisprudence.

3.3.12.3. Concept of ownership in the Common Law

In the Common Law, specialists’ approach to the issue of ownership is different from their counterparts in Islamic and Civil Law in many respects. Few scholars and legal references mention the word "ownership" only in the context of its definition, while most of them often divide it into ‘legal ownership’ and ‘beneficial ownership’, especially in the context of real estate, trust, stocks, corporations and taxes. One of the comprehensive definitions of "ownership" is the definition given by Black's Law Dictionary which defines it as: "[t]he bundle of rights allowing one to use, manage, and enjoy property, including the right to convey it to others… Ownership implies the right to possess a thing, regardless of any actual or constructive control. Ownership rights are general, permanent, and heritable." The same dictionary defines the owner as: "[o]ne who has the right to possess, use, and convey something; a person in whom one or more interests are vested… An owner may have complete property in the thing or may have parted with some interests in it (as by granting an easement or making a lease)." In these two definitions, and according to a group of Law scholars, the most important elements of

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584 Al-Enzi, supra note 566, at 4.
585 See id. at 4-6.
586 See id. at 8.
587 BLACK’S LAW DICTIONARY, supra note 565, at 1215. It defines imperfect ownership, under Louisiana law, as [o]wnership of property subject to a usufruct interest held by another," while perfect ownership, according to Black’s Law Dictionary, is: "t]he complete bundle of rights to use, enjoy, and dispose of property without limitation." Id. Bladel says: "[o]wnership can be divided in legal ownership and economic ownership. Full (100%) legal ownership and full (100%) economic ownership constitute full (100%) ownership." M.L.L. van Bladel, Commentary on: OECD Model tax convention: Revised proposals concerning the meaning of “Beneficial Owner” in articles 10, 11 and 12. (Organisation for Economic Co-operation and Development (OECD), Jan 1, 3013). Available from: https://www.oecd.org/ctp/treaties/BENOWNMILL_vanBladel.pdf. (accessed on 5th July 2018).
588 BLACK’S LAW DICTIONARY, supra note 565, at 1214. Brown states: "Stroud’s Judicial Dictionary of Words and Phrases, 5th ed., defines the “owner” or “proprietor” of a property as “the person in whom (with his or her assent) [the property] is for the time being beneficially vested, and who has the occupation, or control, or usufruct, of it.” Catherine Brown, Beneficial Ownership and the Income
ownership are the right of use (haqq aλisti′mal), the right of possession (haqq alhiaza), the right of enjoyment (haqq aλistimta′), the right of income (haqq aldakhl), the right of management (haqq alidarah) and the right of convey (haqq altahweel).\textsuperscript{589}

3.3.12.3.1. Historical development of the concept of ownership in the Common Law and its relationship with Equity and Trust

The survey of the history of the concept of ownership in the Common Law and tracing its origins and reasons of dividing it into two types: legal and beneficial is an important issue to recognize the reality of Sukuk, the possession of the beneficial owner - the Sukuk holders - of the trust assets and understanding the purposes and objectives of that division.

According to what Nik Abdul Ghani, Muhammad Saleem and Ahcene Lahsasna quote from some researchers, the concept of beneficial ownership dates back to the British Law of trust between the 12th and 13th centuries.\textsuperscript{590} They attributed to those researchers that the term appeared in contrast to the term of legal ownership, but they later attributed to other researchers that the term was in fact related to equity.\textsuperscript{591} To illustrate this division, its development and relation to equity, Catherine Brown says: "the concepts of beneficial owner, beneficial ownership, and beneficially owned are drawn from the law of equity and bring with them a rich history of equitable remedies, defenses, and causes of action."\textsuperscript{592}

She says that since the Common Law adopts a view that does not acknowledge the division of ownership, these legal concepts have arisen, for equity allows for the division of ownership into a ‘legal titleholder’ and

\textsuperscript{589} See Catherine Brown, supra note 588, at 408-09.

\textsuperscript{590} See Nik Abdul Ghani, Saleem & Lahsasna, supra note 241, at 157.

\textsuperscript{591} See id.

\textsuperscript{592} Brown, supra note 588, at 403. She says: "[t]hird, since at least the 1880s, there has been heated debate among trust authorities over the use of the word “owner” in describing a beneficiary’s interest in trust property. The owner at common law held title to the property and enjoyed all the other rights of property ownership. A trust imposed a duty on the common law owner to hold the property for the benefit of someone else. Thus, one of the key rights of ownership—the enjoyment of the property—no longer belonged to the titleholder. Equity provided the person intended to benefit with a means to enforce the right of enjoyment. This was a personal right, or right in personam, against the trustee. It was not a proprietary right, or right in rem, with respect to the trust property itself. Therefore, it is not strictly accurate to refer to the beneficiary of a trust as the beneficial owner of trust property since this suggests that the beneficiary has a right in rem with respect to the trust property." And he says: "Over time, however, a beneficiary was able to enforce his or her rights with respect to the trust property against third parties in certain circumstances. As discussed below, it was the evolution of these third-party rights that led to the argument that the beneficiary may have a right in rem with respect to trust property." Id. at 404.
another who has the ‘beneficial enjoyment’.\textsuperscript{593} As such, the meaning of these terms depends on the context in which they are used.\textsuperscript{594} For example, the description of a person as a ‘beneficial owner’ in the context of the property law (\textit{qanun almumtalakat}) is based on considerations different from the beneficial owner in the context of the ‘trust law’ (\textit{qanun al’uhda/alwisayah}).\textsuperscript{595} Likewise, in the property law, and because the remedy of specific performance may be available, the buyer is called a ‘beneficial owner’ under the purchase and sale agreement.\textsuperscript{596} While in the trust law, the beneficiary is called ‘a beneficial owner’ by virtue of its power to require the trustee (\textit{ameen}) to manage the property in the proper manner.\textsuperscript{597} Since courts recognize equitable rights in both contexts, the term "beneficial owner" is used.\textsuperscript{598} Terms that include "interest(s)," "beneficial owner," and entitlement", are historically derived from the structure of equity as known in the English Law.\textsuperscript{599} The purpose of equity was to achieve justice and fairness in the Common Law.\textsuperscript{600} Brown concludes her account by stating that the designations "legal owner" and "beneficial owner" may be workable in simplified applications of the trust when describing the beneficiary’s equity, while in contemporary applications of the trust, it may not be useful in describing ownership, particularly in some respects.\textsuperscript{601}

\textsuperscript{593} See id. at 403-04.
\textsuperscript{594} See id. at 404.
\textsuperscript{595} See id.
\textsuperscript{596} See id.
\textsuperscript{597} See id.
\textsuperscript{598} See id.
\textsuperscript{599} See id.
\textsuperscript{600} See id. Brown reviews the historical development of the concept of equity (\textit{hoqoq almilkiya}) and trust (‘\textit{uhdah}) in England and its transition to Canada, and how the Common Law in the past did not recognize what is now called as ‘trust’. See id. at 405-07. She notes that courts under Common Law used to consider what is now known as the ‘trustee’ (\textit{ameen}) as sole owner of rights to land transferred to him though its benefits are vested to another person. See id. She adds that equity was established to recognize the trust and its rights to its beneficiaries, especially to what is now called 'beneficial owner’ or ‘beneficiary’. See id. She explains that the purpose of all that in the past was not to redraft the Common Law but rather to cease its strict application, if it involves injustice, and to consider the new circumstances that equity has become a vital issue in the contemporary Public Law and that the beneficiary of a property trusted to others is recognized. See id. Brown points out that trust was originally related to the land transferred to the trustee for the benefit of the beneficiary. In this case, the trustee keeps the title to the land and transfers its profits to the beneficiary and manages it in accordance with the transferor’s instructions. See id. Therefore, it is not surprising in this image that the beneficiary is considered a real owner, who is currently designated as ‘beneficial owner’. Brown also explains how the term ‘trust’ has become so complicated by the expansion and modification made to beneficiary’s equity – such as when equity is conditional or subject to a particular order –, modification in the terms of the trust, the possibility of granting the trustee greater powers, such as selection of beneficiaries or assigning income amount to each one, and the expansion of trust property of the land to include almost all the assets. She pursues how practically, with these developments, it became to differentiate between the "real owner" and the "beneficial owner" of the trust assets. See id.
\textsuperscript{601} See id.
3.3.12.3.2. Meaning of beneficial ownership in the Common Law

Earlier, we have presented the definition and description of the terms ‘ownership’ and ‘owner’ in the Common Law. But, according to Brown, some other descriptions assume that the ‘owner’ stands for ‘beneficial owner’. She quotes one of the researchers as saying that in legal texts, the word beneficial’ is attached to the word ‘owner’ as an adjective "to distinguish a right or power one possesses for his own use and enjoyment from one possessed for the use and enjoyment of another." In the trust property, the trustee possesses the legal title to the property, but he retains it for the beneficiary who has the ‘beneficial interest’ in or beneficial enjoyment of the property. These terms can be used in a slightly different manner in real estate and other cases that come under equitable remedies. A "beneficial owner", according to Black's Law Dictionary, is "[o]ne recognized in equity as the owner of something because use and title belong to that person, even though legal title may belong to someone else; esp., one for whom property is held in trust." Werner Krommes states: "[i]n US securities law, a beneficial owner (as distinct from a 'nominee owner', 'registered owner', or 'record holder') of a security includes any person who, directly or indirectly, has or shares voting or investment power." Beneficial holder of securities is "[a] holder of equitable title to corporate stock… The stock is not registered under the holder's name in the

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602 See id. She quotes Arthur Allen Leff: "[m]ost property, of course, is held both legally and beneficially, i.e., the person with title also has the right to use and enjoyment. Indeed so much is that taken for granted that it would be odd to describe the owner of a fee simple interest in real property as the “beneficial owner,” or to say that he has the “beneficial enjoyment,” or owns the “beneficial estate,” or is “beneficially entitled” to ownership; he is just “the owner” and that he owns it for himself is just assumed." Id. at 409.

603 Id.

604 Id.

605 Id. at 409 n.28.

606 BLACK’S LAW DICTIONARY, supra note 565, at 1214. Another definition of the "beneficial owner" is "[an] entity that enjoys the possession and/or benefits of ownership (such as receipt of income) of a property even though its ownership (title) is in the name of another entity (called a 'nominee' or 'registered owner'). Use of a nominee (who may be an agent, custodian, or a trustee) does not change the position regarding tax reporting and tax liability, and the beneficial-owner remains responsible. Also called actual owner." Beneficial Owner. (business dictionary, n.d.). Available from: http://www.businessdictionary.com/definition/beneficial-owner.html. (accessed on 5th July 2018). Also, it is defined as: "[a] person who enjoys the benefits of ownership even though title is in another name. For example, when shares of a mutual fund are held by a custodian bank or when securities are held by a broker in street name, the true owner is the beneficial owner, even though, for safety and convenience, the bank or broker holds title. Any individual or group of individuals that, either directly or indirectly, has the power to vote or influence the transaction decisions regarding a specific security. Beneficial ownership may be shared among a group of individuals. If a beneficial owner controls a position of more than 5% it must file Schedule 13D under Section 12 of the Securities Exchange Act of 1934." Beneficial Owner. (Investopedia, Feb 7, 2019). Available from: https://www.investopedia.com/terms/b/beneficialowner.asp. (accessed on 5th July 2018).

607 WERNER KROMMES, KOMMENTAR INTERNATIONAL STANDARDS ON AUDITING: THE RISKS OF MATERIAL MISSTATEMENT - DAS AUFLÄRUNGSMODELL DES ISA 315 197 (Springer Gabler, 2018). According to Black’s Law Dictionary, a corporate shareholder "who has the power to buy or sell the shares, but who is not registered on the corporation's books as the owner" is considered as beneficial owner. BLACK’S LAW DICTIONARY, supra note 565, at 1214.
corporation’s records.”

"Beneficial ownership is a beneficiary’s interest in trust property." The equitable interests/title is synonymous with beneficial ownership. Also, it means economic ownership. Black's Law Dictionary defined beneficial interest as: "[a] right or expectancy in something (such as a trust or an estate), as opposed to legal title to that thing… For example, a person with a beneficial interest in a trust receives income from the trust but does not hold legal title to the trust property."

3.3.12.4. Analyzing the definitions in relation to Sukuk

We quoted more than one definition to gather all the possible characteristics and senses of beneficial ownership, since some of its meanings or applications are implicitly referred to or neglected in some definitions. Some said that the term ‘beneficial owner’ is largely used in the "dividends, interest and the royalty articles of tax treaties". But, its actual meaning remains ambiguous. Some important aspects of these definitions concerned the meanings and applications of beneficial ownership, the beneficial owner’s equity and the effects of perfect ownership.

3.3.12.4.1. Beneficial ownership applications

Given these terms and definitions, it becomes clear that beneficial ownership in accordance with the Common Law often involves one of two main senses: income or cash flow from a business or income-producing assets; and the second is the enjoyment and use of properties, especially real estate, use by the actual or true owners without possessing the legal title.

One of these two senses is more applicable in some areas. The right to income and cash flow is, for example, conceived in the stock market and in joint-stock companies. The stockholder owns a share in the corporate profits,

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608. BLACK’S LAW DICTIONARY, supra note 565, at 176.
609. Id. at 1215.
611. See Walduette A. Engelbrecht, a Critical Analysis of the Meaning of Beneficial Owner of Dividend Income Received by a Discretionary Trust iv [A thesis submitted in partial fulfilment of the requirements for the degree M.ACC (Taxation) in the Faculty of Economic and Management Sciences at Stellenbosch University, December 2013]. Available from: https://scholar.sun.ac.za/handle/10019.1/85648. (accessed on 5th July 2018).
612. BLACK’S LAW DICTIONARY, supra note 588, at 885.
613. See Engelbrecht, supra note 611, at iv.
and he also holds an equity in the assets of the company when liquidated from a legal perspective. The holder of that equity is not vested with the right of material possession or utilization of the assets such as residing in houses and the like. The same applies to property administered by the trustee and in his name to invest it in favor of the owners without having the right to dwell in those houses, for example. This meaning is conceived to apply in some types of Sukuk, regardless of their Shari’ah characterization. There may be assets and activities of an income-producing nature. If the owner of such assets desires to obtain financing through Sukuk, he can establish an SPV and sell to it the rights to income only for a period of ten years, for example, at a value of US $ 1,000,000 with the seller’s or originator's promise to redeem these Sukuk at the maturity date at the same nominal or market value. The SPV then issues Sukuk of the same value and the proceeds of the subscription are transferred to the equity’s seller as a price. The returns on Sukuk will be the cash flows or income generated by the assets, which are in the name of the equity’s seller. Precision of forecasting and foreshadowing the amount of cash flows depends on the nature of the assets or activities generating income. If the assets are leasable, the forecast of cash flows will be more accurate than the forecast of the cash flow of certain activities, such as restaurants. Investors will, for example, face operational risks in this image.

The present researcher did not find a case of Sukuk explicitly representing such a structure or that the parties to the Sukuk intended this meaning. But, there is a study titled: "Securitization of Executory Future Flows" that tackled this structure.

The other application or sense of beneficial ownership is that related to the possession of an asset such as the real estate and properties. The beneficial owner here shall have the right to use and enjoy the property, but without the right of disposing of them by way of selling or any other means, for he is not the legal owner of it.

In the Sukuk, this image can be imagined in one of two cases. The first is that the assets are sold to the SPV on the basis of true sale in the Common Law in which the beneficial and the legal ownership are transferred to the

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614 One of the definitions of share of stock is defined as: "a chose in action entitling the holder to participate in the net profit earned by the corporation and on dissolution of the corporation to a portion of the property of the corp. Remaining after payment of debt," Corporations - Nature of Share of Stock- 304 (Columbia Law Review, Vol. 23, No. 3, 1923). Also, it is defined as: "[a] share is proprietary interest in the company and not in the assets." PETER G. XUEREB, THE RIGHTS OF SHAREHOLDERS 142 (BSP Professional Books London, 1989).
SPV, and investors are beneficial owners, since the SPV retains the legal title as a trustee. There is no much controversy about this case.

The second case is that the assets are sold to the SPV with the seller or originator holding the legal title and investors are beneficial owners. Here arises the problem of the possibility of investors’ facing the bankruptcy risk of the originator, the possibility of the inclusion of the Sukuk assets among his bankruptcy estate and the restrictions on investors' right of recourse to the assets. As Thomas Gordon pointed out in the course of his account on immunity from the bankruptcy risk of the originator from the American Law perspective, in order that investors be immune to the originator’s bankruptcy and the contract is not qualified as a secured loan, securitization must be on the basis of true sale. The other issue is that both applications of beneficial ownership - cash flows (or income) and the use of assets without the right of disposing of them - are potentially included in the Sukuk that are based on this type of ownership. To which case will the meaning of beneficial ownership be based, while each one of them has a distinct Shari’ah characterization, as will be explained later? There is a difference between when the object of contracting is the right to the income or it is the asset itself, with the legal title remaining in the name of the seller. All three Sukuk cases under study draw on these two possibilities.

Highlighting these two applications of beneficial ownership is very important in order to glean a correct and distinct legal characterization of each meaning and judge it as permissible or impermissible in Shari’ah. In fact, most of the studies we have found focused on either one of the two meanings only and drew the legal provisions and effects on one of them. However, a detailed account should be provided given the different images, as shown earlier. Each meaning has an idiosyncratic nature - albeit there is some overlapping in some applications - especially that each of the two meanings can be conceived in Sukuk, as will be shown later. The problem here is that when researchers interested in this area or specialists in issuing the fatwa consider one of the characterizations concerning one of the two meanings, they judge the case in view of one of the two meaning, while the other meaning may be the correct one that must be applied.

Perhaps, one of the reasons of the ambiguity and difficulty of distinguishing the two possibilities is that those administering the structure do not recognize the difference between them, especially that many Sukuk structures
do not comply with the Shari’ah standards and become similar to conventional bonds and debt instruments. In addition, there is practically no chance to consider and reflect on the characterization of the financial transaction, especially in some types of Sukuk applications. The reason is that in many cases the issuance involves more than one contract. For example, ISB Sukuk involved a sale contract combined with a lease agreement binding to the two parties. Then, at the maturity date, the repurchase is made, with some promises binding to the two parties in each step. Likewise, the TID Sukuk involved the transfer of some of the company's assets and entering into a Musharakah and management agreement. Upon the maturity date, the repurchase of the assets is made in accordance with the company's promises. The NFCB Sukuk involved the sale of rights and entitlements of the assets to investors and immediate repurchase from them under the terms of the undertakings binding to the two parties. Had these Sukuk been free of such conditions or promises, it would have been possible to determine whether the originator sold the income of the assets or the assets themselves, with the legal ownership remaining in his name, considering the circumstances in the early stage of the Sukuk. Here, we quote a statement therewith the criterion of the application intended in the beneficial ownership can be gleaned. Mohammed Zakaria, Ahmad Salleh and Akhtar Abdul Aziz say,

According to Engku Rabiah, a Malaysian prominent law scholar whereby she mentioned that under Malaysian law, a beneficial interest is normally created as a result of a sale and purchase contract between the owner of the asset and the buyer. However, instead of getting legal title, the buyer gets only the beneficial or equitable interest because of the following reasons:

i. There were no formal registration of transfer; or

ii. Formal registration of transfer has not been made, normally because payment of the price has not been fully made by the buyer.  

Among the factors that help recognize the intended meaning are the amount of the price paid by investors, the intentions of the parties, some items that refer, for instance, to legal ownership and the quality of assets, such as property. Here we will assume that beneficial ownership means the transfer of assets to investors with the legal

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615 Zakaria, Salleh & Abdul Aziz, supra note 571, at 7.
ownership remaining in the name of the seller, which can be derived from the account of researchers who dealt with this issue.

**3.3.12.4.2. Owner’ rights and the effects of legal ownership in the Common Law**

Ownership when generally referred to involves legal effects such as the right to use and legally dispose of the properties, whereas beneficial ownership in the context of real estate and other similar areas involves lesser rights, which do not include the right of disposition, as the beneficial owner does not possess the legal title. Despite that the Common Law, based on the previous definitions and descriptions, holds the beneficial owner as the real owner, one of the most important principles of ownership rights in Shari’ah is the disposition of properties, especially in the absence of any legal impediment banning the exercise of this right, e.g., the properties are pawned or endowed. Consequently, beneficial ownership in the light of these definitions lacks one of the essential elements of ownership in Islamic Shari’ah.

All elements and characteristics of ownership, of which the right of disposition is most important, cannot be imagined to exist in one person at one time in the Common Law unless he is the legal and beneficial owner. In this case, the difference in the concept of perfect ownership - legal ownership and beneficial ownership - is null between The Common Law and Islamic Shari’ah - where ownership in the latter does not require that the owner has the legal title or registration so that he can have the right of disposition - because the two laws has similar positions concerning what ownership involves of rights and powers. If the defaulted Sukuk holders - including the Sukuk cases under study - had this kind of complete ownership of the assets, they would have been immune to the originator’s bankruptcy and would have had the right of recourse to the assets and disposition of them by way of sale - if the Sukuk were typically asset- based throughout the Sukuk term, such as *Ijarah* and *Musharakah* Sukuk – in order to regain their capital upon the originator’s default on his obligations. In the context of securities, the beneficial owner has some right, inter alia, the right of sale, as already mentioned, even if he is not the nominal, legal or registered owner. For further examination of this concept, the researcher will relate the position of Common Law courts that have the prominent role and final say in the legal clarification of this issue.
3.3.12.5. **Beneficial ownership in view of the provisions of some Common Law courts**

In her commentary on the "common" definitions she stated, Brown says that they did not add anything new. They only reiterated the conclusions of equitable principles, whereas other sources, such as judgments of courts dealing with such terms in particular areas, provided more details and specific definitions,\(^\text{616}\) considering that the courts are located in countries governed by the Common Law, which introduced the concept of beneficial ownership.

Brown states,

For example, in considering the definition of "complainant" in section 238 of the Canada Business Corporations Act, the Ontario High Court stated:

A 'beneficial owner' 'is one who is the real owner of property even although it is in someone else's name. The nominal owner has legal title to the property but the real owner can require the nominal owner to convey the property to him and transfer legal title to him.\(^\text{617}\)

Brown gives another example by saying,

In the context of section 43(3) of the Federal Court Act, the Federal Court of Appeal offered the following interpretation of the same term:

As I see it, the expression "beneficial owner" serves to include someone who stands behind the registered owner in situations where the latter functions merely as an intermediary, like a trustee, a legal representative, or an agent.\(^\text{618}\)

According to Brown, the meaning of beneficial owner in any context can be analogized to the two previous interpretations.\(^\text{619}\) She states,

The meaning of "beneficial owner" in the context of a Canadian tax statute has been addressed in several decisions. For example, in *J.C. MacKeen Estate v. Min. of Finance (NS)*, Hart J described a "beneficial owner" in the context of the Succession Duty Act of Nova Scotia in the following manner:

\(^{616}\text{See Brown, supra note 588, at 410.}\)

\(^{617}\text{Id.}\)

\(^{618}\text{Id.}\)

\(^{619}\text{See Id.}\)
It seems to me that the plain ordinary meaning of the expression "beneficial owner" is the real or true owner of the property. The property may be registered in another name or held in trust for the real owner, but the "beneficial owner" is the one who can ultimately exercise the rights of ownership in the property.\textsuperscript{620}

She says,

The judgment of Hart J was sustained on appeal. MacKeigan CJ, delivering the judgment of the Court of Appeal, said in his reasons:

The real owner, the person “beneficially entitled” to [the property], can require the nominal owner to let him use or have possession of the property, or to give him the income from it, or otherwise to let him have the benefit and enjoyment of it. He usually can require the nominal owner to convert the property into another form or to transfer the legal title to some other nominal owner. Above all, he is able, unless restricted by the terms of a specific trust, to call on the nominal owner to convey the property to him and to transfer its legal title to him, the real owner. If he does so, he will then fully acquire the property by achieving full ownership and will cease to be merely beneficially entitled to it.\textsuperscript{621}

With regard to beneficial ownership from the perspective of the US Supreme Court, Brown says,

If one were to search for a general meaning of "beneficial ownership," that provided by the US Supreme Court almost a century ago is probably the most useful. It provides as follows:

The expression, beneficial use or beneficial ownership or interest, in property is quite frequent in the law, and means in this connection such a right to its enjoyment as exists where the legal title is in one person and the right to such beneficial use or interest is in another, and where such right is recognized by law, and can be enforced by the courts, at the suit of such owner or of someone in his behalf.\textsuperscript{622}

As seen in those court judgments, the courts have made more clarifications. They not only established that the beneficial owner is the real owner of the assets but also they provided that he could require the legal owner to transfer to him the legal title that would entitle him to exercise the right to dispose of the assets, unless restricted

\textsuperscript{620} Id. at 410-11.
\textsuperscript{621} Id. at 411.
\textsuperscript{622} Id. at 412.
by specific terms of the trust. But, two issues may challenge these judgments. The first is the ambiguity regarding the legal owner's response to the beneficial owner's request of transferring the legal title to him. For, the legal owner may reject or slacken to do so. So, what would be the legal position in this case, especially if the delay results in harm to the beneficial owner? Second, as we have pointed out earlier, is that the US Bankruptcy Code included all legal or equitable interests of the debtor in property among the debtor's bankruptcy estate when the bankruptcy proceedings are commenced. In addition, as previously mentioned, Thomas Gordon stated that this means all legal and beneficial rights of the seller must be transferred through true sale in order to obtain immunity from bankruptcy. If the beneficial owner is indeed the real owner of the assets, then why will they be included within the legal owner’s estate when bankruptcy occurs?

3.3.13. *Fiqh characterization and Shari’ah ruling of beneficial ownership – as applied and derived from the Common Law- its legitimacy and the Sukukholders’ right of recourse to the assets based on it*

In this section, the views we found concerning the Shari’ah and Fiqh characterizations of this term will be investigated and analyzed.

3.3.13.1. *First view: Characterization of beneficial ownership as lease agreement*

Proponents of the first view characterized beneficial ownership as a lease agreement. Perhaps, the reason for their tendency to this characterization is the resemblance in pronouncing the terms beneficial ownership (*almilkiya alnaf'ia*) and ownership of the property (*milk almanfaa*) in Arabic, and the correspondence in some provisions, such as the right of enjoyment and use. But, this view can be challenged by two arguments. The first is that the beneficial owner in the Common Law is the real owner of the assets and has the right to require the

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623 Zakaria, Salleh and Abdul Aziz state: "[a]ccording to a view from an expert, the sale of beneficial interest as mentioned in the clause and as practiced in asset-based sukuk is actually a leasing agreement whereby the originator only leased his asset to the SPV and subsequently the SPV leased back the asset to the originator. The sale of beneficial interest in the clause is equal to bay' al-manfa'ah in Ijarah contract and it is consistent with the definition of Ijarah by Hanafis scholars whereby they defined Ijarah as a sale of benefit or manfa'ah." Zakaria, Salleh & Abdul Aziz, *supra* note 571, at 11. They also state elsewhere that "[i]t is rarely heard in Islamic practice that the seller only sells the beneficial interest and not the physical of the asset except in the case of Ijarah or leasing whereby the owner leases his property to the lessee. Consequently, he is said to have sold the benefit of the property to the lessee (bay al-manfaah). However, base on the practice in the sukuk issuance, it was stated that the originator only sells the beneficial interest (manfaah) of a property instead of the property itself. This was admitted by a scholar in an interview whereby he agreed that the beneficial interest may be sold to facilitate the sukuk issuance." *Id.* at 9.
transfer of legal ownership to him to dispose of them. In contrast, the lessee does not possess the assets and does not have the legal right to dispose of them by sale or by any other means. The second argument is that beneficial owners, including Sukuk investors, typically pay a sum commensurate with the value of the assets. If the beneficial ownership was a lease agreement, they would pay a lower amount as a rent. Dr. Abdul Sattar Abu Ghodda says, "the closest characterization to beneficial ownership is that it is a lease of the use of a property with the right of holding it." This might be true in some of Sukuk applications, such as some types of Ijarah Sukuk, in which the originator leases the assets to investors for some years for an advance rent, especially Abu Ghodda is talking in the context of real estate usufruct. In the early stages of the Sukuk, he rents them out from them for a higher rent, regardless of the Shari’ah provisions of the transaction. This view may also be plausible if the transaction was set to a specific period. However, this characterization can also be challenged by the same response mentioned in the first argument.

3.3.13.2. Second view: Characterization of beneficial ownership as a mortgage, cash option or ownership restricted by contractual terms

In relation to the characterization of beneficial ownership applied in Islamic financial products, Nik Abdul Rahim Nik Abdul Ghani, Muhammad Y. Saleem and Ahcene Lahsasna in their study, which focused on research in Malaysia, see that properties can be divided into two main types: movable property and immovable property. They also mentioned three characterizations of the term beneficial ownership of movable property in the Common Law from Islamic Shari’ah perspective. However, they underlined that the Fiqh characterization of beneficial ownership of immovable property represents real ownership. In the presence of any restrictions, it will be judged in resonance of movable property.

Before recounting these characterizations, it should be noted the basis on which they established their Fiqh characterization of the term ‘beneficial ownership’ is not clear. In the section concerning the origin of the term ‘beneficial ownership’ in financial transactions related to movable property, they pointed out that this occurs

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624 Al-Enzi, supra note 566, at 18.
625 See Nik Abdul Ghani, Saleem & Lahsasna, supra note 241, at 158-63.
626 See id. at 164.
when the sale contract is conditional on the transfer of legal ownership after payment of the full price, where the buyer is a beneficial owner.  

Yet, in a later section of their research related to the Fiqh characterization, they stated that the transfer of ownership takes place after the conclusion of the sale contract or in the case of deferred-payment sale. They added that the buyer or beneficial owner is forbidden to dispose of the assets by transferring them to a third party, without indicating whether the contract involves the condition of non-transference of ownership until full payment of the amount is made. In the former case, they referred to a specific and clear structure. However, the image in the latter case is not clear, as they did not mention whether the contract involves a condition for postponing the transfer of legal ownership until the full amount is paid. Rather, they indicated that the buyer is forbidden to dispose of the property. But, in fact, there is a difference between the case when one is banned from disposition due to non-payment of the full amount and one who has paid the full amount or has not paid the full amount but there is no restriction on transferring the legal title to him except after payment of the full amount. But, it seems that they drew their Fiqh characterization on the first image, in which payment was not made, and which provided for non-transference of legal ownership except after payment of the full amount. Thus, buyer is forbidden from disposing of the assets by transferring them to a third party, given that in the context of

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627 They state: “[g]enerally, in the Common law as stated by Childs (1914), the ownership of specific goods in a deliverable state is passed to the buyer when the contract is made, provided the contract is not conditional; and this results in the ownership even though the price has not been paid nor the goods delivered.” Id. at 159. And after two paragraphs, they state: “In practice, typically there are certain documents involved in a transaction of movable property. These documents are typically used to ensure to whom the ownership of the property goes. Two documents are mainly used, namely, Delivery Order (D/O) and Invoice. Both are issued by the owner that intends to sell his/her property. Once the buyer has signed the acceptance of the D/O, it means that the title of the purchased property is passed on to the buyer although the transaction is by credit. In the case of sale by credit, the ownership is considered transferred, but the buyer assumes the indebtedness of the payment. However, some transactions are made conditionally by inserting terms and conditions. For example, the transfer of legal ownership shall be made upon the full payment of the price or upon the settlement date. In this situation, the purchaser is normally considered a beneficial owner of the property.” Id. In the next paragraph, they say: “[h]owever, beneficial ownership could be exist in the situation where the sale contract is made by credit and there is a specific term in the agreement providing the transfer of ownership shall be made upon the settlement of the full price. In this circumstance, the ownership of the purchaser can be claimed as a beneficial ownership. Equally, when the delivery of the goods is being postponed, the ownership is still regarded as transferred. The purchaser can be considered the beneficial owner from the legal perspective.” Id.

628 They state, “[h]owever, in practice, sometimes the price is postponed or the contract is made by credit. In this situation, the transfer of ownership is considered to have occurred, but it creates indebtedness upon the buyer. With regard to the ownership transfer, sometimes the contract is being stipulated with certain conditions such as a condition of the settlement of the full price. From the legal perspective, if the contract is conditional upon the settlement of the full price, then it can be said that the contract only gives rise to beneficial ownership. (Note 19) After the full price is paid, legal ownership shall be transferred to the buyer.” Id. at 161. In the next paragraph, they mention that: “[a]ccording to Shari’ah law as discussed earlier, the ownership is deemed transferred when the contract is made. Therefore, if the payment of the price is deferred, the ownership should be fully transferred. In addition the beneficial owner/buyer is restricted from the disposal of the asset to a third party. The question arises when the contract only gives rise to beneficial ownership. Therefore, it is important to critically evaluate the substance of beneficial ownership through the method of takyif fiqhī [fiqh characterisation].” Id.
their analysis of the Fiqh characterizations it appears that they were referring to the seller’s non-receipt of the full amount of the price. We will discuss the two possibilities in the course of evaluating the three characterizations and their relationship to Sukuk, especially the Sukuk cases under study, without referring to the views of Shari’ah jurists and their differences in consideration of Islamic financial contracts underlying beneficial ownership, as this falls outside the scope of this dissertation.

Further, they do not explicitly state whether the term ‘beneficial ownership’ applies to one of the three characterizations or it can be characterized by all of them together. However, in view of the present researcher, it is unlikely that they intended the three characterizations together.

The three Fiqh characterizations that can underlie the term ‘beneficial ownership’ of movable property are pledge (alrahn), cash option or sale and buyback (khiyar al-naqd / bay wafa), and ownership restricted to contractual terms.629

3.3.13.2.1. Characterization of beneficial ownership as a pledge

The above three researchers explain the relationship between pledge (rahn) and beneficial ownership by saying that the meaning of beneficial ownership appears in the financial transaction in which the buyer pledges the sold commodity with the seller as a collateral to ensure full price payment.630 They indicate that the new owner - the pledger - cannot sell the pledged object except with permission of the pledgee, as the latter’s right is attached to the pledged object.631 They add that according to the doctrine of the Shaafi’is and Hanbalis, the ownership and benefits of the pledged property are the exclusive right of the buyer - the pledger – and, therefore, the pledgee has no right to benefit from it.632 They also point out that contemporary civil laws governing the declaration of pledges and their documentation with competent authorities achieves the same pledge contract.633 In addition, contemporary concept of beneficial and legal ownership may replace the pledgee’s receipt of the pledge as required in Islamic Fiqh, if the concept is used to confirm security of the debt.634 They consider that the legal

629 See id. at 161.
630 See id.
631 See id.
632 See id.
633 See id.
634 See id.
owner is a trustee and can be equated with a pledgee in Islamic Fiqh. They permit the pledging of a sold property based on the view of the Islamic Fiqh Academy of the OIC, which states: "[t]here is no right for a seller to maintain the ownership of the good after the contract of sale is made, but it is allowed for him to stipulate a condition on the buyer to pledge the good with him to secure his right in claiming the deferred price."

But, this view can be debated in many ways. As understood from the judicial judgements above, the beneficial owner has the right to require the legal owner to transfer legal ownership to him in order to dispose of the assets, whereas in the pledge, the pledger - owner of the pledged asset - is not entitled to dispose of it. Second, the possession of the assets - whose legal ownership is in another party’s name – typically remains in possession of the beneficial owner, especially in the context of properties and trust, whereas, in pledge, the assets or goods are held by the pledgee or competent authorities. Third, the purpose of the pledge is to secure a debt. In the transaction involving a debt, the creditor may require a collateral from the debtor to secure his right. However, not all applications of beneficial ownership involve debts. The beneficial owner may pay the full price and yet remains a beneficial owner. So, how can this transaction be characterized as a pledge while it is debt-free? As such, beneficial ownership-based Sukuk should not be characterized as involving a pledge. For, investors have paid the full price of the securitized assets and have to the right to claim legal ownership to them under the Common Law as well as in Islamic Shari’ah. This is also true of the three defaulted Sukuk cases under study, in which investors has paid the full price of the assets. If we concede that the securitized assets were pledged, what was the return or interest the Sukuk holders got from pledging the assets?

3.3.13.2.2. Characterization of beneficial ownership as cash option or sale and buyback

According to the above researchers, the second characterization of beneficial ownership in the Common Law is that it resonates with the cash option (khiyar alnaqd) or sale and buyback (bay’ alwafa’) mentioned in books of Islamic Fiqh. They indicate that the analysis will cover the two terms together given that they are close in

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635 See id.
636 See id. at 161-62.
meaning. Then, they began to explain the meaning of the cash option, which involves a stipulation in the sale contract made by the parties concerned. They add that it has two formulas,

The first form: A seller says to a buyer, "I sold to you this item on the condition that if the payment is not being made up to a certain period, then the sale contract will be void." This is similar to the concept of khiyar al-shart. The second form: A buyer says to the seller, I bought this item from you at a certain price on the condition that the contract will be void, if you pay back the full price within a certain time period.”

"This form of khiyar al-naqd is similar to the bay al-wafa'. Therefore, some Hanafis classify bay al-wafa' to be under the khiyar al-naqd."

Then, they discuss the implications of that stipulation on the sale contract from the Islamic Shari’ah perspective. The concluded with three opinions based on the views of some Hanafi scholars who endorsed and elaborated on that stipulation. Other Fiqh scholars deal with this question, with Fiqh differences among them in many respects related to these two images. The first of the three opinions they mentioned was that bay' al-wafa' requires that the buyer be the owner of the purchased good and that he may benefit from it until the seller buys it back at the same price he sold it for. The second opinion is that that stipulation renders the transaction a pledge rather than a sale contract, in which case, the transaction does not involve the transfer of ownership from the seller to the buyer-cum-lender (muqrid). Therefore, the buyer is not entitled to use or benefit from the good unless with its owner’s authorization. The third opinion is that the sale and buyback contract incorporates the characteristics of the sale and pledge contracts, as it establishes some effects of the sale contracts, such as use and benefit, but the buyer has no right to sell the good to a third party.

637 See id. at 162.
638 Id.
639 See id.
641 Nik Abdul Ghani, Saleem & Lahsasna, supra note 241, at 162.
642 See id.
643 They state: "[m]eanwhile, a third position suggests that bay’ al-wafa’ is a contract by itself; having shared features of both sale (bay’) and mortgage (rahn). As stated by Ibn Abidin (1966), al-Zayla’i confirms that the preferred fatwa in Hanafi’s school of thought is that bay’ al-wafa’ is a valid sale because some of its effects and rulings are present such as the permissibility of benefitting the sold object. The only restriction is that the buyer cannot sell it to a third party. In other words, the sale has effectively transferred the
The above characterization can be debated in several ways. First, the first formula assumes the existence of an unpaid price, contrary to many beneficial ownership applications, including the three Sukuk cases under discussion, wherein buyers had paid the full price on time. According to this formula, assuming that the buyer has not paid the full price, the concept of beneficial ownership does not involve any condition that renders the contract void; rather, as we have pointed out earlier, he has the right to require the legal owner to transfer legal ownership to him, unless there are conditions to do that. This formula includes the seller's stipulation of a condition that, for example, the Sukuk applications under study did not involve.

As to the second formula, it differs from beneficial ownership in that the beneficial owner can claim the transfer of legal ownership to dispose of the assets, for example, by sale. According to this formula, the buyer is not entitled to sell or dispose of the assets, for there is the possibility that the seller will pay the full price paid by the buyer. In addition, Sukuk applications are typically devoid of buyer's stipulation as the one mentioned above. If we concede to the validity of this characterization, the reality of the defaulted Sukuk reveals that the seller / originator did not pay the full price so that he can redeem the assets. Sale and buy back (wafa) involves the suspicion of its inclusion under the famous jurisprudential rule that says: "every loan that draws a benefit to the lender is usury (riba)"; since the buyer in practice is a lender taking advantage of the commodity provided by the seller who is in practice a borrower. As such, this contract can be conceived not as a sale but a loan contract.644 For this reason, the majority of Shari’ah scholars, including the Hanbalis, forbade that image mentioned above, namely, that the sale includes a stipulation to regain the commodity when the price is returned.645 The Hanbali scholars exclude from this prohibition the case if the intention was to simply provide assistance to the seller who

644 See IIFA, supra note 83, at 138.
has the option, and the buyer was not intending to circumvent usury. Among the Shari’ah councils that prohibit *bay’ alwafa*’ (debt guarantee sale or sale and buy back) is IIFA.

3.3.13.2.3. **Characterization of beneficial ownership as a property restricted by contractual terms**

In their third characterization of the concept of beneficial ownership of immovable property, the above researchers said that if the buyer - the beneficial owner - had the right to use and dispose of the property, the Shari’ah considered this form of ownership real, as the right to reselling is one of the implications of the sale contract. In case the buyer is restricted to do that because of contractual terms set by the two contracting parties, ownership would be restricted. They also quote three statements by the Shari’ah scholars in this regard. The first is to render any condition restricting the right to dispose of the purchased assets as void. They attribute this opinion to the majority of jurists. The second statement is the permissibility of setting a minor restriction to the right of disposition, provided that the restriction does not cause harm to the buyer. The third is that it is permissible to stipulate any condition, and, therefore, the buyer may be restricted from disposing of the assets. However, this view may be debated by saying that restriction of beneficial ownership in the Common Law is not always permanent. It has been indicated above that the beneficial owner has the right to claim legal ownership from the legal owner, especially if the earlier has paid the full price, in which case he would obtain the right to dispose of the assets. Yet, if the transaction documents provide for the banning of the right of disposition of the assets or setting some restrictions, such as requiring the buyer to sell them to specific persons, it may be said here that ownership is restricted under contractual terms.

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649 See *id.* at 162-63.
650 See *id.* at 163.
651 See *id.*
3.3.13.2.4. Characterization of beneficial ownership as endowment (waqf)

Then, the above researchers mentioned what could be perceived as another characterization of beneficial ownership, where they state:

Perhaps, it can be said that there is a generally accepted principle in Shari’ah allowing a person to be an owner of a property, but without the right to dispose of it via sale or gift. This principle is well-known in endowments (waqf). According to the Malikis, the property of waqf is owned by the waqif (founder), but he is not allowed to dispose of this property via sale or gift.652

However, this characterization may be valid only if the beneficial owner does not have the right to claim legal ownership from the legal owner so that he can dispose of the assets, especially if the price has fully been paid. In addition, both parties to the contract did not intend that transaction to be in the form of waqf.

3.3.13.3. Third view: characterization of beneficial ownership as a right

After giving a number of the elements of beneficial ownership and indicating that it includes, inter alia, the right to use, the right to exploitation, the right to legal and material disposition, considering it a real ownership, Dr. Essam al-Enzi elsewhere in his research characterized beneficial ownership in a way that presents it as one of the rights. He says:

But, I think, Allah knows best, that beneficial ownership is based on the permissibility of the same of compensation of rights, because the beneficial owner has only a right. Hence, it seems to be closer to the sale of facilities (maraafiq), such as aquae immittendae (haqq almaseel), the right to passage, the right to erecting high building, … etc. As indicated earlier, for exclusive right to personal use (hikr) is the lease of the benefit of a property, and legal experts provide in contracts that a usufruct contract is not subject to the provisions of the lease (ijara) Law.653

However, this view is debated by saying that beneficial ownership involves some rights, but the beneficial owner has the right to disposition of assets after claiming the legal title from the legal owner. Thus, beneficial

652 Id.
653 Al-Enzi, supra note 566, at 18.
ownership is much closer to rights in rem (huquq 'ainiya) than to rights in personam (huquq shakhsiya), especially in the context of the contract of purchase and sale of properties.

3.3.13.4. Fourth view: characterization of beneficial ownership as a purchase of returns

Dr. al-Morshedi quotes some researchers as saying that one of the flaws of Sukuk holders’ possession is that it does not involve real ownership; it only entitles them to the right to returns. Ownership of the assets remains in the name of the issuer (originator) who transfers to the Sukuk holders their shares of the rent. Otherwise, the issuance brochure provides that the issuer [originator] has sold to the Sukuk holders the rights to and benefits of the assets without transferring their ownership to them. Dr. al-Morshedi comments on this by saying: “this transaction does not involve the purchase of the assets, but rather it is a purchase of the returns, which is not permissible in Islamic Shari'ah.” This opinion can be valid in one of the applications of beneficial ownership based, which is cash flows. However, in the context of purchase of real estate and with the remaining of legal title in the name of the seller, for example, it is not conceivable that the transaction involves the purchase of the returns. For, the beneficial owner has the right to use the property and to claim the beneficial ownership from the legal owner, especially if he had paid the full price as indicated above.

3.3.13.5. The researcher's opinion on characterization of beneficial ownership and its legitimacy

Since beneficial ownership has more than one case or application and is used in more than one context, such as stocks, trust and the sale and purchase transactions, the Fiqh characterization and Shari’ah ruling corresponds to each application and must not indiscriminately apply to all applications. As seen earlier, the concept of beneficial ownership in the Common Law may be conceived to mean as cash flows generated from assets or business activities. In this case, it appears that the transaction involves usury (riba), in view of those who see that the provisions of gold and silver apply to money. This transaction can be conceived in one of two ways. First, the transaction involves the sale of money for the same kind of currency, which would require the fulfilment of two essential conditions: immediate exchange (taqaabud) in the same contracting session and homogeneity.

654 See AL-MORSHEDI, supra note 106, at, 83.
655 See id.
656 See id.
657 Id.
(tamaathul) of the currencies. Hence, delay and heterogeneity are not permissible. These two conditions are not conceivable in the transaction that involves the purchase of the returns for deferred installments, and these returns may be higher or lower than the price paid for the purchase. Uncertain homogeneity amounts to confirmed heterogeneity in judgment, and this is one of the legal maxims in Islamic law. Second, the transaction may involve the sale of money for a different currency, in which heterogeneity in kind and amount is permissible. But, immediacy of exchange in the same contracting session is a must, which is not available in such transaction, where returns are obtained after the contracting session.

The meaning of beneficial ownership may be conceived as referring to the transaction in which the assets or goods are transferred from the seller to the buyer under the sale contract terms, where the buyer is entitled to the use and enjoyment of the assets, though the assets remain registered in the seller’s name. In the absence of any impediment to the transfer of legal property – for example, the price of the good or assets was not paid in full - the buyer (beneficial owner) has the right to request the legal owner (seller) to transfer the legal title to him to dispose of the assets or good. The buyer does not have the right to dispose of the assets at the outset, but he has to request the legal title from the seller so that he could dispose of them.

In Islamic Shari’ah, ownership of the goods is transferred from the seller to the buyer once the contract including offer and acceptance has been concluded. Registration is not a requirement. Shari’ah scholars unanimously agreed that the contract [devoid of options and remunerative conditions] is binding and enforceable once the two parties parted and left the contracting session and none of them receded from endorsing the contract during that session. But, a disagreement occurred among scholars whether the contract is effective and enforceable in case the offer and acceptance took place and then one of the contracting parties receded from endorsing the contract before the leaving from the contracting session. Once the sale contract has been concluded and the two parties parted and left the contracting session, the good has become the property of the buyer, especially if he paid the price. Therefore, one of the effects of sale contract in Shari’ah is that the buyer has the right to dispose of the

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658 See p. 16-7.
purchased good even if it has not been legally registered in his name. He is considered the beneficial and legal owner of the good in the Common Law. Thus, Islamic Shari’ah courts, such as the Saudi courts, will give holders of the Sukuk – which are based on beneficial ownership, and in which the assets were transferred from the seller to the buyer with the legal ownership remaining in the seller’s name - the right of recourse to the assets as being their real owners. In additions, these assets will not be included within the estate of the originator / seller / legal owner if he has gone bankrupt. Yet, according to the sale contract in the Common Law, the buyer is not entitled to dispose of assets unless the former owner transferred their legal title to him.

The meaning of beneficial ownership may be conceived as referring to temporary endowment (\textit{waqf mu’aqqat}) – as permitted by some - if the transaction involves the stipulation that some persons benefit from the trust assets, with some restrictions on disposition of the assets, and the transaction does not involve paying a price or compensation.

It may carry the meaning of Ijarah if it includes a payment by the beneficiary and the contract was in the form of Ijara and has an expiry date after which the assets would be transferred back to its original owner.

It is not clear how courts in general and Shari’ah courts in particular will deal with the question of distinguishing between beneficial ownership applications, especially if the transaction involves a trust, sale and purchase transactions and securities. One of the factors that can be taken into consideration by the court is custom (\textit{‘urf}), intentions of the parties concerned, the setting or context in which the transaction took place.

\textbf{3.3.14. Reasons of resort to beneficial ownership}

It is important to point out the causes of resorting to beneficial ownership in the context of sale transactions, which may weaken the interests of investors and limit the right of disposal of the Sukuk assets, to try to eliminate those causes and to consider whether or not the case studies include them. Beneficial ownership-based Sukuk, i.e., in which the assets and their rights are transferred to the buyer with the legal title remaining in the name of the seller or originator, are entered into for some reasons, inter alia, the following:
1. The securitized assets are banned to be owned under the laws or as specified by commercial customs, as when they are sovereign assets or property not intended for privatization, such as ports. In some cases, it is not possible to register [legal] ownership, as when the law of the country in which the property is located forbids the registration of such ownership in the name of foreigners.

2. Some institutions use the beneficial ownership as a ploy to obtain financing without relinquishing their assets.

3. The buyer does not pay the full price of the good or the purchased asset.

4. "[I]f the asset is not fully sold to the investors, for example, only 90% of the value of the asset is sold to the investors while another 10% of the value remain with the originator, it is also a sale of beneficial interest according to the common law…"

5. For tax avoidance, as registration would increase the transaction costs. According to tax laws, the returns generated from the securitized assets are profits generated from investments and not from financing process. In contrast, in conventional bonds, the interest gained by the bondholders is tax deductible.

6. The response of the issuer to investors' wish not to bear the assets risk and their preference for holding the beneficial title for a temporary period, which explains the reasons for the legal ownership of the assets remaining in the name of the originator, according to some.

7. Perhaps, one of the reasons is the implications of the terms used in the issuance brochures of conventional securitization bonds, which predated Islamic securitization, on Sukuk structurers without realizing the difference between them and what the securities represent. According to Joseph C. HU, "an SPE [special purpose entity] is a trust that is set up by the originator for the purpose of purchasing the loans it originates and issuing in the capital market a certificate of beneficial interest, for which the cash flows are backed solely by the cash flows of loans purchased from the originator."

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660 See AL-MORSHEDI, supra note 106, at 83-4; see also Bouheraoua & Dasuki, supra note 525, at 119.
661 See AL-MORSHEDI, supra note 106, at 85; see also Zakaria, Salleh & Abdul Aziz, supra note 571, at 5.
662 See Bouheraoua & Dasuki, supra note 525, at 119.
663 See Zakaria, Salleh & Abdul Aziz, supra note 571, at 6; see also Nik Abdul Ghani, Saleem & Lahsasna, supra note 241, at 159.
664 Zakaria, Salleh & Abdul Aziz, supra note 571, at 4.
665 See id. at 8.
666 See id.
667 See id.
668 JOSEPH, supra note 117, at 5.
8. Some researchers state that assets of the asset-backed Sukuk should be of good quality:

in order to meet the pricing requirement. Only an asset with good quality is allowed to be facilitated in a true sale asset-backed transaction. However, there are very few companies which have such quality assets. Therefore, it is an obstacle for them to raise capital if they are compelled to get funding via asset-backed sukuk transaction. Hence, the asset-based sukuk is probably the suitable option for them to maintain in their business and it is better than they go for the conventional interest based bond.669

9. Lack of eligibility of beneficial owner, such as minors [in some jurisdictions] 670

3.3.15. Evaluation of whether the concept of beneficial ownership in Common Law was really applied in the defaulted Sukuk

Beneficial owners of Sukuk can be conceived in two images. The first is that the originator / seller transfers the legal and beneficial ownership via true sale to the SPV, which acts as a trustee of the securitized assets in favour of investors and the legal owner. Here, investors are considered beneficial owners. The second image is that the originator sells the assets to the SPV, though they remain in his name, and the Sukuk holders are beneficial owners. The problem is that many Sukuk, including the cases under study, include terms stipulating an undertaking or promise by the originator to repurchase the securitized assets in specific circumstances. This stipulation also provided for the investors’ temporary ownership of the assets, while the assets remain in the originator’s name. The major problem here is that many Sukuk applications oblige investors to sell the assets to the originator exclusively, whereas the originator is obliged to purchase the assets in the event of his default on payment, as in the ISB Sukuk, or to purchase the Sukuk at specified periods or in case of his infringement or negligence, as in TID Sukuk, on the grounds of the undertakings or promises made by the parties concerned .

Many Sukuk cases involve provisions different from what is typically exhibited in conventional beneficial ownership. We pointed out above that the beneficial owner – in many jurisdictions - needs the legal ownership to be transferred in his name in order to be able to dispose of the assets, which was not considered in many of the

669 Zakaria, Salleh & Abdul Aziz, supra note 571, at 8.
Sukuk applications. So, how can investors be able to dispose of the assets by selling them to the originator while they are still in his name, contradicting what we indicated above that the beneficial owner cannot dispose of the assets until they are transferred to his name? In some Sukuk applications, it is noted that the transaction inherently involves more than a legal contract. For example, these applications involve trust, sale and purchase transactions and securities.

We pointed out earlier that researchers in conventional securitization emphasized the importance of transferring legal and beneficial ownership of the assets through true sale so that they are not included within the originator's estate upon its bankruptcy. Yet, in many Sukuk applications, including the three cases under study, beneficial ownership is probably established, in the sense that the legal ownership is in the seller’s name. The documents of those Sukuk provided that in the event of default, the originator, by virtue of being a contracting party to the Sukuk, as a buyer or a lessee, is obliged to purchase the assets in fulfilment of his undertakings and promises. From the legal perspective, the inclusion of the assets within the originator's estate will occur in such cases for two reasons. The first reason is that the legal ownership of the assets is in his name, and the second is that he had undertaken to buy the assets in the event of default. Thus, the competent court can rule that the creditors of the originator have the right of recourse to those assets from two perspectives. First, from the Shari’ah point of view, the assets will not be included within the originator's estate upon his bankruptcy, but the Sukuk holders will be given the right of recourse to the assets, provided that this does not constitute a breach to the contract terms, if they are devoid of any conditions restricting the exercise of their rights.

The key question here is that since the originator defaulted on paying the scheduled installments, how will he be able to pay the full price that has become prematurely payable due to his default? Or, how will he be able to pay the investors in return for repurchasing the assets while he has gone bankrupt?

3.3.16. Ideal standards to ensure investors’ right of recourse to the assets

To ensure investors’ protection from the risk of the originator’s bankruptcy and non-compliance with Islamic Shari'ah, to safeguard their right of recourse to the assets, to resolve any ambiguity and controversy in some Sukuk applications, and to eliminate investors’ exposure to the negative implications of any arising dispute, a set of
procedures and measures must be observed. These can be useful not only when filing a case before Shari’ah courts but also before courts governed by non-Islamic laws. Given the nature of their underlying contract, some Sukuk applications may benefit in part from those procedures. The responsibility of the implementation and application of those procedures is shared by the competent legal authorities and concerned parties involved in the Sukuk, especially those representing investors. For, Sukuk originators may have plausible reasons not to abide by them, as, for example, they may be in favour of potential Sukuk holders. These procedures and standards should be taken into consideration by credit rating agencies - particularly Islamic ones - when rating Sukuk issuances. It should be noted that the present researcher will attempt to classify the standards and procedures under certain headings, although some standards may defy classification under one heading.

3.3.16.1. SPV Standards

1. For some reasons, such as if the State in which the Sukuk were issued does not recognize the trust system that exists in other States and helps, for example, in transferring the assets to be securitized to the trustee, the SPV cannot take the form of a trustee. In this case, the SPV shall be founded in the form of an orphan company, or its shareholders shall represent potential investors or any other party independent of the originator or not the holder of the SPV shares. This is done for several reasons. The first reason is to avoid the possibility that courts, especially Islamic ones, will treat the SPV as an affiliate to the originator, in case he is its originator and the holder of its shares. So far, the Shari'ah bodies and councils have not issued a resolution in this regard. Meanwhile, there are jurists who have not recognized the principle of separation of companies owned by the same party, though they may have adopted the separation standards agreed upon in many laws. Non-recognition may result in the nullification of the transaction that has been carried out, since the Shari’ah court may judge the Sukuk structure on the grounds that the assets were transferred by way of sale to the same owner. There are examples illustrating the non-recognition of separation of companies whose shares are held by the same party, whether one of them is an affiliate of or associate with the other. For example, some jurists stated that one of standards of the validity of the third party’s guarantee to the capital or returns of investors is that the guarantor / sponsor must be completely separate from the two parties to the Sukuk. As such, "a holding company cannot act as guarantor to one of its
affiliates, or vice versa. Likewise, an SPV established by the issuer for the purpose of being the guarantor for the issuance, regardless of the legal registration of the name of the owner of that SPV," as seen by Dr. Hamed Merah, is not legally valid.\textsuperscript{671} Dr. Abdulazem Abuzaid says,

The separation and distinction between this company [SPV] and the parent company that had established it does not legally permit various types of mutual guarantees or direct sponsorship that are not valid between the investment manager and investors, such as guaranteeing the capital, the profits or purchase of the assets sold to investors at the nominal value. But, the parent company and the SPV are treated as one party from this perspective, given the ownership of the first by the second in reality ... \textsuperscript{672}

Other contrasting views recognized the validity of one of the two companies' guarantee/sponsorship to the other under two conditions.\textsuperscript{673} The first condition is that each company has a separate entity and financial receivables, and the second condition is that neither of them is wholly or by a majority percentage owned by the other.\textsuperscript{674} However, other views permitted that, regardless of the percentage of ownership.\textsuperscript{675}

The present researcher did not find any particular view indicating the possibility of judging a transaction involving a contract between the SPV and the originator as void or not recognized on the grounds that the owner is one and the same. Yet, this does not mean that some examples do exist. The researcher’s view is supported by an account quoted by Dr. Abdulbari Mashal from Dr. Mohammed A. al-Qari, as saying "this company shall be legally separate from the Sukuk issuer and originator, so that it is not owned by them as an affiliate, associate, or any other relation." \textsuperscript{676}

The second reason is to enhance the guarantee that the SPV works in the interest of investors and keeps itself away from any influence from the originator, from the outset of the Sukuk process to its end. The transaction in

\begin{footnotes}
\item[671] \textsc{Merah}, supra note 130, at 93.
\item[672] \textsc{Dr. Abdulazem Abuzaid, Almunsha’a Dhat Algharad Alkhasi Mahamiha Wadawabituha Alshareia [Special Purpose Entity and Its Functions and Controls Shari'ah]} 4.
\item[673] See Al-Morsheidi, supra note 106, at 100.
\item[674] See id.
\item[675] See id.
\item[676] Dr. Abdulbari Mashal, \textit{Alsharikat Dhat Algharad Alkhasi (SPV) Fi Alsukuk [Special Purpose Vehicle (SPV) in Sukuk]}. (Assabeel Newspaper, Aug 6, 2015) Available from: http://assabeel.net/article/2015/8/06/%D8%A7%D9%84%D8%B4%D8%B1%D9%83%D8%A9-%D8%B0%D8%A7%D8%AA-%D8%A7%D9%84%D8%BA%D8%B1%D8%B6-%D8%A7%D9%84%D8%AE%D8%A7%D8%B5-spv-%D9%81%D9%8A-%D8%A7%D9%84%D8%B5%D9%83%D9%88%D9%83 (accessed on 13th May 2018).
\end{footnotes}
which the SPV’ originator is also the seller of the securitized assets - as the reality of the Sukuk under study and most applications - may involve conflict of interest. The SPV is supposed to be representative of the Sukuk holders and protecting their interests, yet its shareholder is its originator, who usually seeks financing through Sukuk may have established it to serve his own interests. As such, the originator should not run the SPV in order to ensure its separation. In case the SPV is established in the form of a corporation, the existence of items restricting its board from filing a voluntary bankruptcy petition, such as the inclusion of an independent member acting in the interest of investors, has raised doubt about its feasibility, especially if the SPV shareholders considered that filing a voluntary bankruptcy petition is in their best interest, despite that these items are among the motifs for investors’ consent to get low returns.677

2. Availability of certain conditions in the SPV’s board members, whether it is in the form of a company or a trust, in order to ensure its loyalty to the interest of investors. Such conditions are, for example, similar to those

677 Michael Cohn states: "[a]lmost any law applying to the governance of a corporation has, at its roots, the concept that corporations are formed for the purpose of maximizing wealth for their shareholders. Laws requiring that directors of a corporation execute their duties with the utmost consideration for the well-being of the shareholders of the corporation have no place in an analysis involving an SPV. It is tempting to analyze the fiduciary duties of an SPV’s directors under traditional corporate governance principles because on the surface the SPV appears no different than any other corporation. Nothing could be further from the truth however. The only parallel between a typical corporation and a corporation that is created for the purpose of acting as an SPV is that they are both corporations in terms of their formal structure. The similarities stop there. Substantively, the SPV’s structure aims at protecting those who invest in the securities. The purpose of the SPV should never be held out as wealth maximization for the shareholders. This is most obvious when the sole shareholder of the SPV is the originator, which frequently is the case. Protecting investors is the SPV’s purpose. When the corporate form is utilized for the SPV, the parties to the transaction insert bankruptcy remote provisions in either the charter or the bylaws, or both. Typical provisions require unanimous consent of all of the directors, where at least one of the directors is independent. The independent director of the SPV is beholden (either explicitly or implicitly) to the creditors, not the shareholders. This design blocks the voluntary bankruptcy petition. This procedural roadblock is one of the primary conditions that enables the debt instruments to receive high ratings which entice investors to invest their money at a low rate of interest. It seems likely that the bankruptcy remote provisions applying to directors will eventually face challenges in courts by SPV shareholders who determine that it is in their best interest to file a bankruptcy petition. For example, a petition may be filed without the consent of the independent director and then challenged for lacking the director’s consent. Another way in which this issue could come before the courts is through a shareholder suit against an independent director for breach of fiduciary duty based on a refusal to sign a petition when it is in the best interest of the corporation, but not the SPV’s creditors, to seek protection of the bankruptcy laws. There are two ways in which a shareholder suit of this nature could arise. The first is when the shareholder posing the challenge is the originator. In that case, it should be entirely clear that the originator is trying to have it both ways. On the one hand, the SPV’s bankruptcy remote provisions enable the originator to obtain low-cost financing. On the other hand, the originator seeks to invalidate the provisions that provided the benefit at the expense of the investors who relied on it. Since the originator, as well as its share transferees, are cognizant of the unanimity and other charter provisions, and benefit from the financing made possible by them, they should be estopped from attacking the provision later.” Cohn, supra note 481, at 949-51.
provided for by the Special Purpose Company Jordanian Regulation, inter alia, the members of the SPV’s board have no interest in contracts related to the Sukuk and be reputable.678

One of the suggestions is the existence of at least one independent member with veto powers to ensure that the SPV’s acts do not lead to its bankruptcy. The existence of an independent member, or a procedure similar to that adopted by the Jordanian SPV system, will ensure the SPV’s separation from the originator from the outset of the Sukuk process and realize investors’ interests. The SPV’s non-subjection to the control of the originator will also prevent its merging with the originator, as it does not function on arms-length basis. Besides his responsibilities, the independent member must ensure that the structure of the Sukuk is compliant with the Shari’ah and legal standards, and that the transfer of the securitized assets was done ensuring the Sukuk holders’ right of recourse to them as the real owners. The need for an independent member is significant when it is clear that the SPV shareholder is also the originator, as usually the case. This independent member can also alleviate potential conflict of interests and make an important balance to the SPV. On the one hand, the SPV is claimed to represent the Sukuk holders, while on the other hand, it is established and structured by the originator, at best if we exclude its manipulation and control by the originator while managing it.

3. Exemption of the transfer of the assets from the originator to the SPV or the trustee from taxes, which will not only boost the turnout of Sukuk, but also will raise the level of their practical and contractual prosperity. This helps eliminate some of the reasons for the assets seller’s - the originator - retaining of the legal or nominal ownership of the securitized assets.

4. Relaxing the requirements of issuing Sukuk, especially in Saudi Arabia. Such as allowing some legal formulas for companies to issue debt instruments and Sukuk and reducing the conditions that must be met for the originator of the Sukuk. In Saudi Arabia, for example, the originator of SPV can be a Joint-Stock Company. This type of

678 The Jordanian Special Purpose Company Regulation states: "A- the chairman and members of the board of directors, their representatives, or its general manager shall fulfill the following conditions: 1. To be not less than twenty-five years old. 2. Not to have been convicted of a felony or misdemeanor involving moral turpitude or public ethics. 3. Not to have been convicted of bankruptcy and not yet rehabilitated. 4. Not to be a member of the board of directors of a company similar in its work to the company, or to work in a company similar in its goals or that competes with the company. 5. Not to have any direct or indirect interest in the contracts and projects concluded with the company or on its behalf. B- The chairman or any member of the board or the general manager of the company may not be changed except after the approval of the Board." Special Purpose Company Regulation, No (44) JO § 8. (2014).
companies is entitled to issue debt instruments and Sukuk. The minimum capital ratio of the joint-stock company is SAR 500,000, which may be among the reasons for the weak demand on Sukuk and a cause for the company to attempt to recover these amounts by including defective terms in the contract underlying the Sukuk as a way of compensation. However, in Saudi Arabia, the limited liability company, although the Companies Law does not require any capital limit, does not have the right to issue debt securities or Sukuk.

Dr. Abdulbari Mashal says that the SPV can be established in a number of formulas, such as a trust, a one-person company or in accordance with a special law or the system of the limited liability company found in most laws.

But, as quoted by him, from Dr. Mohammed A. al-Qari, it is not typical to use the limited liability company because of the high management costs and legal requirements of the capital ratio.

In Saudi Arabia, the Companies Law consented State and legal institutions to establish a one-person joint stock company, provided that the capital of company shall not be less than SAR 5000,000. This in fact may hinder companies with low capital from establishing an SPV for the purpose of securitization, as well as it does not help the growth of Sukuk markets in the Saudi Arabia. In contrast, the Jordanian Sukuk Regulation does not require a specific capital limit of the SPV's originator, but it stipulated the approval of the competent authorities for some companies. Soon, we will touch on the reality in Saudi Arabia and analyze some of the conditions to be met by a originator/sponsor of a special purpose vehicle.

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679 See Companies Law, supra note 51, § 122.
680 See id. § 54.
681 See id. § 153.
682 See Dr. Abdulbari Mashal, Alsharikat Dhat Algharad Alkhasi (SPV) Fi Alsukuk (2) [Special Purpose Vehicle (SPV) in Sukuk (2)]. (Assabeel Newspaper, Aug 6, 2015) Available from: http://assabeel.net/article/2015/8/20/%d8%a7%d9%84%d8%b4%d8%b1%d9%83%d8%a9-%d8%b0%d8%a7%d8%aa-%d8%a7%d9%84%d8%b4%d8%b5%d9%83%d9%88%d9%83-2. (accessed on 13th May 2018).
683 See id.
684 Companies Law provides: "[n]otwithstanding Article 2 of the Law, the State, public legal persons, companies wholly owned by the State and companies whose capital is not less than five million riyls may incorporate a jointstock company of one person. Such person shall have the powers of the shareholders assemblies, including the incorporation assembly and powers thereof." Companies Law, supra note 51, at § 55.
685 The Jordanian Islamic Finance Sukuk Law provides: "[w]ith due consideration to the provisions of Article 8 of this Law, the following parties may issue Islamic finance suukuk directly or through a special purpose company established for this purpose: A- The Government. B- Official organizations and public institutions after receiving the approval of the Council of Ministers. C- Islamic banks. D- Companies that offer Islamic finance services. E- Companies and institutions that receive the approval of the Board." Islamic Finance Sukuk Law, No (30) JO § 11. (2012).
3.3.16.2. Standards related to assets, contracts and terms underlying the Sukuk

1. Assets shall be transferred from the seller - in the Sukuk structure involving the transfer of assets - to the SPV through a sale process involving the transfer of beneficial ownership and legal ownership (i.e. the transaction should be concluded on the basis of true sale) to the SPV or trust and the separation of the assets outside the latter’s balance. The SPV, the legal owner of the assets, shall not dispose of the assets except in accordance with the purposes for which it was established or with the approval of the Sukuk holders who are the real owners, especially if the originator has breached its obligations. Consequently, foreign investors who do not have the right to ownership should not invest in this type of Sukuk, even if the beneficial ownership is a real one. For, how will they have the right to dispose of the assets while they are not legally in their name? This situation could give advantage to the originator to reach a financial settlement in his favor. To ensure that this standard is met, the reasons for resorting to beneficial ownership should be addressed.

2. Sukuk must be devoid of any items that may lead some to interpret the sale contract as fictitious, and of any conditions that may invalidate the contract. They must be based on a contract free of major controversial issues prevented by most Fiqh councils and by the majority of Muslim jurists. For instance, Sukuk should not be based on reverse ‘Inah sale in the manner referred to when talking about NFCB Sukuk, and it can be replaced by the murabahah contract, i.e. potential Sukuk holders purchase the assets intended to be securitized from third party and then sell them to the finance seeker on the bases of the credit sale agreement and the cost-plus contract. The Sukuk structures that involve the SPV’s lease of the assets to their seller through a lease-to-buy agreement, such as ISB Sukuk, should be avoided. The alternative is, for example, that the transaction includes the purchase of the assets from the market (third party) and leasing them to the finance seeker as lease-to-buy agreement in accordance with the standards approved by AAOIFI and IIFA. In addition, the transaction should be free of any a binding bilateral promise, and the purchase promise at redemption date should not be exercised at the nominal value, especially in Musharakah and Mudarabah Sukuk. The Sukuk should also be devoid of any binding conditions obliging the Sukuk holders to sell the assets to the originator upon his default. Purchase promise should not be relied upon if the Saudi courts is competent to hear Sukuk disputes. One of the principles issued by the
Supreme Judicial Council in its Permanent Body in Saudi Arabia is that promises are not binding, yet they are recommended to fulfil. 

3.3.16.3. Standards related to assets

1. The assets should be capable of being legally and customarily owned. For, what is the point of considering the beneficial ownership of the assets as real ownership while the assets cannot be owned? Further, how can they be disposed of by sale or any other means while they are under such restriction?

2. Fair appraisal of the assets before securitization. This is to ensure their sale in the market at a fair price and with minimum loss at the end of the Sukuk term and when the parties concerned are not willing to fulfill their non-binding promises - or the intention of that option’s holder not to fulfill the repurchase promises, in view of those who approve promises and their bindingness when made by one party only. The reason for setting that standard is that some asset types are appraised at double their market value when sold to Sukuk holders, which means that Sukuk holders can only dispose of them by selling them to the issuer [or originator] through a repurchase promises at nominal price.

3.3.16.4. Standards related to the Shari’ah committees supervising the issuing process

1. Sukuk shall be supervised by a Shari’ah Committee independent of the companies originating or issuing them. Such committee, for example, can be regulated by the legal authorities competent in securities, so that its members do not receive wages from these companies in return for their supervision. This is to ensure full independence of and freedom from the companies’ influence and the committee members are assured that their decisions will not have any repercussions on them, such as dismissal from work. When selecting the committee members, it should be observed that they meet all Shari’ah, legal and technical requirements, especially of the country where the Sukuk were issued. The legislator in Jordan took into account this point, as the Board of Commissioners of the

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687 See AL-MORSHEDI, supra note 106, at 84.
Securities Commission appointed four members specialized in Islamic economy to attend the meetings dealing with Sukuk.688

2. Provisions and rules of tradition (taqlid) and reasoning (ijtihad) in Islamic Shari’ah, as stated in Islamic jurisprudence, should be considered when selecting the members of the Shari’ah Committee. For example, members who have the power of selection should not appoint those who are known of issuing Fatwas that are lenient or appealing to them.

3. There should be, when possible, an attempt to make harmonization between the judgements issued by the courts competent to hear Sukuk cases, when a dispute arises, and the views of the Shari'ah Committee. It is possible to select a former judge or someone with good background on judicial decisions, such as a member of the Shari’ah Committee.

3.3.16.5. The Governing Law

1. When selecting the law governing the Sukuk process, not only should recognition of the Shari’ah-compliant contracts and other related terms and conditions be considered, but competent courts of jurisdiction should be judging in accordance with Islamic Shari’ah. The reason is that Sukuk is an Islamic product, the remedies offered are bound by Islamic law and reassurance is given to investors who prefer to adhere to Islamic Shari’ah.

2. Resort should be made to legal arbitrators who have Shari’ah, legal and technical qualifications, in the event of ambiguity in the judgements of Islamic courts and a dispute arises.

3.3.17. Situation in Saudi Arabia

Saudi Arabia needs a set of procedures and legislations in this regard to bridge the gap between it and other countries that have made a lot of progress and development in the Sukuk area. This is to ensure that the standard of "Shari’ah compliance" is not employed as a means of marketing, to ensure the governance of Shari’ah committees and its independence from the sway of the companies they are affiliated to, and to ensure that the practice complies with the decisions of these committees. For example, although Companies Law provides that

688 See Islamic Finance Sukuk Law, supra note 417, at § 3. The Jordanian Sukuk Law also provided for the formation of the Central Shari’ah Supervisory Commission, upon recommendation of the Fatwa Council, whose responsibility involves providing the Shari’ah view regarding the issuances and ensuring their compliance with the Shari’ah provisions throughout the Sukuk term. The Commission should also include members specialized in securities, without having the right to vote. See id. at § 3-5.
debt instruments must be Shari'ah-compliant, there is no Shari'ah Committee affiliate to the Capital Market Authority - the competent entity approving the issuing of securities - to ensure the Sukuk compliance with Shari'ah. However, this does not dispense with a Shari’ah committee affiliated with each company or bank desirous of dealing with Islamic products, provided they are separate from those institutions. Moreover, there are no legislations regulating the work of the Shari’ah committees, which exist almost in all banks and companies in Saudi Arabia, whether those companies are specialized in real estate, finance, or vehicles.

Regarding SPV/SPE in Saudi Arabia, although there are rules governing the activities of SPEs, the present researcher sees that they are flawed by some weaknesses, shortcomings and ambiguities. The rules requires a sponsor for the SPE. It then distinguished between the nature of the legal form of the sponsor in debt-based debt instruments and the nature of the debt instruments associated with or based on assets, which are supposed to include Sukuk – though they were not referred to by those rules. It provides that the sponsor in the earlier case must be a joint stock company, and in the latter an authorized person, a local bank or a finance company. Having said that, a question arises: is the Murabahah Sukuk, which is debt-like instrument and whose structure requires the existence of assets in its early stages, considered a debt-based debt instrument and, accordingly, included in the earlier case? If so, the sponsor must be a joint stock company, whose capital must not be less than SR 500,000 as provided by the Saudi Arabian Companies Law, which may constitute a barrier to companies that are unable to provide such amount.

With regard to the second case concerning debt instruments associated with assets, the Rules for SPEs provides that the sponsor must be either an authorized person, a bank or a financing company. By referring to the Authorized Persons Regulation concerning dealing with securities, it stated that the applicant for a license to carry out acts of dealing, custody and managing business must be a subsidiary of a local bank, a joint stock company, or a subsidiary of a joint stock company or a subsidiary of a foreign financial institution. It provides that the

689 See Companies Law, supra note 51, § 121.
691 See id. § 29.
692 See id.
693 See Companies Law, supra note 51, § 54.
capital of the applicant desirous of engaging in acts of dealing and custody shall not be less than 50 million Saudi riyals, and for acts of managing business, the capital shall not be less than 20 million riyals.\textsuperscript{695} It further stated that if the license is only for acts of arrangement and giving advice, the sponsor's capital must not be less than SR 1,000,000 for arrangement and SR 400,000 for giving advice, and the applicant may be invested with any legal form recognized in Saudi Arabia.\textsuperscript{696} These conditions for the SPE’s sponsor may restrain the increase in sukuk activities, because the sponsor could be either in the form of a legal entity that can only be realized with difficulty or in a simple legal formula that demands financial requisites, which may be difficult to be fulfilled.

**3.3.17.1. Procedures that decision-makers, especially in the Saudi Arabian, should follow**

One of the duties of States that wish to play a pivotal role in the Sukuk industry is to enact laws - most important of which were referred to when reviewing the standards – that contribute to Sukuk development, taking into account what has been mentioned earlier that requires legislation of relevant laws. Saudi Arabia is lagging behind other countries, although it is one of the most Shari'ah-compliant countries and is supposed to be a pioneer in the regulation of Sukuk involving Islamic products. The importance of these legislations - despite the researcher's reservation over excessive number of legislations in principle - is that they exempt Islamic investment instruments from subjection to some laws, such as Securities Law, Corporate Law, foreigners’ ownership laws and taxes. Legislations are required for various purposes, such as exempting sukuk from certain legal requirements such as taxes, work organization of Shari’ah committees, extricating Sukuk from some securities provisions by issuing a special law for them and regulating the role of the trust.

**3.3.17.2. What Saudi Arabia and some countries need in this regard**

1. Enactment of special law for sukuk that takes into consideration its particular nature.

2. Amendment of the Corporate Law so as to allow the board of directors of the established company to include an independent member who has the right to veto decisions that obstruct the fulfillment of their commitments to investors, given that the originating company seeking financing is a party to the Sukuk.

\textsuperscript{695} See id.

\textsuperscript{696} See id.
3. The establishment of an SPV should not require high financial costs that may jeopardize its use as a means of issuing sukuk. For example, the capital requirements for the sponsor should be relaxed if he is an authorized person. In addition, legal forms of the sponsor that do not involve strict requirements, such as the condition of having a large capital, should be devised.

4. Amendment of the laws relating to taxes, including corporate taxes as well as other pertinent taxes, such as those levied on the transfer of assets. Besides, Sukuk holders should be exempted from income tax in line with the policies of many governments that exempt conventional bondholders from interest taxes.\(^{697}\)

5. One of the important propositions is to amend the regulations restricting foreigners’ ownership, especially investors in assets. For example, in Saudi Arabia, there are restrictions on foreigners’ ownership of real estate. Furthermore, there are certain prerequisites that may be difficult to implement and procedures that would delay the approval of investors' request, which would have a negative implications on Sukuk due to the length of time, though the government has a tendency to mitigate those restrictions.

An alternative solution could be to exempt specific areas from the ban on foreigners’ ownership of assets, particularly real estate. However, this proposition will qualify only a certain number of companies – desirous to obtain financing through securitizing their assets via Sukuk - that own assets in that region only in which foreigners can hold ownership, should they be permitted to do that. In reality, the assets of companies desirous of obtaining finance are scattered over many regions of Saudi Arabia.

6. Setting up a system that regulates the work of the Shari'ah committees, ensuring that the practice is in line with the opinion of the Shari'ah committees, such as the establishment of an audit and follow-up committee.

3.3.18. Plausible standards for investors to have the right of recourse to assets

For legislative, financial or technical reasons, it is hard for all Sukuk issuances to adopt optimal standards that ensure almost zero risk. This suggests the provision of plausible low risk standards. Here, a set of plausible

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\(^{697}\) Jordan, Bahrain and Malaysia are among the best countries in terms of legislations related to some aspects of Sukuk, and Saudi Arabia should pursue their steps in this connection and lift the reservations. Saudi Arabia will have an advantage over them given that Sukuk products will be more recognized in Saudi courts as Islamic products, and Saudi courts follow Islamic Shari'ah provisions, especially if ideal standards are observed. Malaysia and some other countries, though advanced in some Sukuk aspects, follow either the Common or Civil Laws, and this is a point of weakness.
standards and procedures can be suggested to deal with the risk of the originator’s bankruptcy and the risk of non-compliance with Islamic Shari’ah.

1. The SPV shall be completely separate from the originating company to ensure that they are not consolidated when a dispute arises, exposing the Sukuk holders to the risk of the originator’s bankruptcy and placing them on equal footing with his creditors.

2. The transfer of assets - in the Sukuk requiring that - from the originator to the SPV shall include the transfer of beneficial and legal ownership, which is called true sale. In the event of realistic difficulties for the transfer of legal ownership, it should be verified that the assets are of the type that can be legally owned in principle. This is to ensure that investors can have the right of recourse to them and to dispose of them, in case of the originator’ default or insolvency. This standard is clearly stated by the Fatwa Board in the Dubai Market. But, it is possible to exclude the transfer of legal ownership if the laws give buyers the right to dispose of the assets, though they are not legally registered in their name as, for example, in the context of Saudi Arabia, provided that the regulations and legislations allow the Sukuk holders to own the assets. In the Arabic version of its Shari’ah standards, AAOIFI stated: "[t]he basis of the seller's holding of the legal registration of the sold property is that ownership is transferred in Shari’ah by virtue of offer and acceptance. As to the legal registration, it is only for the purpose of documentation." [699] But, it is possible to exclude the transfer of legal ownership if the laws give buyers the right to dispose of the assets, though they are not legally registered in their name as, for example, in the context of Saudi Arabia, provided that the regulations and legislations allow the Sukuk holders to own the assets. In the Arabic version of its Shari’ah standards, AAOIFI stated: "[t]he basis of the seller's holding of the legal registration of the sold property is that ownership is transferred in Shari’ah by virtue of offer and acceptance. As to the legal registration, it is only for the purpose of documentation." [699]

3. Sukuk shall be based on an Islamic contract valid in the view of the majority of Fiqh councils.

4. The contract underlying Sukuk shall be void of promises binding to the contracting parties or of obligation by the Sukuk holders to sell the assets to the originator or issuer. However, it may include an undertaking or promise binding to one of the two parties only, in which case the other party will have the option to engage in the implement or not, as best in his favour. This is the opinion of most of the contemporary Fiqh bodies.

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[698] See Fatwa and Shari’ah Supervisory Board, supra note 215, at 11, 16.
[699] AAOIFI, supra note 85, at 1376.
5. The issued Sukuk shall have a Shari'ah Committee to ensure their compliance with Islamic Shari'ah and a follow-up and audit committee to carry out what the Committee deems best. The Shari'ah Committee must be independent of the entity with which it is affiliated, and which is desirous to obtain finance through Sukuk.

6. The governing law shall recognize Islamic contracts and products.

When comparing the standards of Sukuk vis-à-vis conventional securitization and considering the ideal standards proposed in this dissertation, which take into account the Shari’ah provisions as well as relevant laws, these standards appear to have achieved valuable results. They are developed to protect the rights of Sukuk investors – regardless of their economic, religious or purely economic interests, as in the case of Western investors -, enhance Sukuk position and improve its fame worldwide. These standards and procedures, though strict in some respects compared to others, give Sukuk holders the right of recourse to assets in order to protect them from the originator’s bankruptcy and the risk of non-compliance with Islamic Shari’ah.

3.3.19. Adequacy of establishing a SPV and effectiveness of investors’ right of recourse to assets in the face of credit and bankruptcy risks as sole guarantee and procedure

Even when the standards and procedures proposed in this dissertation beside the current standards are observed, the maximum that Islamic securitization can offer – with or without the SPV - is to ensure investors’ right of recourse to the securitized assets, i.e. their capital, which can smoothly and unrestrictedly be gained in some Sukuk types, such as Ijarah and Musharakah Sukuk. However, this advantage is not available in Murabahah Sukuk following investors’ sale of the assets to the originator, in which case the assets are no longer in their possession and, accordingly, they cannot have recourse to them. Meanwhile, Shari’ah scholars see that the crediting seller has the right to claim their property from the bankrupt buyer. In case investors sold the assets and the buyer went bankrupt without paying the price, now they would have the right of recourse to the assets

700 AAOIFI, in its Shari’ah Standard No. (3) related to Procrastinating Debtor, states: "2/1/7 In the case of a Murabahah sale, if the asset that was sold is still available in the condition in which it was sold, and the buyer has defaulted in the settlement of the price and has later become bankrupt, then the seller (the Institution) is entitled to repossess the asset instead of initiating procedures to obtain a bankruptcy order." AAOIFI, supra note 43, at 89. It also, in its Shari’ah Standard No. (5) related to Guarantees, states: "[t]he Institution [or Sukuk holder] is entitled to recover first its tangible items that were sold to or manufactured for a customer and have not been paid for and can be identified among the assets of the customer." Id. at 133.
when the bankruptcy proceedings are taking place and the assets are still in the originator’s possession in their original condition.

One of the problems facing investors is that protection covers their capital and not the returns on it. When the originator goes bankrupt, investors can dispose of the assets in any Shari’ah-compliant method, provided that appropriate standards and procedures entitling them to that right are observed. However, there is no guarantee that investors will receive Sukuk returns such as Ijara Sukuk rentals as long as the originator/lessee went bankrupt. In some Sukuk types, though holders may have the right of recourse to the assets as owners, the relationship between them and the originator remains, even after they have sold the assets, especially if the Sukuk involves no promises binding to the two parties, or if the binding promises – in view of those rendering the promises binding – are unilaterally issued by the originator to repurchase the Sukuk. For example, in the Ijara Sukuk involving the originator’s selling of the assets to Sukuk holders who lease them to him through lease-to-buy agreement, or involving investors’ buying certain assets from a third party and lease them to the finance seeker, the lessee, though investors may have sold the assets in the market, remains committed to paying them until the end of Sukuk term. The new buyer cannot restrict the lessee’s use of the assets, in view of many Shari’ah scholars. In this case, the lessee may default on his payment, causing investors to lose their returns, though they had the right of recourse to the assets. Shari’ah Scholars held two opinions regarding the sale of leased property. The first opinion, approved by the majority of Shari’ah scholars, render the sale contract true and enforceable.701 However, the Hanbali scholars grant the buyer the right of option: either to terminate or endorse the contract in case he was not informed the property lease.702 The second opinion is that the sale of leased property is valid with the lessee’s approval.703

Recourse to the assets is in fact an advantage upon the originator’s bankruptcy. However, in many cases, the originator does not actually go bankrupt. Rather, he goes through a temporary insolvency causing him to be late on payment, after which he recovers and becomes able to meet his financial obligations. It may be in the interest

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701 See AL-MORSHEDI, supra note 106, at 117 n.1.
702 See id.
703 See id.
of investors not to request the bankruptcy of the originator for many reasons, inter alia, litigation long time, high expenses and entry of new creditors, even if their dues have not become payable by the bankrupt debtor. In addition, recourse to the assets and Sukuk holders’ request from the competent court to subject the originator to bankruptcy proceedings are not useful in many cases. For example, the returns offered or promised to investors may be higher than what is offered in the market; prices of the securitized assets may have depreciated lower than the price paid when bought from the originator or a third party; or investors may face difficulties in selling the assets, such as low demand on them due to the nature of some types of assets, or they are of high value, causing a delay in the sale. Therefore, investors may not be tempted to recourse to the assets and terminate the contract underlying the Sukuk, and they would rather hold on to the contract with the originator, especially if the contract involves advantages such as late payment compensation. Thus, patience with the originator in the event of late payment may be more feasible than rushing into selling the assets in the market, especially if other financial guarantees are provided.

3.3.20. Conclusion

Securitization per se, even when the structure involves the establishment of an SPV, does not necessarily secure investors’ rights against the risk of bankruptcy or insolvency of the originator (finance seeker) unless specific standards are taken into consideration. To enhance Sukuk holders’ protection from bankruptcy risk in particular, the present researcher proposed a set of ideal standards and plausible standards and procedures related to several aspects that would help realize this goal from Islamic Shari’ah as well as traditional laws viewpoints. These standards are stricter than the currently adopted traditional and Islamic standards, and they have taken into account the established provisions of courts abiding by Islamic Shari’ah, especially courts in Saudi Arabia. With reference to contemporary conventional securitization standards, the proposed standards focused on protecting investors from two major risks: the bankruptcy of the SPV and the bankruptcy of the originator. As to protection from the bankruptcy of the SPV, which the assets has become in its name, a group of researchers suggested some standards to prevent it from voluntary or compulsory bankruptcy. One of these standards is that
its Charter bans it from borrowing – except under specific circumstances provided in the Charter –, merger or engagement in any activity beyond the purpose for which it was established.

With regard to protection from the bankruptcy of the originator, specialists in conventional securitization – particularly from the Common Law perspective – emphasized that the transfer of the assets from the originator to the SPV is carried out via true sale, in which the legal and beneficial ownership are also transferred to the SPV. They also underlined that the SPV should be separate and function on arms-length basis.

With regard to Sukuk standards, researchers’ conclusions are mixed, contrasted and overlapping. Many of them divided Sukuk into asset-backed Sukuk and asset-based Sukuk, asserting that only asset-backed Sukuk can give Sukuk holders the right of recourse to the assets. They presented different structures and instances belonging to each type. One of the applications of Sukuk structures classified by many researchers as coming under asset-backed Sukuk - which represent most of the Sukuk issuances at present - is the Sukuk based on the concept of beneficial ownership, which, according to some, practically underlie most of Sukuk issuances. Researchers attributed that to some reasons, inter alia, taxes and legislations, e.g., because the government prevents foreigners from buying specific types of assets to be securitized or for avoiding costs of registration. The present researcher scrutinized the characterization of all types of beneficial ownership as stated in the Common Law provisions and their compatibility with the concept of ownership in Islamic Shari’ah. He also examined whether Sukuk holders have recourse to the assets upon bankruptcy or default of the originator, and whether they are real owners of the assets so that they can dispose of them, for example, by way of sale, from Islamic Shari’ah and Saudi law perspectives. Further, the researcher investigated whether the Sukuk allegedly based on beneficial ownership was actually based on that concept as expressed in the Common Law. This dissertation stressed that in Islamic Shari’ah, legal registration is not preventive from disposing of the assets, whereas in the Common Law, the real owner has the right to claim legal title from the legal owner so that he can dispose of the assets. It was concluded that, with respect to disposition of assets, Islamic Shari’ah offers more advantages and protection to Sukuk holders than the Common Law. Beneficial ownership, especially in the context of real estate, property and the availability of three elements of ownership in Islamic Shari’ah - which would grant Sukuk holders the right of disposition of
the assets, if applicable – was discussed because the three Sukuk case studies under study did not involve the transfer of legal ownership to Sukuk holders. The documents of these Sukuk provided for the sale of the rights and entitlements to the assets, supposed to be the object of securitization, with the assets remaining in the name of the originators.

The researcher finds that the object of sale and securitization in those three Sukuk is not clearly indicated in the available documents, making it difficult to predict how courts, especially Shari’ah courts, will judge these Sukuk. For, the sale of rights, benefits and entitlements to the assets differs from the sale of the assets themselves, despite their remaining in the seller’s name. However, assuming that the terms "entitlements," "rights" and "benefits" of assets in the Common Law in the context of purchase and sale of real assets indicate that the assets were sold but legal ownership or legal title are not transferred, this dissertation concluded that Sukuk holders’ right of disposition of the assets is established in Islamic Shari’ah and not in the Common Law. Perhaps, the meaning of the characterization of such transactions and resolving ambiguity in the contract can be gained through identifying the purposes of the parties concerned and other items in the transaction.

The researcher also observed a number of items in some of these Sukuk that make the transactions not only incompatible with the provisions of Islamic Shari’ah, but also with the concept of beneficial ownership in the context of property and trust, in which the owners did not obtain legal title. For example, in the event of default, the originator is bound to purchase the assets and the Sukuk holders are bound to sell them only to him under the purchase and sale undertakings/promises committed to by the parties concerned. The ISC Sukuk, which is based on Ijarah contract ending in ownership, did not meet the standards proposed by Sukuk as well as conventional securitization specialists to avoid bankruptcy of the originator. The transaction involved legal irregularities that may affect the validity of the contract underlying the Sukuk.

NFCB Sukuk also violated conventional norms and Shari’ah provisions. In addition, it was based on ‘Inah sale contract forbidden by the majority of Muslim scholars and Shari’ah councils. It contained terms not even approved by those consenting the permission of ‘Inah sale, making it in contravention with the provisions of Islamic Shari’ah and exposing the Sukuk to the risk of invalidation if considered before Shari’ah courts. TID Sukuk,
which is based on Musharakah contract, was the least exposed to the risk of non-compliance with Shari’ah provisions and the most abiding by Shari’ah standards. However, it is no different from the others in terms of departure from conventional securitization standards, as TID kept the assets of the Musharakah contract in its name. Hence, the distinction of each Sukuk case from the others in abiding by the standards recognized by specialists and its inclusion of some items neglected by others indicate the importance of non-generalization of judgements on all Sukuk, and that each case must be investigated separately.

Finally, the most that can be gained from the advantage of the right of recourse to assets or Sukuk holders’ immunity in the event of the originator’s bankruptcy is that the securitized assets will not be included among the originator’s bankruptcy estate, and, as such, the assets they own will be immune to the claims of the originator’s creditors. This is clearly seen in some Sukuk types such as Ijarah and Musharakah Sukuk. As to Murabahah Sukuk, investors in it, when selling the assets on deferred payment to the originator / finance seeker, will enjoy this advantage only if the Sukuk remains in the possession of the finance seeker and has not changed at the time of bankruptcy proceedings. This advantage can also be useful in the event of bankruptcy and not temporary insolvency, and it serves to preserve investors’ capital but not the returns on Sukuk. This underlines the importance of not being content with this advantage and the need to include adequate financial hedges and safeguards in Sukuk to ensure protection of Sukuk holders.

3.4. The evaluation of the obligation of the originator to purchase the securitized assets in the event of his default as a way to deal with default and bankruptcy risks

3.4.1. Introduction

In the chapter on the situation of the three Sukuk under study, we mentioned how credit and bankruptcy risks can possibly occur in three types of Sukuk: Ijarah, Musharakah and Murabahah. Perhaps, in response to these possibilities, the three defaulted Sukuk comprised many undertakings and promises to counter these risks. But, one of those Sukuk included a binding undertaking that could be financially feasible in countering these risks, namely that the defaulter/originator/lessee is obliged to buy the securitized assets, which means acceleration of its maturity date. The Sukuk in which the originator/lessee provided an undertaking to purchase the assets from
the Sukuk holders in case of default is ISB. Its structure provided that the originator (ICB) sells the beneficial interest to the assets to the issuer (ISB). It also stated that both parties separately made a unilateral, irrevocable and unconditional undertaking that ICB shall purchase the assets and its issuer shall sell it to ISB at the Exercise Price, which is enforceable upon default, liquidation or end of the lease term, as referred to earlier when providing information about the three Sukuk. We also mentioned the cases that can be described as default and how the transaction documents expanded the scope of default beyond its commonly recognized meaning so as to include many other cases, including default, even once, on payment of the due installment or coupon.

Here, we will discuss and analyze this item in particular. Then, we will look at its weaknesses, problems it can face and whether it is feasible as a hedge against the risk of default and bankruptcy.

3.4.2. The significance of this undertaking/clause in terms of financial and contractual aspects and the possibility of its generalization

The reason for considering this item in ISB Sukuk, which is based on the lease-to-buy contract, as plausible and in the interest of investors is that it will propel the party that provided the undertaking to pay Sukuk returns, which are in the form of rent, regularly. When the committed lessee realizes that default on paying one due installment or coupon, for example, will cost him the purchase of all of the Sukuk at the nominal value, which practically means the redemption of the securitized assets prior to the maturity fixed date, he will be compel to honor his promise and not to default. This advantage is realized on the assumption that investors are the real owners of the assets and that they have the right to dispose of them, regardless of the rhetoric raised about beneficial owners' rights, which was discussed above in detail in the section on a SPV.

However, this advantage is neither conceivable in NFM Sukuk, which is based on the so-called Murabahah contract, nor in TID Sukuk, which are based on Musharakah contract. In the Sukuk based on Murabahah contract or the sale of ‘Inah, investors and the Sukuk holders do not own assets, because they - or their representatives - sold them to the finance seeker as deferred sale after having owned them at the early stage of the Sukuk.

As for Musharakah Sukuk, being variable income instruments and characterized by the fact that their assets’ manager is presumably not obliged to pay fixed returns to the Sukuk holders, it is inconceivable that the manager
will be obliged to purchase the securitized assets, because those Sukuk does not face the risk of default in relation to returns only. The Sukuk, as explained above, does not guarantee fixed returns at fixed times and does not guarantee investors' capital. However, in case of the manager’s infringement on the assets, he guarantees the investors' capital. Nevertheless, Shari’ah scholars differed regarding guaranteeing the achieved or estimated returns in case of his infringement or negligence.\footnote{See Dr. Hussein H. Hassan, 'Iisdar Alsukuk Bimuraeat Almuqasid Walmalat Wamalkiat Hamlatiha Wadamanatiha 68-70 [A paper presented to the Thirty-Second al-Baraka Symposium on Islamic Economics, held in Jeddah, Saudi Arabia, Aug 10-11, 2011]. (Al-Baraka Banking Group: Manama, Bahrain, 1st ed. 2011).}

3.4.3. Implications of that undertaking on the transaction validation from the Shari'ah perspective

We mentioned in more than one place the relation between Shari’ah non-compliance risk and credit risk and underlined that the revocation of the contract underlying the Sukuk due to the existence of a clause or an item in breach of the Shari’ah will nullify the entire transaction, requiring each party to claim back what it has provided. By revoking the contract, investors will only recover their capital, and thus they will have to give back the returns already paid to them. On the other hand, the other party may not be able to give back the price it had received from the Sukuk holders because it would have spent it on his projects, which will cause harm to investors.

However, we did not find any of the classical Shari’ah scholars or contemporary Shari’ah councils or committees, such as AAIPV and ISFE, who have specifically examined this image. But, the judgment of this case can be gleaned by considering some of the rules and regulations mentioned by scholars and Shari’ah councils. This item included two issues: revocation of the lease contract and engagement in the sale contract upon default. The issue of the contract revocation will be discussed after analyzing the second issue, which may stand in contradiction to the provisions of Islamic Shari’ah for one of two reasons

The first reason is that it can be interpreted as one of transactions that involve a bilateral promise\footnote{AAOIFI states in its Shari’ah Standard No. (49) related to Unilateral and Bilateral Promise: "2/1 For the purpose of this Standard, a unilateral promise is given when a party informs another of its resolute intention (undertaking) to act in the future in the interest of the other, with the other having the option to avail itself of the promise. The party undertaking the promise is called the ‘promisor’, the party receiving the promise is called the ‘promisee’ (the beneficiary of the promise) and the action is called the ‘promised action’. 2/2 Bilateral promise in this Standard refers to the exchange of two backto-back promises between two parties, each promising to perform an act in the future relating to the same subject matter." AAOIFI, supra note 43, at 1164.} made by the parties to the contract, which contravenes the standards and views of Fiqh councils that invalidate binding promises by the two parties, as explained above in the chapter on case studies. In addition, AAOIFI, for example,
does not mention this image among the Guarantees and Treatment of Ijarah Receivables. But, elsewhere it provided that the granting the ownership of a property to the lessee must be recorded in a document separate from the lease contract. Then, it provided that the promise of granting ownership through one of the methods it listed becomes binding when made unilaterally by one party only. The reason for considering this image as based on promises is that the documents included the phrase "undertakings".

On the issue of fulfilling the promise, there are seven opinions, and the majority of Shari’ah scholars are in agreement that fulfilling a promise is recommended and not obligatory. The Hanbalis, the juristic School followed by the Shari’ah courts in Saudi Arabia, adopted the same view. And it was pointed out above that the Saudi Supreme Judicial Council in its permanent Body has issued a judicial ruling that rendered promises as not binding. The other opinion, which is one view attributed to the Hanbali School and the adopted view by Ibn Taymiyah, the influential Hanbali jurist, sees that fulfilling the promise is obligatory. Those who rendered it obligatory differed regarding considering the fulfillment of the promise a religious or legal duty.

The other reason is that the mentioned item, which involves a binding undertaking by the lessee to purchase the assets if he defaults and is met by a binding undertaking by the lessor to sell them, may render the contract as conditional (mu’allaq). When the condition is met, which is the default on payment, the two parties will have to engage in the sale contract. Conditional contracts are forbidden in view of the majority of Shari’ah scholars,

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706 See id. at 246.
707 See id. at 249-50.
708 See THE KUWAIT MINISTRY OF AWQAF AND ISLAMIC AFFAIRS, ALMAWSUEAT ALFAQHIA [ENCYCLOPEDIA OF ISLAMIC JURISPRUDENCE] vol. 44, p. 75 (the Kuwait Ministry of Awqaf and Islamic Affairs, 1404-1427 AH).
709 See id. at 74.
710 See id. at 73-5.
711 The conditional contract is the contract "whose formula does not involve its conclusion or effectiveness immediately after its conclusion, but it indicates by one of the conditional phrases, whether explicit or implicit, the suspension of the creation and enforcement of the contract on the occurrence of a future incident. This is in contrast to the enforceable contract, in which the formula is absolute, and its terms are effective from the time of its conclusion, such as when someone says to another: If I have traveled from this town, you would be my agent in selling my house." Talafha, supra note 124, at 28.
including the widely known opinion of the Hanbalis. Ibn Taymiyyah, in contrast, held it permissible and valid, but under specific rules, such as compliance with the Shari’ah requirements.

The reason why the above image may be characterized as a conditional contract is that some provided that the promise must be separate from the contract. One of the signs of the conditional contract is that it includes a device of condition.

The distinction between these concepts and their meaning in view of Shari’ah scholars needs further analysis and falls outside the focus of the present research. However, in any way, this distinction is insignificant in this context, as the two contracting parties in these cases are exposed to the risk of non-compliance with the Shari'ah, since the majority of jurists invalidated them. This is contrary to the situation when one of them is in favour of one of the contracting parties, which would then require more investigation. In both cases, Sukuk holders are likely to face the risk of non-compliance with Islamic Shari’ah and non-recognition of the item in question. The transaction containing the item may be characterized as a conditional promise, and this image needs further research to arrive at the appropriate Fiqh characterization.

3.4.4. Stipulation / non-stipulation of the revocation of lease contract and sale contract upon default

The court judgement may involve the revocation of the lease (Ijarah) contract between Sukuk holders and the originator upon his default on paying the rent, especially if the revocation is stipulated in the contract. In this case, the revocation of the contract upon default is viewed as rescission of the Ijarah conditional contract. Former judge in Saudi courts, Hani al-Jubair, says in his published paper, "If a property is leased for an immediate rent and the lessee has become insolvent and unable to pay the rent, the lessor has the right to revoke the contract and regain

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714 See Talafha, supra note 124, at 92.
the property. There is no controversy about that."\textsuperscript{715} Then, having related some scholars’ argument in support of his view, he added, "If the lessee procrastinated and did not pay the rent on time despite his affordability to pay, he would be a dilatory solvent. In this case, will the lessor be entitled to revoking the contract or not? Shari’ah scholars differed on this issue and held two opinions."\textsuperscript{716} The first opinion, he said, which is the view of Malikis, the well-known view of the Shafa’is, one view attributed to the Hanafis and the Hanbalis and the view adopted by Ibn Taymiyah, is that the lessor has the right to revoking the contract.\textsuperscript{717} The second opinion, he related, is that procrastination does not warrant revocation, and that is the well-known view of the Hanbalis and one view attributed to the Shafa’is. He recounted the argument of every group and selected the first opinion as the plausible one claiming that it resonates with justice.\textsuperscript{718}

The court judgments that the present researcher has found tend to approve revocation of the Ijarah contract upon the lessor’s request and the lessee's delay to pay the rent, whether or not the contract involved the stipulation of the right of revocation when payment is delayed.\textsuperscript{719}

In the Ijarah standard, AAOIFI has permitted the lessor to stipulate that the contract be revoked if the lessee defaulted on paying the rent.\textsuperscript{720} Standard 54 of the Revocation of Contracts by Exercise of a Cooling-Off Option provided that both parties may stipulate bilateral or unilateral right of revocation in certain cases specified in the contract, provided that they do not contravene Islamic Shari’ah provisions.\textsuperscript{721} But, in the same standard when talking about the applications of stipulated revocation, the standard also stipulated that: "[a] creditor is entitled to stipulate the right, after notifying the debtor, to accelerate all installments and the right to revoke the contract or one of them in the event that the debtor fails to pay two or more installments despite being solvent."\textsuperscript{722}


\textsuperscript{716} Id.

\textsuperscript{717} See Id.

\textsuperscript{718} See Id.


\textsuperscript{720} See AAOIFI, supra note 43, at 249.

\textsuperscript{721} See id. at 1250.

\textsuperscript{722} Id. at 1252-253.
It can be gleaned from this text that if the insolvent lessee defaulted and is unable to pay the rent, the contract will not be revoked, despite the lessor may have stipulated revocation in the event of the lessee’s default.

By analogy, Sukuk based on Murabahah contract or a reverse ‘Inah sale contract, as in NFCB Sukuk, can entitle Sukuk holders to the right of revoking the sale contract if the buyer has defaulted on payment. This means they can claim the assets sold to the originator / finance seeker. To ensure this, the standards and procedures proposed in the previous section of this dissertation should be implemented. However, the problem with the revocation of the sale contract arises when the buyer / originator / obligor sells the assets to a third party for cash, in which case the Sukuk holders will not benefit from the revocation because the sold assets are no longer in his possession.

Revocation of the contract is in the best interest of Sukuk holders when the originator faces financial problems and he defaults on payment or becomes bankrupt and unable to pay. In ISB Sukuk, the lessor investors have the right to revoke the contract with the originator and sell the Sukuk in the market, if they desire, according to Islamic Shari’ah that the Saudi courts follow. If, for example, the Saudi courts were to consider a Sukuk case similar to ISB’s, they would regard the promises - made by the parties concerned obliging themselves to entering into sale and purchase contract upon default - non-binding. As stated above, one of the judicial rules in Saudi courts is that promises are not binding.

In order for investors to get the maximum benefit from the possibility of recourse to the securitized assets and sell them in the market, the standards and procedures proposed in the previous section of this dissertation should be followed. One of those standards concerns the appropriate appraisal of the assets price when purchased by investors from the originator. In some Sukuk structures, assets are sold at a price higher than the fair price so that investors cannot dispose of the assets except by selling them to the originator. The non-binding promises ruled by Saudi courts include the originator who may not desire to buy the assets because of his financial inability.

According to AAOIFI's view, the promise can be binding on one party to the contract while the other party is privileged with the right of option. We mentioned earlier that, based on this opinion, entering into a new contract becomes mandatory when there is a desire to fulfill the promise. In the case the self-obliged party broke the
promise, compensation for the damage caused will be made as stated in the contract, according to what is understood from AAOIFI’s view. In its Shari’ah standard No. 9 on Ijarah and Ijarah ending with ownership (Muntahia Bittamleek), it stated that in the event of the promising party’s renege on his word, the promised party - which AAOIFI assumed to be the institution that bought the assets to lease them to the promising lessee ending with ownership – is entitled to receive "the difference between the cost of the asset intended to be leased and the total lease rentals for the asset which is leased on the basis of Ijarah Muntahia Bittamleek to a third party ...”\(^{723}\)

In its liquidity standard No. 44, it stated that the institution that has leased and sold the assets can make a promise to purchase the assets at the nominal value provided that it is not the manager of those assets.\(^ {724}\) Thus, compensation in the case of lease ending with ownership at the nominal value - typically the purchase price – can be conceived of as close to what AAOIFI mentioned in its standard No. 8 on Murabahah. It stated that the institution from which the assets are promised to be bought has the right to sell the Murabahah goods [or assets] in the market and charge the promising party the difference between the purchase price and the market sale price if the party under binding promise – who has no option to cancel the contract, unlike the institution receiving finance that may opt to cancel the contract, since the binding promise is unilateral, in view of AAOIFI - reneged on his promise to purchase the assets.\(^ {725}\) This is the closest image to ISB Sukuk, if the originator only is obliged to buy the assets at the nominal value. However, the fact is that the binding undertaking was bilateral.

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\(^{723}\) Id. at 239.

\(^{724}\) AAOIFI, in its Shari’ah Standard No. (44) related to Obtaining and Deploying Liquidity, states that one of permissible modes of obtaining liquidity is "[i]ssuing investment Sukuk to expand the institution’s activities This involves issuing the types of investment Sukuk explained in Shari’ah Standard No. (17) on Investment Sukuk in order to obtain funds from Sukuk investors and undertake projects required of the institution. The institution may securitise some of its assets by selling them to Sukuk subscribers, managing the assets on their behalf and promising to purchase them at the market price or at a price to be agreed. If the institution is only the lessee and not the manager of the Sukuk assets, it may promise to purchase them at face value." Id. at 1090.

\(^{725}\) AAOIFI, in its Shari’ah Standard No. (8) related to Murabahah, states: "4/1 It is not permitted for the Institution to consider that the contract of Murabaha is automatically concluded by its mere taking possession of the asset. Likewise, the Institution may not force a customer who is the purchase orderer to take delivery of the asset and pay the Murabahah selling price, if the customer refuses to conclude the Murabahah transaction. 4/2 The Institution is entitled to receive compensation for any actual damage it has incurred as a result of the customer’s breach of a binding promise. The compensation consists of the customer reimbursing the Institution for any loss due to a difference between the price received by the Institution in selling the asset to a third party and the original cost price paid by the Institution to the supplier." Id. at 220.
3.4.5. Adequacy of this method as a way of dealing with default risk and level of its power

Although the stipulation of this item can be useful in prompting the lessee/obligor to meet his payment obligations towards the other party, it is not considered adequate for some reasons. The obliged party may be keen on payment, but he is crippled by his financial situation. The best that the item can offer is that the two parties to the Sukuk will engage in a contract of selling the assets to execute that item. However, there is no guarantee that the originator will be able to repurchase the assets from Sukuk holders while he has failed to commit to the periodic payments - which are lower than the price of repurchase binding to him under the sale and purchase undertakings – due to his insolvency. The originator may face a worse situation, i.e. declaration of his voluntarily or compulsory bankruptcy, in which case investors may not be able to regain their dues.

Hedges or procedures of dealing with credit risk can take different forms. Some of them spur the obligor to meet his financial obligations to avoid further repercussions, as pointed out above, while others ensure investors’ regaining of their capital, even if the originator went insolvent or deliberately delayed payment despite his affordability.

The second reason is the possibility that this item presented as guarantee is in conflict with the plausible view of the majority of Shari’ah scholars and Fiqh councils, if interpreted as making bilateral promises by the two parties. In addition, it can also be contrary to the view of the majority of Shari’ah scholars, if characterized a conditional contract.

The third reason is that this item, assumingly valid, can be conceivable only in some types of Sukuk such as Ijarah Sukuk, while it cannot be conceived in the Murabahah or Musharakah Sukuk. For, in Murabahah Sukuk, ownership of the assets would have been transferred to the finance seeker, and there is a possibility that he has later sold them for cash. On the other hand, Musharakah is not one of the fixed-income instruments, since the originator is not obliged to pay a fixed sum as in Ijarah and Murabahah Sukuk, although the originator in Musharakah Sukuk – in case he is the Sukuk manager - is obliged to guarantee investors’ capital in the event of his negligence or infringement. As such, the application of this item in Ijarah Sukuk cannot be analogized to Murabahah and Musharakah Sukuk.
However, if we consider that the contract also involves the right of the lessor/Sukuk holders to revoke the lease contract upon default, they are still invested with some advantages, inter alia, the possibility of selling the assets in the market following the contract revocation, especially when the standards proposed in the previous section are taken into consideration. However, the rule is that the lessor has the right to sell his leased asset at any time, in view of the majority of Shari’ah scholars including the Hanbalis, though the Hanbalis approved the right of the buyer to consent or revoke the contract in case he was not informed that the property was leased. In contrast, the Hanafis suspended the validity of the contract to the lessee's consent. According to AAOIFI, revocation of the sale contract may be suspended to default, which will enable Sukuk holders to recover the assets, especially if they remain in the possession of the on credit buyer who has defaulted on payment. The problem in some Sukuk, such as ISB’s, is that the contract underlying them included a bilateral binding undertaking by the parties that the assets are sold to the lessee only. Meanwhile, Saudi courts will consider promises stipulating future contracts as non-binding, as mentioned above.

3.4.6. Conclusion

The contract underlying ISB Sukuk included an item whose Shari’ah characterization and judgement were controversial among Fiqh scholars, even though it is meant to prompt the obligor to fulfill his obligations and avoid further repercussions. The item involved binding, unconditional and irrevocable undertakings, inter alia, if the lessee / originator defaults, he will be obliged to purchase the securitized assets leased to him, and the Sukuk holders are obliged to sell them to him exclusively. This item ensured the right of Sukuk holders as lessors to revoke the lease contract upon the lessee’s default. This is well-established in the viewpoint of Saudi law, which is based on Islamic Shari’ah, and not from AAOIFI perspective. However, Shari’ah scholars are not in agreement regarding the characterization and ruling of the obligation of the lessee to purchase the securitized assets. In case this obligation was considered bilateral undertakings by both parties to enter into a sale contract, it would stand in conflict with the AAOIFI and IIFA view that on-credit approves the unilateral promise. Moreover, one of the

726 See AL-MORSHEDI, supra note 106, at 117.
727 See Id.
rules established in Saudi courts is that promises of future contracts are not binding to fulfill. Should the case be characterized as a conditional contract, it would be prohibited in view of the majority of Shari’ah scholars, which corresponds to the well-known view of the Hanbalis. The case may also be characterized as a conditional promise. If the default on Sukuk occurred in Saudi Arabia or was Islamic Shari’ah the governing law, the Sukuk holders would have the right to revoke the contract and sell the assets in the market to recover their capital. The present researcher did not clearly find out the method of dealing with issues involving binding promises made by two parties from the perspective of AAOIFI and others who approve unilateral promises. As for the adequacy of this item as a guarantee or option to deal with credit or bankruptcy risks, the researcher believes that it is inadequate, although it may propel the obligor or the lessee, especially who is solvent, to meet his obligations. Although this item can be regarded as contrary to Islamic Shari’ah, the lessee is in arrears in paying the periodic installments, how will he pay the capital of investors or an approximate sum? The lessee may be willing to pay, but he may experience a financial crisis or be declared bankrupt. In addition, this item can be envisaged when applied in some types of Ijarah Sukuk, as in one of the cases under study, while it is not envisaged in Murabahah and Musharakah Sukuk. Thus, even on the assumption that this item was in accordance with Islamic Shari’ah, investors should hedge against credit or bankruptcy risks by adopting further guarantees. At the same time, the wording of this item needs more revision to comply with Islamic Shari'ah provisions.
Chapter 4: Reinforcing Propositions and Solutions to Deal with Default and Bankruptcy Risks in Sukuk Structures Based on Contracts as those of the three Cases under Study

4.1. Introduction

In the previous chapter, we evaluated and developed the guarantees and hedges provided to holders of the three defaulted Sukuk cases, highlighted the obstacles and points of strength and weaknesses in them and underlined the ineffectiveness of some guarantees and the inadequacy of others in protecting Sukuk investors, even after amending and reforming them. This chapter proposes some direct and indirect solutions and protective procedures conforming to Islamic Shari’ah to deal with the above risks. Some of these solutions are already employed outside of Sukuk markets, aiming to reassure investors with different interests and elevating Islamic capital and debt markets.

One of the objectives of the above propositions is to enable prominent investors in Sukuk markets, especially capital-seekers, to select solutions commensurate with their financial position or legal setting that may not approve of some of the proposed solutions. In addition, the inclusion of various financial hedges and precautionary procedures combined with financial guarantees provided to defaulted Sukuk holders, for example, will boost investors’ confidence, given that some institutions and governments seeking finance do not get a high rating from credit rating agencies or do not desire to get it, calling for further guarantees against credit and bankruptcy risks in order to attract investors. This is likely to lead to reduction in the financing cost or the return margin thanks to the low credit and bankruptcy risks. Besides, some solutions have been developed to facilitate debt restructuring, which is in the interest of the parties involved. Another objective of the above propositions is to contribute to reducing the negative effects of default, which affect Sukuk holders more than their counterparts in bonds, as described in the chapter on the research issue.

Other proposed reinforcing solutions involve acceleration of deferred installments upon the default of the obligor in Sukuk; compensation for Sukuk holders for damages caused; charging late payment fees spent in philanthropic causes; development of debt and capital markets; guarantorship; the engagement of Sukuk holders -as purchaser- and the obligor in Sukuk -as seller- in Salam contract and making the debt owed by the originator
as price whose the purchaser is supposed pay in this contract; and raising the return margin higher than the return margin in the market, with a stipulation to reducing it to be commensurate with the return margin in the market provided that the obligor remains committed to payment. Those propositions will be discussed and analyzed later, underlining their obstacles and hindrances and examining their adequacy and applicability to the three Sukuk types under study.

**4.2. Prematurity of delayed debts when the obliged originator defaults on payment on time**

**4.2.1. Introduction**

One of the items that may be included in the Sukuk transactions to propel the originator’s payment is the stipulation by Sukuk holders’ representative that the delayed returns payable by the obligor fall due upon his default. This measure can be considered as a means of minimizing the risk of delay or default on payment. This section will discuss the importance of this item as a hedge against the risk of default, its legitimacy, effects, scope of work, adequacy to deal with credit and bankruptcy risks and its points of weaknesses.

**4.2.2. The importance of Sukuk’s inclusion of this item, with no rigor in its application**

The inclusion of this item in the transaction documents accomplishes certain purposes and aims. It propels the obligor or originator – for example, a credit buyer or lessee - to fulfill their obligation to pay and eliminates procrastination, making it an effective means of dealing with the risk of default. However, it is recommended that the obligor be granted a respite, once or twice, in the event of his default. In other words, the contract stipulates, for example, that in case the obligor defaults on more than two consecutive installments, all installments or payments will become payable immediately. In the Murabahah Sukuk in particular, if the Sukuk structure included this item, the amortization amount will also be payable, which is typically equivalent to the purchase price of the commodity or the asset sold to him on credit at the same price plus mark-up profit. The reason for granting the obligor flexibility in payment is to reassure finance seekers who may become reluctant to deal in Sukuk as a financing instrument fearing the rigorous measures in this term.

It should also be noted that from the perspective of Islamic Shari’ah all installments and scheduled debts become payable – even when not stipulated in the contract - upon the debtor’s or obligor’s bankruptcy. This
corresponds to the view of AAOIFI, which stated that creditors of the deferred debts do not have the right to claim bankruptcy of the debtor, but they share the bankruptcy estate with the creditors of current debt.\textsuperscript{728} This also conforms to the opinion of IIFA.\textsuperscript{729}

4.2.3. Compliance of this item with Islamic Shari’ah and scope of its work

Saif al-Saif says that Shari’ah scholars see that clearing the debt when solvency is obligatory,\textsuperscript{730} Perhaps he means the time of the debt maturity. He says that the deferred debt does not have to be paid off before the time of its maturity.\textsuperscript{731}

Here, we point out to the conflict among jurists is typically related to some of the debt instruments, such as loan: are they deferrable? Or, they inevitably fall due on the maturity date, even if the creditor has deferred them. However, al-Saif states that if the debt is spread over periodic installments payable at certain dates and the debtor defaults on paying one of the installments, the default is dealt with in view of one of two situations.\textsuperscript{732} The first is that there is no stipulation in the contract requiring the prematurity of all installments, in which case the rest of the installments will not fall due, even if the debtor is in default.\textsuperscript{733} The second situation is that there is a stipulation in the contract requiring the prematurity of all installments upon the default. This latter situation involves two cases.\textsuperscript{734} The first is that the defaulter is insolvent and unable to pay, which warrants granting him a respite.\textsuperscript{735} But the insolvency plaintiff must prove his insolvency to the court so that it declares him insolvent. In addition, insolvency cases involve complicated procedures causing prolongation.\textsuperscript{736}

The second case is that the defaulter is procrastinating solvent, or his insolvency is not verified. This case gives rise to some juristic contestation. One opinion allowed the stipulation of prematurity of all installments in case of

\begin{thebibliography}{10}
\bibitem{728} AAOIFI, in its Shari’ah Standard No (43) related to Insolvency, states: "5/5/1 All of the debtor’s undue debts become due despite the creditors of such undue debts having no present right to demand a declaration of his insolvency. The creditors of undue debts are entitled to share the sequestered assets with the creditors of due debts." AAOIFI, \textit{supra} note 43, at 1069.
\bibitem{729} IIFA, in its Resolution No (64) concerning Installment Sale, states: "Sixth: If a debt falls due because of the death, bankruptcy or procrastination of the debtor, it may be reduced in all these cases in order to speed up the coming to terms." \textit{See} IIFA, \textit{supra} note 83, at 136.
\bibitem{730} \textit{See} \textit{id.}
\bibitem{731} \textit{See id.}
\bibitem{732} \textit{See id.}
\bibitem{733} \textit{See id.}
\bibitem{734} \textit{See id.}
\bibitem{735} \textit{See id.}
\bibitem{736} \textit{See id.} at 14.
\end{thebibliography}
default, while others approved it but under some conditions. For instance, AAOIFI has approved that term in deferred sale contracts, Murabahah contracts and lease contracts under specific conditions, such as when the default occurred without a plausible excuse. Further, IIFA approved that term provided that the debtor is not insolvent. This term has been endorsed by some Saudi courts in some cases outside of Sukuk field. The second opinion, which is supported by the Permanent Committee for Scholarly Research and Fatwas in Saudi Arabia, did not approve that stipulation. Some judges in the Saudi courts rendered this term void despite the validity of the contract. Each opinion provided its evidence, but relating and discussing the evidences fall outside the focus of the present research, as the researcher's opinion will not resolve this debate.

However, it is worthy noting that judges in Saudi Arabia revoked the term and did not endorse it, but they did not revoke the contract, following the view of the Hanbali scholars in their flexibility in financial transactions compared to other juristic schools that may invalidate the contract altogether consequential to the invalidation of the term. It is also noted that judges supporting the other opinion approved that term compared to other Fiqh

737 AAOIFI, in its Shari’ah Standard No (5) related to Guarantees, states "5/1 Bringing forward future instalments in case of default on payment: It is permissible to include a term in a debt contract to the effect that, if the debtor defaults on the payment of one or more instalments, some or all of the future instalments shall fall due immediately, provided the default was not caused by unforeseeable intervening events or force majeure. However, this term shall not be effective until the debtor has been served with a reminder notice and after a reasonable period of time has elapsed." AAOIFI supra note 43, at 129.

738 AAOIFI, in its Shari’ah Standard No (8) related to Murabahah, states: "5/1 It is permissible for the Institution to stipulate to the customer that instalments may become due before their originally agreed due dates in case of the customer’s refusal or delay in paying any instalment without any valid reason after the lapse of the time specified in the notice to be sent by the Institution to the customer within a reasonable period of time following the due date." Id. at 212.

739 AAOIFI, in its Shari’ah Standard No (9) related to Ijarah a and Ijarah Muntahia Bitumlek, states: "6/2 The two parties may agree that the rental be paid fully in advance. It is also permissible to make the rent payable in instalments, in which case the lessor may stipulate that the lessee should immediately pay the remaining instalments if he, after receiving a specified period of due notice, delays, without a valid reason, payment of one instalment or more, provided that the asset shall be made available for the lessee to use for the remaining period of time. Any stipulated upfront rental or accelerated -because of delay of payment- rental is subject to settlement at the end of the Ijarah period or, if the Ijarah contract is terminated earlier, at the time of such termination." Id. at 246.

740 IIFA, in its Resolution No (64) concerning Installment Sale, states "Fifth: It is permissible for the two parties to a debt to agree on the fact that all installments shall be due for payment if the debtor refuses to repay any one of the installments owned by him, as long as he is not insolvent." IIFA, supra note 83, at 136.


schools that restrict the inclusion of stipulations in the contract. Hanbali scholars, especially Ibn Taymiyah and Ibn al-Qayyim, are considered among the most flexible in relation to financial transactions.

4.2.4. Adequacy of this guarantee in Sukuk and the level of its power

This item is significant in terms of prompting the debtor and the obligor not to default on payment and to regularly keep paying his installments on time – be they in the form of rent or the purchase price in credit sale - fearing the negative consequences, i.e. premature payment of all installments. But, this guarantee or method of dealing with default risk is not adequate for some Shari’ah, legal and financial considerations.

The first consideration is the non-consensus among Shari’ah scholars regarding the validity of this term; some judges, for example, in Saudi courts rendered it invalid without invalidating the contract itself, while other judges approved the term.

The second consideration is that it can not be generalized to the three Sukuk cases under study; it can only be applied in Murabahah and Ijarah Sukuk in question. For example, the parties to the TID Sukuk could not stipulate that term as they are based on a variable-income Musharakah contract in which the originator is not committed to pay a fixed amount throughout the Sukuk period.

The third consideration is that some of those who approved the item see that the increase in the price or profits vis-à-vis the deferred installments or against time should be deducted.744 as those profits are in return for a maturity date that has not fallen due yet. This will put Sukuk holders at disadvantage, as they will lose a percentage of the returns, especially if the profit margin is high. Apparently, AAOIFI's view, as stated above, is that the deferred installments should not be deducted if they have become payable under that term. This view was given without elaboration. The IIFA, in contrast, concluded that if the debt, for example, has become payable – for instance, because of the debtor’s procrastination - it is permissible to reduce the amount of the debt by mutual consent to speed up payment.745 For, the increase is warranted against the delay in the payment. When investors

745 IIFA, in its Resolution No (64) concerning Installment Sale, states: "[i]f a debt falls due because of the death, bankruptcy or procrastination of the debtor, it may be reduced in all these cases in order to speed up the coming to terms." IIFA, supra note 83, at 136.
know that the competent court will take this standard into consideration or there is a possibility to effectuate it, they may not tend to implement this item seeking the full profits, even if there was a delay in payment. There are some judgments issued by Saudi courts obliging the debtor defaulting on one installment to pay the full installments without deducting the profits of the deferred installments, and the contract comprised the stipulation of payment of full installments in case of default.\textsuperscript{746}

The fourth consideration is that this term applies to the solvent procrastinating debtor, as stated above and not to the insolvent, although the legal verification of insolvency requires specific procedures and conditions that may not apply to the insolvency petitioner.

The fifth consideration is that it is highly possible that the obligor will not be able to pay the full installments. When a debtor experiences a financial crisis or faces bankruptcy preventing him to pay one of the due installments, he is not likely to pay the rest of deferred installments, while he has defaulted on paying one installment? As such, this item is more useful for protecting against solvent defaulters.

The sixth consideration is that this item, taking into account the above, can be useful to ensure the continuity of the obligor’s full of payment of the Sukuk returns in the medium and advanced stages of the Sukuk period. However, this advantage will cease upon amortization and redemption. The Sukuk obligor may fear the consequences of his default on payment at the beginning of the Sukuk period, which will prompt him to pay the entire undue installments and propel him to commit to payment. In the period of amortization or redemption, in which the obligor typically pays the largest sum of the dues to the Sukuk holder, this item has a minor advantage because the amount of amortization would have been paid without this term, tempting the obligor to delay the payment.

\textsuperscript{746} See \textsc{Saudi Arabian Ministry of Justice}, supra note 741, at vol. 1, p. 129.
4.3. Compensating the Sukuk holders for the delay in paying the returns or fining the obliged originator for default

4.3.1. Introduction

Of the principles and rules in Islamic financial transactions is to prevent injustice. For this reason, giving or accepting usury (riba) is prohibited, whether agreed at the outset of the contract or at the end of the term, even if mutually consented by the parties. In this view, Islamic banks have developed some Shari’ah-compliant financial alternatives which, for example, does not involve usurious interest. Usury, be it in debts or sale, is categorically prohibited, and all Shari’ah late and present scholars as well as contemporary Fiqh councils unanimously emphasized its prohibition.

However, few Fiqh councils and contemporary Shari’ah scholars have proposed two options or remedies that are controversial. Some contemporary jurists approved - under specific standards - the obligation of the solvent debtor to compensate the creditor for the delay in payment. Other contemporary jurists and Fiqh councils have approved the imposition of a fine on the debtor that can be spent on philanthropic purposes, but the creditor cannot benefit from it, as will be indicated later.

In this section, the significance of these two options will be addressed as a remedy for the risk of default, their legitimacy, their adequacy and their effectiveness.

In line with the focus of the present research, there will be no elaboration on the views regarding each option or discussion of its evidence, be that from the perspective of contending scholars or from the perspective of the present researcher in relation to their legitimacy. We shall be concerned with recounting the relevant views of contemporary Fiqh councils, the judgements issued by Saudi courts – given that these two options have attracted scholars’ interest and attention –, the types of debtors this compensation applies to (in view of those who approved it) and whether Shari’ah principles and views of the early jurists of the four schools of Fiqh had explicitly or implicitly had endorsed the debtor’ obligation to compensate the creditor in particular, regardless of the designation, as it involves usurious interest. It is worth noting here that the majority of scholars of the four Fiqh schools lay restrictions on financial sanctions.
4.3.2. Obligating the solvent debtor to compensate the creditor for delay damages

4.3.2.1. Significance of this remedy in dealing with credit and bankruptcy risk in Sukuk

From a purely financial perspective, this remedy is very effective in dealing with credit risk and compensating investors and Sukuk holders for losing the opportunity and mark-up by reinvesting their capital if they have been able to reclaim their money. When the debtor/originator knows that the creditors will claim financial compensation in return for damages arising as a result of the late payment of the coupons and debts, he will be more punctual in payment than when knowing that creditors are not entitled to claim such compensation.

4.3.2.2. Compliance of this remedial option with Shari’ah and the scope of its work in view of its proponents

Dr. Salman al-Dakhil, in his paper "Compensation for Damages Caused by Delay in Debts", having mentioned the conditions of financial compensation - presumably proposed by those approving the principle of financial compensation, as conceived from the context – stated that all contemporary jurists, including the proponents of financial compensation, agreed on the following:

- The insolvent debtor may not be obliged to pay compensation for the delay in fulfilling his financial obligations, because the insolvent is entitled to a respite, and the obligation to pay compensation is contrary to that concession prescribed by Shari'ah.747

- Invalidity of stipulating financial compensation for the delay in the payment of debt and the determination of a certain percentage or fixed amount in the contract for that, because this is an image of the pre-Islamic usury (riba).748

- Exclusion of deterrent financial penalties fixed by the ruler as he deems fit, which will go to public treasury and be spent in the public interest of Muslims, because the money collected in this case comes by means of deterrence (zawaajir) and penalty and not personal compensation (jawaabir).749

748 See id.
749 See id.
With regard to the obligation of the procrastinating solvent debtor to pay financial compensation unstipulated in the contract, Fiqh scholars held two opinions. The first is that it is not permissible to pay compensation in the event of delaying the debt payment. Following this view, most Fiqh councils, including AAOIFI, IIFA and the majority of contemporary Fiqh scholars, have prohibited this compensation and considered it as *riba*, which is essentially forbidden by all. They also prohibited the stipulation of a fixed percentage as compensation in the contract. Saudi courts have adhered to this view, as will be shown below.

The second opinion is that financial compensation unstated in the contract may be valid in principle, but its proponents disagreed whether this compensation is a kind of deterrent penalty or a personal financial compensation for the damage caused. Dispute over the characterization has given rise to differences in some aspects, such as method of determining the compensation, who has the authority to apply it and beneficiaries from it. Among the proponents of this view is the Shari’ah Advisory Council of Bank Negara Malaysia, which issues several decisions endorsing compensation under certain conditions, such as the compensation sum is not in excess of the principal amount of the debt. However, these decisions do not distinguish between the solvent and the insolvent debtor, as appears from the inclusion of the insolvent debtor in the compensation lawsuits, which is in conflict with the consensus of contemporary jurists – as mentioned earlier - including those approving compensation and excluding the insolvent debtor from compensation.

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750 AAOIFI, in its Shari’ah Standard No (3) related to Procrastinating Debtor, states: "2/1/2 It is not permitted to stipulate any financial compensation, either in cash or in other consideration, as a penalty clause in respect of a delay by a debtor in settling his debt, whether or not the amount of such compensation is pre-determined; this applies both to compensation in respect of loss of income (opportunity loss) and in respect of a loss due to a change in the value of the currency of the debt. 2/1/3 It is not permitted to make a judicial demand on a debtor in default to pay financial compensation, in the form either of cash or of other consideration, for a delay in settling his debt." AAOIFI, supra note 43, at 88.  
751 IIFA, in its Resolution No (51) concerning Sales on Installments, states: "Third: If the buyer/debtor delays the payment of installments after the specified date, it is not permissible to charge any amount in addition to his principal liability, whether it is made a pre-condition in the contract or it is claimed without a previous agreement, because it is "*Riba*", hence prohibited in Shari'a. Fourth: It is prohibited (Haram) for a solvent debtor to delay the payment of the installments from their due dates. However, it is not permissible in Shari'a to impose a compensation in case he delays the payment." IIFA, supra note 83, at 104.  
752 See al-Dakhil, supra note 747.  
753 See id.  
754 See id.  
755 See SHARIAH ADVISORY COUNCIL OF BANK NEGARA MALAYSIA, supra note 252, at 129, 133-34.
4.3.2.3. Adequacy of financial compensation as a means of dealing with credit and bankruptcy risks

Despite that this remedial option, from a purely economic and legal perspective, will propel the Sukuk originator - who is obliged based on the nature of the contract underlying the Sukuk, especially Murabahah and Ijarah Sukuk - to pay the Sukuk holders the returns throughout the Sukuk period as well as the amortization amount to avoid damage compensation claimed due to the delay, it is not applicable at all Sukuk stages in the Musharakah Sukuk ending with ownership of the assets by the originator. It can be applicable in case of delay in paying the amount of amortization, which materializes in the originator’s purchase of the assets, if he undertook to re-purchase them and the two parties have engaged in a repurchase agreement but the buyer defaulted on payment. This is particularly in view of those rendering the promises as binding. The contract underlying the Musharakah Sukuk is of a type that does not guarantee to the Sukuk holders, who are theoretically partners of the originator, any fixed returns in compliance with Islamic Shari’ah.

Compensation can be an effective remedy to deal with the risk of the originator's default if he is solvent and capable. But, in cases of bankruptcy, the situation will be unclear, as the insolvent company's assets may not be equivalent to the principal amount of the debt let alone compensation for the late payment damage. Thus, this option would not be useful if the debtor was insolvent. In the view of those approving compensation, they excluded insolvent debtors from the compensation claims.

From the Shari’ah perspective, this remedial option will likely be considered in breach of Islamic Shari’ah principles, especially in Saudi Arabia, whose courts adopt the Hanbali school of Fiqh in general. Compensation may be made in one of two ways, each is promoted by a group of contemporary jurists, though relatively few. The first is by stipulating it in the contract without specifying a fixed percentage. This is the most contentious in terms of materializing the risk of breaching the Shari’ah provisions. The second is the non-stipulation in the contract, in which case creditors would claim compensation for the actual damage or mark-up loss due to delay of payment. The researcher has pointed out above that the majority of contemporary Fiqh councils and contemporary jurists support the prohibition of compensation, irrespective of it stipulation in the
contract, because it is considered as usury. As such, this remedial option is often abandoned by the Shari’ah courts and arbitrators adopting Islamic law, be the compensation for the mere delay, actual damage or loss of mark-up.

More serious, however, is the stipulation of compensation in the contract underlying the Sukuk, even without specifying a fixed percentage, as this stipulation may cause the revocation of the contract. Dr. Muhammad Shbeir says that the forbidden item that contradicts the Shari’ah provisions, by breeching the principles of the Qur’an or the Sunnah, such as a condition involving usury and uncertainty (gharar), revokes the contract as maintained by the majority of Hanafi, Maliki, Shaafa’i, Hanbali and Dhahiri Shari’ah scholars.\(^ {756} \) He added that Ibn Taymiyah [generally one of the Hanbali prominent scholars] sees that the person making a stipulation either knows that it is forbidden, where the contract would be valid [and accordingly binding] while the stipulation is rendered as void, or he is unaware that it is prohibited, in which case he would have the option: either to relinquish the stipulation and the contract would be valid, or to rescind the contract.\(^ {757} \)

When the competent Shari’ah courts renders the compensation as riba, the contract may be revoked by this stipulation, meaning the overturning of all effects created under the contract; the seller reclaims the assets and the buyer reclaims the price. If this provision were to be applied to some Sukuk types that create indebtedness, investors would lose the Sukuk returns, although they would be entitled to a rent of the like (‘Ujrat al-mithl) in return for the originator’s or obligor’s use of the assets as a buyer or a lessee. On the other hand, based on the above, it is assumed that the assets transferred to the originator by way of invalid sale will not be included in the originator’s total bankruptcy estate, if he is declared bankrupt.

In the Saudi Arabian courts, though they do not adopt the legal precedents law, it is useful to refer to a case involving a similar stipulation in a sale contract. The plaintiff in that case sold to the buyer a batch of wood on credit described in the lawsuit and stipulated that if the buyer is late in payment, he will pay SR 2,000 per month in fine. Accordingly, the plaintiff required the court to oblige the defendant to pay the late payment fine as stipulated in the contract. The Court of First Instance dismissed the plaintiff’s request, ruling that the stipulated

\(^ {756} \) See Shbeir, supra note 122, at 104.

\(^ {757} \) See id.
provision was not valid in Shari’ah, and the judgment was later confirmed by the Court of Appeal.\footnote{See Saudi Arabian Ministry of Justice, Majmoeat Al’Ahkam AlQadaiyyat Lijam 1434 [Group of Judgments for 1434 AH] vol. 3, p. 25-6 (Ministry of Justice, Riyadh, Saudi Arabia, 1436 AH). Available from: https://www.moj.gov.sa/ar-sa/ministry/versions/Documents/AhkamGroup_1434/1.pdf (accessed on 5th January 2019).} Here, the stipulation was revoked because it was contrary to Islamic Shari’ah, but the contract remained valid. It may be claimed that the reason for disregarding the stipulation is the provision of a fixed amount of the fine in the contract. However, another judgement from another court rejected the plaintiff’s compensation claim for the damage caused by the defendant’s delay in payment, considering compensation as usury.\footnote{See The Saudi Arabian Board of Grievances, supra note 743, at 268.} Further, there is also another provision that did not take into consideration the loss of mark-up profit.\footnote{See id. at 1989.}

But, from a purely legal point of view and from the Shari’ah perspective, it is in the best interest of investors who support the legitimacy of this stipulation, following jurists approving it, not to stipulate that in the contract lest it would jeopardize the contract. Instead, they may seek compensation for damages caused by the debtor’s late payment. The present researcher sees that this stipulation is definitely contrary to Islamic Shari’ah as it involves usury prohibited by Shari’ah. In addition, the stipulation of compensation in the Sukuk contract may tarnish the reputation of Islamic financial products among investors who are keen to comply with the provisions of Islamic Shari’ah.

4.3.3. Imposition of a fine on the debtor to be spent in public interest

4.3.3.1. Significance of this proposition in dealing with credit and bankruptcy risks in Sukuk

The imposition of a late payment fine, although it will not be paid to the Sukuk holders, is one of the consequences that the debtor would be keen to avoid by paying the Sukuk returns and the amortization amount in time. For example, when Murabahah-based Sukuk holders stipulate that the finance seeker will be liable for to pay a fine to one of the charitable organizations in the event of his late payment, he will most likely be prompted to keep his payments in time to avoid the fine.
4.3.3.2. Compliance of the fine with Islamic Shari‘ah and scope of its work

With regard to the Fiqh ruling of stipulating such a fine and donating it to charitable organizations, contemporary Shari’ah councils held two opinions. AAOIFI, in more than one place, approved the inclusion of a stipulation in the contract obliging the procrastinating debtor to make a donation to a charitable organization not affiliated with him or with the creditors. This is stated in the standard related to the procrastinating debtor,\textsuperscript{761} the Murabahah\textsuperscript{762} and Ijarah\textsuperscript{763} standards. However, its provisions were not precise and clear as to whether the fine includes the insolvent or bankrupt debtor and the debtor who has a valid excuse, or it only applies to the solvent or the late debtor without good reason. In the third standard related to procrastinating debtor, AAOIFI, when addressing the scope of this standard, stated that it is intended to deal only with the procrastinating debtor and not with the insolvent or bankrupt debtor. Then, it defined the procrastinating debtor in the Appendix relevant to this standard as: "[a] debtor who is solvent but refuses to pay a debt that is due, without any legitimate reason, after receiving the normal demand for payment."\textsuperscript{764}

In this standard, an example of the debtor who had procrastinated in the Murabahah contract was provided. In the eighth standard related to Murabahah, AAOIFI, whether in the Arabic or English version, did not give much details but it stated that it is permissible to stipulate in the Murabahah contract the commitment of the buyer to pay a fixed amount or percentage of the debt if he defaults on payment. This amount is to be spent in charitable purposes. In the ninth standard on Ijarah, the Arabic version did not specify whether the lessee is insolvent or solvent, or whether the delay is with or without a valid excuse, but it described him as a procrastinator.\textsuperscript{765} However, in the English version, AAOIFI stated that the contract may comprise the obligation of the lessee who

\textsuperscript{761} AAOIFI, in its Shari‘ah Standard No (3) related to Procrastinating Debtor, states: "2/1/8 It is permissible in contracts involving indebtedness (such as Murabahah) to stipulate an undertaking by the debtor, that in case of procrastinating in payment, the latter will donate an amount or a percentage of the debt to be spent for charitable causes through the Institution." AAOIFI, supra note 43, at 89.

\textsuperscript{762} AAOIFI, in its Shari‘ah Standard No (8) related to Murabahah, states: "5/6 It is permissible that the contract of Murabahah consists of an undertaking from the customer to pay an amount of money or a percentage of the debt, on the basis of undertaking to donate it in the event of a delay on his part in paying instalments on their due date. The Shari‘ah Supervisory Board of the Institution must have full knowledge that any such amount is indeed spent on charitable causes, and not for the benefit of the Institution itself." Id. at 214.

\textsuperscript{763} AAOIFI, in its Shari‘ah Standard No (9) related to Ijarah and Ijarah Muntahia Bittamleek, states: "6/4 It may be provided in the contract of Ijarah or Ijarah Muntahia Bittamleek that a lessee who delays payment for no good reason undertakes to donate a certain amount or percentage of the rental due in case of late payment. Such donation should be paid to charitable causes under the co-ordination of the Institution's Shari‘ah Supervisory Board." Id. at 246.

\textsuperscript{764} Id. at 101

\textsuperscript{765} See AAOIFI, supra note 85, at 250.
delayed payment without a valid reason to make a donation to charitable organizations. 766 Now, by juxtaposing these texts, it can be conceived that they refer to the solvent or procrastinating debtor who has no valid reason for delay.

One of the parties that approved the contract’s inclusion of a fine on the debtor to be spent in charitable purposes without distinguishing between solvent or insolvent debtors is the Shari’ah Advisory Council of Bank Negara Malaysia in Malaysia. 767 The same view was also adopted by some Shari'ah committees for banks in Saudi Arabia provided that the debtor is not insolvent. Dr. Salman S. Al-Dakhil attributed a statement to some researchers saying that some creditors, due to the difficulty of verifying debtors’ solvency or insolvency - especially in banks dealing with thousands of clients - circumvent this stipulation (the debtor being insolvent) by including an alternative stipulation in the contract that the debtor is regarded as solvent and treated accordingly unless he is legally declared bankrupt, which is a rare case, thus they can claim compensation [or a fine], though the debtor is in fact insolvent. 768

In contrast, IIFA disapproved the imposition of any extra sums on the debtor, considering that any increment is usury. 769 Saudi courts are likely to view the fine as in conflict with Islamic Shari’ah. Dr. Salman Al-Dakhil, quoted Dr. Ahmad Fahmi Abu Sinna, as saying that fining the debtor is an innovative penalty based on reason and in contradiction with the consensus of jurists prohibiting it. 770 It is generally established that consensus is one of the fundamentals of legislation in Islamic Shari’ah.

4.3.3.3. Adequacy of fine to deal with credit and bankruptcy risks

With respect to the effectiveness of fine as a measure to deal with credit risk, what was said in compensation above applies here too. However, fine is ranked in a lower position, because it does not go directly to the creditors or Sukuk holders, but it is spent in charitable purposes. Also, in consideration of the shortcomings and limitations,

766 See AAOIFI, supra note 43, at 246.
767 See SHARIAH ADVISORY COUNCIL OF BANK NEGARA MALAYSIA, supra note 252, at 129, 133-34.
768 See al-Dakhil, supra note 747.
769 IIFA, in its Resolution No (51) Concerning 'Sales on Installments', states: "[t]hird: [i]f the buyer/debtor delays the payment of installments after the specified date, it is not permissible to charge any amount in addition to his principal liability, whether it is made a pre-condition in the contract or it is claimed without a previous agreement, because it is "Riba", hence prohibited in Shari'a." IIFA, supra note 83, at 104.
770 See al-Dakhil, supra note 747.
there are some similarities between fine and compensation. First, fine applies to the solvent debtor who has defaulted on payment without a valid excuse. Second, it has no use in the case of bankruptcy. Third, in view of the majority of Fiqh scholars, it is considered in conflict with Islamic Shari’ah. Fourth, it does not discriminately apply to all types of Sukuk, such as the variable-income Musharakah Sukuk. However, it can be imagined, for example, to apply to that type of Sukuk at the stage of amortization, in view of those rendering the repurchase promises binding - if the other party has the option of endorsement of revocation after entering into that contract - and the two parties have engaged in the contract and the delay occurred. It can also be conceived if the Musharakah assets have been sold in the market after the originator, who pledged and committed himself to repurchasing them, reneged on his promise and there was a difference between the price of selling them in the market and the promised repurchase price by the originator, in case the partner is not an agent (mudarib), a proxy (wakil), or a manager (mudeer) of the Musharakah assets - in view of AAOIFI - or in case he was one of them, in view of some jurists who approved that and distinguished between the promise of repurchase at the nominal value and the guarantee of the capital, which is prohibited in Islamic Shari’ah. However, it is inconceivable to apply this image in the Musharakah Sukuk by Saudi courts, which see promises as non-binding. Based on the above, although positive in some respects, the imposition of a fine cannot be considered adequate in the face of the originator's credit and bankruptcy risks.

4.4. Development of debt, capital and financing markets to enhance liquidity in the market

4.4.1. Introduction

The researcher considers that one of the methods to deal with the default risk is the availability of sufficient sources to provide liquidity and finance to the market, thus facilitating the defaulting companies to meet their financial obligations incurred from their engagement in the contracts underlying the Sukuk. Lack or insufficiency of liquidity in the market and difficulty of finding an Islamic financial product that provides defaulted - or near defaulting - companies with required liquidity will only increase credit and bankruptcy risks, regardless of the financial situation of companies seeking financing through Sukuk. Liquidity and finance can be obtained from various sources, most notably loan and debt markets.
This section discusses the shortcomings and problems in the loan markets, especially the reality of Islamic banks, and, more specifically, Saudi banks. It will, therefore, emphasize the importance and effectiveness of Sukuk and debt markets as a collateral and complementary source of financing and liquidity in a way that serves to deal with credit and bankruptcy risks in Sukuk, despite the allegedly negative effects of the expansion in issuing debt instruments. This will be followed by an assessment of the reality of the Sukuk market in Saudi Arabia in particular, with reference to their drawbacks, methods of their development, challenges and obstacles facing this development and the effectiveness of developing the loans and Sukuk markets - to provide liquidity - as a means of dealing with credit and bankruptcy risks facing Sukuk holders.

4.4.2. The reality of conventional and Islamic banks and their problems in the Middle East, especially the Gulf States

4.4.2.1. The need of companies defaulted in Sukuk for Islamic banks

From the Shari’ah perspective, companies are essentially interested in Islamic transactions, be it the desire of the founders, the board of directors or for attracting investors - who prefer to deal with companies governed by Islamic Shari’ah, which are called in Saudi Arabia, for example, 'pure companies' - to invest in these companies or subscribe to them when listed or when increasing their capital. These companies face challenges when obtaining finance in compliance with the Islamic finance system, unlike conventional companies that are not affected by the constraints facing Islamic companies, and, thus, they have direct access to capital. Defaulted Islamic companies are interested in securing finance through Islamic financial institutions or Islamic banks offering Islamic finance products.

4.4.2.2. The size of the assets of Islamic banks

The problem faced here is that the assets of these banks are relatively modest in contrast to the assets of conventional banks, whose main role is to provide loans and buy easy- to-liquidate assets, such as conventional bonds - especially low-risk ones - and sell them quickly when facing any drop of their deposits below the legal
threshold. Islamic banks' assets amounting US $ 1.5 trillion in 2016, according to the IFSB, are too small to be compared to the assets of conventional banks in the world, or at least to one of the conventional banks in the US. For example, JPMorgan Chase's assets reached US $ 2.352 trillion, far above the level of the assets of all Islamic banks combined in the world. Remarkably, there is a strong relationship between Islamic banks and Sukuk. For example, these banks managed nearly US $ 144 billion of Sukuk in 2012.

4.4.2.3. The reality and analysis of Saudi and commercial banks in general

In general, the Saudi, Gulf and commercial banks combined have relatively lower assets than Islamic banks as well as many of the developed countries’ banks. In 2016, the assets of Islamic banks were four times the assets of Saudi banks for the same period, taking into account that some Saudi banks are considered among the Islamic banks. The total in-kind assets of Saudi banks amounted to approximately SR 2,256 trillion [equivalent to approximately US $ 600 billion at the current exchange rate], according to the Saudi Arabian Monetary Authority (SAMA).

The size of bank assets in Saudi Arabia is not commensurate with what is expected, since individuals and citizens in Saudi Arabia are considered among of the world's highest paid, given Saudi Arabia’ affluence. Perhaps, the reason for this is that many Saudis are religiously conservative and do not invest their money in conventional banks that deal with usury (riba) and give interest on savings accounts, which is the case with banks in the world. This underlines the importance of Islamic banks and explains their rapid growth, because they created alternatives to interest-based investment and attract a segment of investors who prefer to deal with Islamic transactions. There is hardly a conventional bank in Saudi Arabia that does not have branches offering Islamic banking services. Yet, Islamic banks face legislative and competitive challenges that require countries to address them in order to boost

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Islamic banks and increase liquidity supply and finance that uphold Sukuk and economic growth of the country. Perhaps, the challenges and obstacles faced by these banks were the motivation for some countries to inspire banks to choose between the Islamic banking model or the conventional model, without combining them. This could be an impetus to give Islamic banks larger opportunity and motivate conventional banks to switch to the Islamic model, despite the problems related to compliance with Islamic Shari‘ah.

4.4.2.4. Defaulted Sukuk companies’ need for conventional banks

Defaulted joint stock companies, particularly that do not comply with Islamic finance principles, may resort to interest-based bank loans, benefiting from the Fiqh dispute over the ruling of buying shares from companies whose main financial activities are permissible, but they get financing through usurious sources at a certain level\(^{775}\) of their total finances, with the consensus of Muslim jurists on the prohibition of usury (riba). These companies’ dealing with riba will not dissuade investors who follow the views of jurists approving buying the shares of these companies or subscribing to them. Further, many conventional banks in Saudi Arabia and elsewhere have banking services offering Islamic finance products.

4.4.3. Obstacles and restrictions of borrowing from Islamic and conventional banks in Saudi Arabia and elsewhere

Despite the importance of conventional loan markets and Islamic finance, for which banks are one of the most fundamental finance sources, reliance on them as sole or primary source will reduce liquidity options, resulting in increased default or bankruptcy risks. There are several reasons calling for increasing options and not relying on those markets.

The first reason, as mentioned above, is that the assets value of Islamic banks combined are much lower than that of conventional banks. Besides, assets of banks in the Gulf States are relatively lower than those of other

\(^{775}\) For more discussion about the Shari‘ah ruling on participation or subscription in the shares of companies that borrow on interest, see Dr. Hamad M.al-Hajiri, Hakam al-Aktitab Walmutajarat fi ‘Ashhum al-Sharikat al-Musahamat alty Tumaras ‘Aemalat Wa’anshitatan Mukhtatitana [The Shari‘ah Rulings on Subscription in and Trading of the Shares of the Joint Stock Companies that are engaged in mixed Businesses and Transactions]. (Journal of Sharjah University for Shari‘ah and Legal Sciences, vol. 5, issue No. 2, 201-247, June 2008).
In the Middle East, commercial banks are generally reluctant to provide adequate loans to the private sector, and the assets of local banks have historically been unable to provide long-term loans. The Basel III standards, which gave banks a fixed period to implement the new requirements ending in 2019, would increase the existing restrictions on project financing and lending processes. Saudi Arabia is a member of the Basel III agreement, and SAMA is overseeing the implementation of its standards in the Saudi banks. Although economists held different views on the challenges and adverse effects that Saudi and other banks would face when implementing Basel III standards, many of them see that the new requirements would have negative effects on project finance and medium- and long-term economic activities. In her research on the role of Sukuk in enhancing partnerships between the public and private sectors to finance projects, Krista Mancini says,

> With restrictions being implemented through 2019, the full effects of Basel III on international markets for project finance remain uncertain. Assuming current growth rates, the Middle East banking sector is projected to face an average capital shortfall of around 25 percent of total regulatory capital required by 2019…. The typical twenty to thirty-five year term of a PPP contract will deter many Basel-conscious banks from extending credit to such operations, and the capital adequacy ratios of Basel III will likely have a material and adverse effect on the project finance market.

In addition, bank loans face a shortfall in terms of the volume and the high cost of these loans. With the implementation of Basel III, experts believe that the cost of loans will rise. These reasons underscore the

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778 See id.
780 Mancini, supra note 776, at 322-23.
781 See id.
782 See al-Badrani, supra note 779.
importance of finding another source of liquidity and collateral resources for the banking sector - which faces future challenges to finance economic activities – i.e., the debt markets.

4.4.4. Importance of developing the debt and Sukuk markets

High liquidity debt and Sukuk markets have a positive impact on dealing with credit and bankruptcy risks for many reasons. For instance, they can provide defaulted companies with necessary liquidity to meet their financial obligations to Sukuk holders; they fulfil the needs of Islamic banks and companies desirous to obtain finance - especially through Sukuk, for Shari’ah-abiding reasons – and they minimize the likelihood of companies to default on Sukuk.

The development of these markets will contribute to mitigating the negative effects that the holders of some defaulted Sukuk may face, for example, if banks are among investors by selling other Sukuk in their possession to deal with any potential shortage in their deposits to respond to customers’ demand. The importance of developing Sukuk markets in particular is doubled when it comes to Shari’ah-compliant banks that forbid the acquisition and circulation of debt securities that are based on forbidden usurious (riba) and conventional bonds. The existence of well-developed Sukuk markets will relax the financial pressures that these banks may face, as some Sukuk types can rapidly be liquidated. As such, the development of debt markets will not only remedy the imbalance in the loan markets, but will also be an important source of liquidity.

According to some researches, the role of debt markets emerges from the fact that "firms, controlled by large shareholders with excess control rights, may choose public debt financing over bank debt as a way of avoiding scrutiny and insulating themselves from bank monitoring."783

The development of Sukuk markets in general, especially the Sukuk that can be legally circulated, will help reduce the possibility of companies’ default. Islamic Sukuk will enable Shari’ah-compliant companies to diversify their investment in assets to include assets that can easily be liquidated for cash and are not subject to much market volatility. In many cases, companies at the brink of default and own other assets, such as real estate – whose worth

may outweigh their financial obligations and debts – would be reluctant to sell them for fear of devaluation, especially if the time available to pay off debts is short. Also, they may have difficulty in finding a buyer for them. Dr. Essam al-Enzi, when discussing the reasons for institutions’ default and lack of liquidity, says:

among the reasons for this are, their inability to liquidate their assets due to the lack of prospect buyers, or for the significant devaluation of the assets, making the sale of these assets at low price highly damaging.

Also, the sale of some assets takes time, as buyers need to assess and scrutinize these assets in order to reach a fair price.784

These problems will not exist if companies have rapidly-liquidable assets such as Sukuk. Assets vary in the speed of their liquidation depending on their type. For example, real estate are much slower to liquidate than assets or securities, since the latter can be circulated, for instance, in secondary markets or a trading market that accelerates the bartering and trading process, plus they can be fragmented into smaller, low value units, compared to real estate, making them more sellable to investors. To achieve this advantage, companies should diversify their portfolios to include financial assets that generate competitive returns and, at the same time, make them easier to liquidate when cash is needed.

As such, the development of Sukuk markets has three main advantages. The first is that it will help diversify the sources of liquidity needed by defaulted or near-defaulting companies, as well as banks, especially Islamic banks. Second, it will contribute to the diversification of assets and investments of corporates, which could quickly sell liquidable assets without bearing losses to meet their financial obligations, and mitigate some of the adverse effects that banks face, if they hold defaulted as well as stable Sukuk. Third, an adequate source of finance, such as Sukuk markets, can ease pressure on the loan market and give private high-credit rated firms access to low-cost financing, which could prompt banks to deal with moderate-credit rated firms.

4.4.5. The reality of Sukuk and debt markets in Saudi Arabia compared to other countries

4.4.5.1. The weak position of Sukuk compared to conventional debt instruments

To demonstrate the Sukuk stake of the total debt instruments, the volume of outstanding Sukuk nearly amounted to US $ 320 billion in 2016, according to IFSB,\textsuperscript{785} including sovereign and corporate Sukuk in all countries. In contrast, international outstanding debt securities owed to issuers in the government sector in all countries amounted to almost US $ 1.6 trillion in the fourth quarter of the same year, according to Bank for International Settlements.\textsuperscript{786} The above comparison between the volume of outstanding Sukuk and conventional debt instruments does not include domestic debt instruments nor corporate issuers, which underlines the vast gap between the two industries. According to the same source, international outstanding debt securities in the developed countries alone, including the government and corporate sectors, amounted to US $ 16 trillion in the fourth quarter of the same year.\textsuperscript{787} In this comparison, domestic debt instruments, developing countries and others were excluded, indicating the big gap between Sukuk and other debt securities.

In the GCC area, which is considered one of the most pivotal investors in the Sukuk market, bonds acquired the largest stake of debt securities issued in 2017. Despite the fast pace of Sukuk issuances, which rose by 81% reaching US $ 22.85 billion, they represented almost 22% of the GCC market issuances in 2017.\textsuperscript{788} In Saudi Arabia, the volume of bonds was by far larger than Sukuk.\textsuperscript{789}

The liquidity allocated to conventional debt markets has remarkably surpassed that of Sukuk, which reflects positively on the commitment of traditional defaulted firms to meet their financial obligations. In addition, conventional debt instruments, of which banks and financial institutions own a large stake, are considered as assets that can be readily sold in the market for cash. Yet, Islamic banks and other institutions that own similar

\textsuperscript{785} See ISLAMIC FINANCIAL SERVICES BOARD, supra note 771, at 3.
\textsuperscript{789} See id.
assets still face legal restrictions that prevent the sale of debt in general, in view of traditional jurists and contemporary Fiqh councils.

4.4.5.2. Weakness of debt markets in general in the Sukuk-interested countries, especially the GCC compared to other debt markets

Interest in conventional debt instruments, including bonds and Islamic Sukuk, is relatively low among investors in the GCC area and some other regions in terms of market value and circulation compared to their stock markets. In contrast, this interest is widespread in the developed countries, such as America and all parts of the world, as figures indicate. According to some figures, the global bond market has grown in excess of US $ 100 trillion, while the global stock market amounts to US $ 64 trillion.\(^{790}\) In America, the total amount of outstanding debt reached approximately US $ 40 trillion at the end of 2017.\(^{791}\) In contrast, the value of all outstanding shares exceeded US $ 30 trillion.\(^{792}\) According to other estimates, the value of domestic stock markets did not exceed US $ 20 trillion, while the figures concerning bonds did not vary.\(^{793}\) Thus, the above figures show a clear superiority of the debt securities - compared to the stock market – in terms of volume and interest.

In Saudi Arabia, which is considered the largest Arab market, the situation is different not only in terms of volume and figures - which are subject to several factors - but also in relation to investors’ interest and focus. The Saudi stock market is far more attractive to investors than the debt markets. According to Cbonds website, all Saudi sovereign and non-sovereign bonds issued in Saudi riyals, US dollar, Euro and Malaysian ringgit reached approximately US $ 136.5 billion,\(^{794}\) after converting the non-dollar issues into US dollars. The Saudi government has strongly entered the debt market in the past three years. Without such state participation at unprecedented levels, the size of the Saudi debt market would have been much lower. For example, in 2017, the Saudi Ministry


\(^{792}\) See Melendez, supra note 791.

\(^{793}\) See 5 Bond Market Facts You Need to Know, supra note 790.

of Finance issued bonds and Sukuk in local and dollar currency amounting to more than US $ 37 billion. On the other hand, the total market capitalization – meaning the value of all outstanding shares - at the end of 2018 reached approximately US $ 495 billion. The result is that the Saudi stock market is attracting investors' funds in excess of two and a half times the debt markets. In addition, the Gulf States Sukuk issuances and fixed debt instruments represent almost 15% of the developing countries debt issues. Consequently, debt markets are generally weak, indicating weak liquidity sources and Gulf investors' lack of interest in Sukuk compared to their interest in shares.

4.4.5.3. Weakness of debt and Sukuk markets in Saudi Arabia

Besides the relatively small market stake of the volume of debt and Sukuk markets in Saudi Arabia and the large interest in shares more than debt securities and Sukuk compared to many countries, the Saudi debt market faces other problems that may explain why some Saudi companies prefer to issue Sukuk in other countries that have more mature and developed markets. For example, in 2015, Al Bayan Holding Company issued Islamic bonds in Malaysia to become the first Saudi company to take this step. Although the condition of the Saudi debt market at present is different from the past - as it has taken positive steps in many respects, such as Saudi Arabia's accession to some bond indices, giving more attention to credit rating agencies and the growth of government Sukuk issuances at an unprecedented level - the obstacles are still present, especially with respect to legislation and procedures.

One of the features of the weakness of the Saudi debt market is that trading in the secondary market is very weak, and therefore debt instruments are considered difficult-to-liquidate, especially when compared to the thriving Saudi shares. Krista Mancini says: "[y]et despite the establishment of the sukuk market trading platform on the

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795 See Kuwait Financial Centre K.P.S.C "Markaz", supra note 788.
Tadawul (the Saudi stock exchange) and the recent surge in issuances, the Saudi bond market remains 'highly illiquid'. 799 She based this view on the fact that the circulated bonds represent a small stake of Tadawul's total listed issuances, ascribing that to investors' desire to retain them out of their interest in the yield rather than investing them in the secondary market. 800 She added: "[t]he illiquidity of the instruments must be overshadowed by an attractive discount for investors, but the high cost of bond financing discourages issuance by private entities." 801

However, the Shari’ah provisions should be taken into account when trading Sukuk and debt instruments. For example, trading Murabahah Sukuk after selling the assets to the finance seeker, as mentioned earlier in more than one place, is not allowed in Islamic Shari’ah, posing another challenge to liquidating Sukuk and Islamic debt instruments.

In contrast, in many other countries, debt markets are characterized by heavier circulation than stock markets, indicating that these markets feature a high degree of liquidity that attracts investors. In America, for example, the value of bonds traded on a daily basis amounted approximately to US $ 700 billion, while the daily trading volume of shares was US $ 200 billion. 802 Many investors prefer active secondary markets due to the rapidity of liquidating the securities for cash. Weakness of the secondary market of Sukuk would make investors reluctant to subscribe to Islamic debt instruments.

The listing of Saudi Arabia's Sovereign and quasi-sovereign debt instruments in the emerging government bond market indices, which are a key benchmark of the performance of international investors in debt instruments in emerging markets, was late. The Sukuk and bonds of Saudi Arabia, as well as of some Gulf States, will be listed in JP Morgan indices this year, which will positively reflect on polarization of foreign investment, reduction of debt cost and rise in the interest in the Sukuk of those countries, according to some economists. 803 But the bond listing is conditional to their credit rating by one of the three major rating agencies. 804 This poses a challenge to

800 See id. at 26.
801 Id.
802 See 5 Bond Market Facts You Need to Know, supra note 790.
803 See Barbuscia, supra note 797.
804 See id.
the suggestion of setting up Shari’ah-compliant Islamic credit rating agencies – as mentioned in the previous chapter – as it is difficult to find an alternative to the major CRAs that takes into account the Shari’ah standards in addition to the peculiarity of Islamic financial products.

Another feature of the weakness of the Saudi Sukuk markets is the existence of legislations that complicate the issuance of Sukuk and debt instruments, such as the requirements for the establishment of SPV, the exclusion of issuing those securities to joint-stock companies only and other issues related to taxes. Further, the credit rating process is very poor, as explained in the previous chapter.

4.4.6. Methods of developing loan, debt and Sukuk markets in Saudi Arabia

4.4.6.1. Methods of developing loan markets in Saudi Arabia

Despite the shortcomings in the loan markets, they should not be neglected, as they represent an important source of liquidity, especially in short-term finance needed by companies facing financial difficulties to meet their financial obligations to others, such as Sukuk holders.

4.4.6.1.1. Contributions of bank financing

The significant role of loan markets in project finance is underlined by Dr. Yahya al-Yahya, who says:

57% of the projects costing US $ 396 billion in the Middle East between 2006 and 2009 were financed by loans. But, with the implementation of the requirements of Basel III…it would be difficult to replicate the current funding structure of most regional banks, and the new set of regulations is likely to increase the costs for banks, especially long-term project debt.805

Furthermore, loan markets help finance high-credit companies, limiting their acquisition of debt markets and reducing liquidity, and low liquidity would have negative impact on low-credit rated companies. Some previous studies have confirmed that high quality companies do not usually tend to issue debt securities, but they prefer to borrow from banks.806

805 Al-Badrani, supra note 779.
4.4.6.1.2. Contributions of non-bank financial institutions

In developing loan markets to help Sukuk defaulting companies or low-credit rated companies, Saudi Arabia should encourage and attract non-bank financial institutions to operate in Saudi Arabia in compliance with Islamic Shari’ah provisions and regulations. Researches emphasized that non-bank financial institutions extend loans to the riskiest and high-risk companies more than conservative banks that tend to extend loans to investment-grade companies, i.e., low-risk companies. Some attributed that for more than one reason, inter alia, the existence of legislations, capital requirements and supervisory bodies that restrict bank lending. Rihab Grassaa and Hela Miniaouib state:

There are only a few studies that distinguish between bank and non-bank private debt. Denis and Mihov (2003) find that the primary determinant of the choice of debt source is the issuer's credit rating. Firms with the highest credit rating borrow from public sources; firms with medium credit rating borrow from banks; and firms with the lowest credit rating borrow from non-bank private lenders. Moreover, non-bank private debt plays a unique role in accommodating the financing needs of firms with low credit ratings and the choice of sourcing the debt is influenced by managerial discretion.

The licensing of non-bank financial institutions will contribute to the provision of capital to defaulted companies to meet their financial obligations to Sukuk investors, thereby helping to reduce credit and bankruptcy risks.

However, this view can be challenged by the fact that previous studies on samples of non-banking financial institutions were limited to specific regions and countries, not including Saudi Arabia whose institutions may have different policies. Besides, the Arab countries in general, including Saudi Arabia, need to develop a favorable economic and legislative environment to encourage these institutions to invest in Saudi Arabia. In addition, the interest of a large segment of investors, businessmen and companies in Saudi Arabia in finance and investment

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807 See id.
808 See id.
809 Id. at 455-56.
is linked to their compliance with Islamic Shari’ah, which is lacking in many of these institutions, especially the foreign ones, which may reduce its effectiveness.

4.4.6.1.3. Interest rate reduction

Governments should encourage banks’ finance activities by reducing the interest rates of central banks - which is already forbidden by Islamic Shari’ah - as this cut will limit central banks deposits and, thus, direct these deposits to financing projects and businesses. But, one of the hurdles to cutting interest rates is the Saudi riyal's pegging to the US dollar, and its volatility is subject to dollar’s volatility. This pegging is a longstanding Saudi policy that is hard to change, though there are some positive reasons for the de-pegging far more important than the issue of developing the Sukuk markets.

4.4.6.2. Methods of developing Sukuk markets and Islamic debt instruments in Saudi Arabia

One of the measures of the development of Islamic debt instruments is the implementation of the recommendations and ideas made in this dissertation regarding the precautionary hedges and financial guarantees provided for Sukuk holders, which will likely abate the concerns of financial institutions and investors, especially those who will finance defaulted companies. These investors will be in a more dangerous position than Sukuk holders who had financed those companies before their default. Prospective financiers may finance companies that have become low-rated due to their default or for being at the brink of bankruptcy.

It is also important to reform and develop all factors related to the debt markets in general and Islamic debt instruments and Sukuk in particular, such as credit rating agencies, investors’ tax exemption, corporate governance and enactment of separate legislations for the SPV exempting it from corporate laws and requirements, in consideration of their uniqueness and complex structure, especially in relation to Sukuk compared to conventional debt instruments. All that was described in the previous chapter that dealt with these factors and presented some developmental propositions.
4.4.6.2.1. Rescission or relaxation of some legislative restrictions and attraction of foreign investors

Limited liability companies should also be allowed to issue Sukuk and securities. In the current situation, as in the Arab Gulf States, Saudi limited liability companies are not permitted to issue Sukuk and debt securities, as pointed out in the previous chapter. In contrast, American laws - for example - allow this in general.810 Lifting these restrictions will help attract foreign companies desirous to issue Sukuk and take advantage of cash abundance in Saudi Arabia, or at least it will prevent local companies from issuing Sukuk outside Saudi Arabia. Malaysia, for example, has encouraged companies from several countries to issue Islamic bonds there. For instance, after the holding company, First Gulf Bank in Abu Dhabi - the third largest bank in the UAE by assets - issued Sukuk in Malaysian currency - equivalent to more than US $ 1 billion - followed by Turkish Finance Bank.811 However, the idea of allowing those companies to issue debt instruments could face objections such as that Saudi Arabia's economic and legal environment is not used to this process, or that limited liability companies are based on intuitu personae. The opposition may grow stronger if the proposition includes the possibility of the Sukuk’s conversion into shares. Also, this proposition could be challenged by saying that the minimum value of issued Sukuk is often greater than the affordability of the companies whose financial capacity is not usually like that of the joint-stock companies.

4.4.6.2.2. Relaxation of Sukuk issuance and circulation requirements

One way to help develop Islamic debt markets is to relax the issuance and circulation requirements of Sukuk. Currently, for the registration and listing of Sukuk and bonds, their total value must not be less than SR100 million for issuers who do not have any listed securities, whereas those with securities listed in the market the Sukuk and

bonds must not be less than SR 50 million. But, CAM can exclude debt instruments "if it is satisfied that there is a sufficiently liquid market for these instruments."

The reduction of the minimum value for issuing Sukuk could have positive impacts in favor of developing the Sukuk markets. For example, this procedure will help more companies to enter Sukuk issuance and debt instruments market due to reducing the minimum debt issuance requirements.

Given the current situation, joint-stock companies permitted to issue Sukuk may have to issue Sukuk to finance their financial activities or to pay off their debts at a value higher than they need in order to meet the issuance requirements, which will negatively impact the process of securitization of assets and their pricing in excess of their market value. Thus, they may be inclined to include some terms in the structure that guarantee the originating company to recover the assets through repurchase promises in the Sukuk to which this concept applies, which is contrary to the proposed standards mentioned by the researcher in the previous chapter.

But, this idea may be challenged by saying that relaxing the requirements could lead to the entry of non-qualified issuers into the market, taking advantage of the attraction of Sukuk markets to some investors. This proposition could also be contended by the fact that technical and monitoring capabilities in Saudi Arabia at present are not ready to accommodate the expansion of the debt market resulting from the relaxation of legislative and procedural restrictions.

4.4.6.2.3. Government encouragement and political will to increase the effectiveness of debt markets, particularly Sukuk

The effectiveness of encouragement given by the Saudi government through issuing sovereign Sukuk to attract investors' attention, both internally and externally, should not be downplayed. This has become evident recently, as Saudi government has issued and sponsored Sukuk at unprecedented volumes, although it is too early to evaluate these experiences and their impact on the bolstering of Islamic debt and investment markets. Further, the

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813 See id.
political will to develop this market is crucial, especially in the absence of political obstacles to this will. The Saudi Council of Economic and Development Affairs is vested with great powers. It particularly works on the improvement of the economic and financial climate in the country by preventing the duplication or inconsistency between legislations and effectively linking the financial authorities with the relevant ministries. The government encouragement can be crystalized when the Saudi sovereign funds and investment institutions – that have a large financial reserve - invest in domestic Sukuk to stimulate debt markets and encourage companies to switch to these markets, and government investment institutions have huge liquidity to implement this policy. In addition, one of the practical steps that Saudi Arabia should take is to reduce its holdings of US Treasury bonds and invest in local Sukuk. The Saudi government holds US bonds and treasury bills worth US $167 billion in February 2019. While Saudi government investments, according to some economists, in securities (including bonds and treasury bills), assets and cash in US dollars are $1 trillion in 2016.

4.4.6.2.4. Acceleration of fulfilling the requirements of global indices

One of the most effective elements that contribute to the growth of the Saudi debt market is to join the indices of debt instruments. In order to achieve this goal, the conditions and standards to be covered by such indices should be expedited - without contradicting Islamic Shari’ah provisions- which will be welcomed by investors, especially foreigners, and raise the reputation of the Saudi debt market.

4.4.6.2.5. Highlighting the benefits of Sukuk issuance to companies

It is also important to disseminate and underline research findings related to the factors and benefits that can motivate companies to issue Sukuk rather than conventional bonds in order to draw the attention of companies that need financing. Among the important factors for companies to issue bonds rather than bonds are "firm sizes, past Sukuk issue experience and tax incentives." 


816 Grassaa & Miniaouib, supra note 806, at 456.
In addition, some research found that companies in GCC area prefer to issue Sukuk rather than bonds in large and long-term debt issuances.\textsuperscript{817} One of the benefits of issuing Sukuk in Malaysia is that it "contributes to an increase in the firm's stock returns. The cumulative abnormal returns of Sukuk issuers are statistically higher than those of conventional bonds issuers. This means that the choice to issue Sukuk rather than conventional bonds has a significant influence on shareholder value."\textsuperscript{818} This can be analogized to the situation in Saudi Arabia.

It is also important not to exclusively focus on Sukuk whose circulation may face legal restrictions, such as Murabahah Sukuk. Sukuk structures should be diversified to include, for example, Musharakah and Ijarah Sukuk so that the secondary market becomes active and Sukuk becomes a high-liquid instrument.

The importance of compliance with Shari'ah provisions related to the circulation of Sukuk and the sale of debt should be emphasized. This conforms to the Saudi laws that require that all financial transactions must be Shari'ah compliant and helps to attract investors, gain their trust, avoid the risk of financial crises – which already occurred before, as a result of non-compliance with Shari’ah provisions, and boost the Sukuk and debt market's efficiency and trustiness.

It should be noted that some of the development methods of the Saudi debt market mentioned above require further research to address them in depth and to study all other relevant aspects, such as the issue of allowing limited liability companies to issue Islamic Sukuk.

4.4.7. Adequacy of this method to deal with credit and bankruptcy risks

Despite the researcher's view about the importance of liquidity and its positive impact on defaulted sukuk through the development of sukuk markets, as well as banking and non-banking financial institutions as described, this development is contingent upon political, economic, legislative and cultural factors, especially in Saudi Arabia and the Gulf markets.

Moreover, what we have proposed to develop the loan and sukuk markets – as an additional option rather than an alternative for bank transfers - needs time to achieve the expected objectives, the most important of which are

\textsuperscript{817} See id. at 454.
\textsuperscript{818} Id. at 456.
liquidity and the good pace for liquidating sukuk that are legally permissible to be traded. This is due to the inherent complexity of sukuk, the lack of specialists in it, disinterest of foreign investors in sukuk compared to conventional bonds and securitization and the juristic controversy over some of sukuk applications.

Besides, the proposition would be more effective –if positively considered- in the period leading up to the absorption and uptake of the available liquidity by the renewed issuances of sukuk and debt instruments, in both the loan/financing and debt markets, which would reduce liquidity for being used and exploited. The flourishing of debt markets and loans after their development and the implementation of the propositions we have suggested will help attract many of the finance seekers to expand their businesses or meet their financial obligations. In that way, liquidity will be reduced.

Also, it is not possible to predict the decisions of local and foreign investors toward the market following its readjustment and development, especially towards the troubled companies, which need finance to be able to pay their arrears to the sukuk holders. Perhaps, Investors' fear and reluctance to invest in these companies may prompt some of these companies to issue debt instruments based on mortgages or to include measures and guarantees that can attract investors.

4.5. The engagement of Sukuk holders -as purchaser- and the obligor in Sukuk -as seller- in Salam contract\textsuperscript{819} when the obliged originator defaults on payment

4.5.1. Introduction

One of the effective methods of dealing with the risk of default of payment experienced by the originator of Sukuk and an alternative to the usurious interest against the delay is the proposition made by Dr. Essam Al-Enazi in his research on the insolvency of financial institutions.\textsuperscript{820} He quoted few Fiqh scholars who approved making the debt payable by the debtor as price in the forward sale (salam).\textsuperscript{821} The custom is that the buyer in the forward sale pays the price upfront to the seller in exchange for the specified commodity in the forward sale. In principle,

\textsuperscript{819} A Salam contract is defined as "the purchase of a commodity for deferred delivery in exchange for immediate payment. It is a type of sale in which the price, known as the Salam capital, is paid at the time of contracting while the delivery of the item to be sold, known as al-Muslim Fih (the subject-matter of a Salam contract), is deferred. The seller and the buyer are known as al- Muslim Ilaihi and al-Muslim or Rab al-Salam respectively. Salam is also known as Salaf (literally; borrowing)." AAOIFI supra note 43, at 289.

\textsuperscript{820} See al-Enzi, supra note 784, at 471-72.

\textsuperscript{821} See id.
salam is unanimously permitted by the Shari’ah scholars, but they differed as regarding some of its images and applications. But, few Fiqh scholars have approved that the price in the salam contract is the debt owed by the seller and created from a former contract. It would be as if the buyer in the salam contract had received his money from a former contract and then paid it the seller in exchange of a specified commodity to be delivered at a later date. According to this argument, the Sukuk holders and the originator may enter into a salam contract, in which the originator undertakes to deliver a specified asset in return for the debt owed by him. Thus, the Sukuk holders were treated as if they had received the returns of the sukuk or their capital and then entered into another investment agreement. The price of the specified commodity is typically lower than its market price. In this section, we seek to examine the remedial feasibility and the legality of this proposition, as well as its adequacy to deal with credit and bankruptcy risk.

4.5.2. Importance of this proposition in dealing with the credit and bankruptcy risk in Sukuk

This remedial option can be classified as a method on which Sukuk holders can rely when dealing with credit risk post to the originator’s default. There are precautionary measures and financial guarantees to be considered before Sukuk investors’ subscription in order to avoid the originator’s default or insolvency. This method – admitting its legality - is important to both parties of the stumbling Sukuk and can be seen as a viable alternative - from the investment perspective - to debt restructuring.

For the indebted originator, this method will give him respite until his financial position improves, as he most likely assumes to obtain funds from profits or finance, enabling him to provide and deliver the assets as described before the due date. He can also enter into a forward sale agreement of fully described goods that represent some of his assets, and therefore he can sell these assets at an appropriate price with no loss. Often, the debtor possesses assets that need a period of time until they can be sold, either for the low demand on them, seeking a fair price or their sale requires specific procedures.

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822 See AAOIFI, supra note 43, at 284.
823 See id. at 285.
824 See al-Enzi, supra note 784, at 473.
825 See id.
As for the Sukuk holders, this method will have a positive impact on them, especially if they include financial institutions and banks. The creditors in the forward sale contract will write down in their records that they have bought assets. Dr. Essam quoted some who said – in the course of their account on the risks that Islamic banks may face when their clients default on payment – that banks can enter into an agreement with an institution in which it undertakers to buy the described assets after the bank has taken possession of them. Also, the bank may engage with an institution or factory in a forward sale contract in which the bank undertakes to provide assets that are described to the institution that will pay the price immediately. The SPV, as a representative of the Sukuk holders, can hold a contract with the defaulting originator based on such structure as a remedy for credit risk and as an alternative to debt restructuring, provided that it should not involve interest (*riba*).

4.5.3. The legality of making immediate debt a price in forward sale contract

Fiqh scholars differed with regard to making immediate debt that has not been received a price in the forward sale contract. The first opinion, which is attributed to the Hanafis, the Malikis in the most popular view, the Shaf'a'is, the Hanbalis and others, is that it is not permissible and not valid. Among the contemporary Fiqh bodies that disapproved it are AAOIFI and IIFA. However, some Shari‘ah scholars from among the Malikis, Ibn al-Qayyim – who attributed this view to his Sheikh Ibn Taymiyyah and some of the contemporary scholars, authorized it. But, Dr. Osama al-Lahem says that Ibn Taymiyyah and Ibn al-Qayyim held

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826 See id.
827 See id. at 472.
828 See id. at 472-73.
833 AAOIFI, in its Shari‘ah Standard No (10) related to Salam and Parallel Salam, states: “3/1/4 It is not permitted that a debt be recognised as the capital of Salam, such as using as the capital of Salam loans or debts owed by the seller to the Institution as a result of previous transactions.” AAOIFI, supra note 43, at 274.
834 IIFA, in its Resolution No (85) Concerning ‘As-Salam (Forward Sale with Immediate Payment) and its Modern Applications, states: “[a] debt may not be used as a capital for a Salam sale, since this would amount to selling a debt against another debt.” IIFA, supra note 83, at 186.
two views regarding this question, and attributing permissibility to them in this matter is not correct. He pointed out that the most preponderant view for them – and Allah knows best - is to disapprove the legality of the above question, which corresponds to the view of the majority of scholars.\textsuperscript{837} Rashed Al-Hafeez recounted some conditions and controls attributed to Ibn Taymiyah and Ibn al-Qayyim for the legality of the question.\textsuperscript{838}

4.5.4. Adequacy and effectiveness of this proposition in Sukuk

Despite the remedial feasibility of prompting the debtor originator to pay the debt - whether in the form of returns or the amount of amortization of sukuk - in some cases and aspects, and suitability of this proposition as a financial alternative to debt rescheduling, with the inclusion of an interest, it is fraught with Shari’ah, financial and investment flaws and problems. As for its legality, the established view adopted by the four Fiqh Schools as well as the contemporary Fiqh councils is the prohibition of this transaction. In addition, there is much debate about the attribution of this approving view to two of the most notable and profound Hanbali jurists: Ibn Taymiyah and Ibn al-Qayyim. Assuming that their opinion is the permissibility, some have suggested that this permissibility is subject to meeting specific conditions. Although the courts in Saudi Arabia, with their various jurisdictions, rely on the views of these two leading scholars in many cases, the banning of this transaction by the majority of Shari’ah jurists as well as most of the Fiqh councils makes it more likely to be rejected by the courts of Saudi Arabia and to revoke its legal effects. It is worthwhile noting that the present researcher could not find a typical case resembling that transaction.

From the investment and economic perspective, this proposed method can be remarkably effective – admitting its permissibility - if the defaulter obligor acts in good faith, and the specialists in the financial markets can verify that his financial conditions are destined for improvement. Without these two conditions, the Sukuk holders, if entered into a \textit{salam} contract with him, may face delays in the delivery of the assets on time as described under the \textit{salam} agreement. If a defaulted obligor in sukuk owns some assets and desires to sell them for cash to clear

\textsuperscript{837} See AL-LAHIM, supra note 79, vol. 1, p. 167-75, 625.
his debt to the sukuk holders, but he is reluctant to do that in haste for fear of selling at a low price, entering into a salam contract with him for assets described in his property would be beneficial to the sukuk holders and obligor.

4.6. Requesting a personal guarantor of the originator in some Sukuk structures or third party guarantor in some others

4.6.1. Introduction

One of the long-established customs and traditions in conventional and Islamic financial and business markets is the inclusion of a guarantor in the transactions - that create indebtedness relations - who will be committed to repay debts when the guaranteed party defaults or goes bankrupt. The case studies of the defaulted Sukuk were void of a personal guarantee that the present researcher considers important in dealing with credit and bankruptcy risks faced by the Sukuk holders. The concept of guarantee was not considered in researches on Sukuk in the same way as third party guarantee was stressed in Mudarabah and Musharakah Sukuk only. All the studies that the researcher found were either concerned with the legal position of taking a consideration for providing personal guarantee in contexts irrelevant to Sukuk and without making a legal analysis of this guarantee, as compared to the approach of this dissertation, including the challenges, obstacles and feasibility of dealing with credit or bankruptcy risks, or were dealing with third party guarantee in Mudarabah Sukuk or in investment accounts and deposits in banks, which differ from conventional personal guarantee in several aspects - though the common denominators between them - as will be explained below.

Here, we will briefly define the meaning of guarantee in Islamic Fiqh, with particular reference to the sense intended by the researcher, explaining the difference between the concept of personal guarantee and the third party guarantee that is commonly used in Sukuk studies. This part of this dissertation will concern some of the most important Fiqh and legal provisions and rules related to sponsorship and letters of guarantee commonly used in the field of banking and Islamic financial markets. This also includes a survey of some restrictions on them. Then, we will consider whether this method can be analogized to the Sukuk and its effectiveness and adequacy as a means of positively dealing with the risk of default or insolvency of the originator in Sukuk to serve the
Sukuk holder and investors’ interests. In addition, the challenges encountering the application of this method will be analyzed.

**4.6.1.1. Meaning of the personal guarantee and third party guarantee**

In Islamic law, the word "guarantee" expresses different senses, namely the imposition of a fine for causing damages, the obligation to carry out a particular work, and bearing the consequences of loss and defects.\(^{839}\) For example, according to Ibn Qudamah, one of the Hanbali scholars, guarantee is defined as: "the joint liability of the guarantor and the guaranteed party toward a particular right."\(^ {840}\) This is the sense intended in this dissertation. Some scholars distinguish between guarantee (daman) and sponsorship/guarantorship (kafala), intending the earlier to mean guarantee of wealth (amwal), and the latter as guarantee of the physical rights (abdan), which is the obligation to bring the financial debtor to his sponsor.\(^ {841}\) In this dissertation, the researcher uses these two senses to express the guarantee of wealth and debt.

This type of guarantee has not been dealt with in studies related to Sukuk adequately. Researches and studies on guarantee are scarce, although some Sukuk applications, such as the Emirate Nakheel Sukuk, have used it, yet it did not protect its holders.

As to the third party guarantee, the researcher did not find a definition for it, but there are some Shari'ah and legal provisions related to it. It can be defined as the obligation of a third party to voluntarily pay a sum commensurate to the capital of investors upon its loss in full or in part, or to voluntarily pay to the expected profits. This sense was the focus of former researches on Sukuk.

After discussing some of the Shari'ah rules and other related issues, the present research will turn to identify the most important differences between the personal guarantee - which was overlooked by previous researches on Sukuk - and the third party guarantee as intended in the Sukuk, so as not to confuse the meaning of each of them. Although they are similar in terms of commitment and applicability in Sukuk, they differ in some matters,

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\(^{839}\) See al-Omrani, *supra* note 132, at 233-34; see also al-Mulhim, *supra* note 659, at 525-26.

\(^{840}\) IBN QUDAMAH, *supra* note 24, vol. 4, p. 399.

\(^{841}\) See al-Mulhim, *supra* note 659, at 529.
such as the nature of the guarantors, the separation between them and the parties to the Sukuk and the right of the guarantor to return to the sponsored person as described below.

4.6.2. The importance of the personal guarantee and third party guarantee in dealing with the credit and bankruptcy risk in the Sukuk

Personal guarantee plays an important role in the economic and social fields, and it occupies a high position in almost all jurisdictions. It protects small inexperienced investors, helps to maintain economic stability and accelerates strategies for dealing with cases of default of financial institutions. On one hand, it strengthens the credit position of those who will be debtors or obligors to making future payments. On the other hand, the personal guarantee reassures the creditor and encourages him to carry out commercial transactions even if the client he is dealing does not have a credit quality. In the same way, guarantors such as banks in the conventional markets will benefit from that by taking a commission from the guaranteed debtor and charging him fees in return for this guarantee. Often, the guaranteed debtor keeps his payment and the guarantor does not have to pay the debt. If the debtor defaulted on paying the debt and the guarantor had to pay the debt, the latter would have right of recourse to the debtor and redeem as much as he paid, especially if the guarantee contract establishes the right of recourse to the guaranteed party. Besides, the guarantor bank will also invest the financial cover provided for it for issuing the letter of guarantee over a specified period, which will motivate it to provide such service to its customers.

The use of guarantorship (kafala) in Islamic financial markets is relatively new compared to its use in conventional financial markets. This can be explained by the fact that Islamic financial markets in the contemporary characterization are also relatively new, and guarantee is related to them and was used only when they emerged. Else, guarantee in the Islamic world is common and widely practiced at the level of individuals. However, the provisions of guarantee in Shari’ah differ from those in conventional laws.

Guarantee in Sukuk can be considered one of the most important precautionary measures against default and bankruptcy risks, as Sukuk holders have the right of recourse to the guarantor when the guaranteed debtor defaults

843 See id.
844 See id.
or becomes insolvent. With the presence of a guarantor, they will have two sources to redeem their capital, which diminishes the chance of delay in retrieving their capital.

The third party guarantee is also important in the investment circles of the Sukuk because it guarantees investors’ capital expected profits. Some Muslim jurists and experts also see it as an appropriate alternative to guarantee of the agent (mudarib) to their capital or returns, which is forbidden by the Shari’ah for being a form of usury.

### 4.6.3. The legality of the personal guarantee and third party guarantee and legality of related applications

In order to know the Shari’ah ruling on personal guarantee or the third party guarantee and other related issues in Islamic Sukuk as a contemporary application, it is necessary to identify certain provisions of the personal guarantee and the third party guarantee from Shari’ah perspective.

#### 4.6.3.1. The personal guarantee (debt guarantee)

Muslim jurists have unanimously agreed on the legality of personal guarantee in general. However, there are some Shari’ah rules for personal guarantee and third party guarantee, which imposes certain restrictions on the application of these two concepts in comparison to conventional financial transactions.

##### 4.6.3.1.1. Taking compensation or fees just for presenting guarantee

Among the Shari’ah restrictions or rules on personal guarantee and preventive measures to deal with the risks of credit and bankruptcy of Sukuk is the prohibition of taking a consideration or fees for presenting guarantee. Some scholars mentioned that the majority of contemporary Muslim scholars forbade it, while others said that early Muslim jurists unanimously agreed on its impermissibility, as will be shown below. Most of the contemporary Fiqh councils and Shari’ah committees of Islamic banks, such as AAOIFI and IIFA, have

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845 See AAOIFI, supra note 43, at 140.
846 AAOIFI, in its Shari’ah Standard No. (5) related to Guarantees, states: "3/1/5 It is not permissible to take any remuneration whatsoever for providing a personal guarantee per se, or to pay commission for obtaining such a guarantee. The guarantor is, however, entitled to claim any expenses actually incurred during the period of a personal guarantee, and the Institution is not obliged to inquire as to how the guarantee produced has been obtained by the customer." Id. at 127.
847 IIFA, in its Resolution No. (12) Concerning the Letter of Guarantee, states: "[t]he guarantee (Kafala) is a benevolent contract, motivated by grace and mercy. The jurists have decided against taking fee for issuing guarantees; the reason being that, in the event of guarantor’s payment of the guaranteed sum, it will resemble a loan generated profit to the lender and that is forbidden in Shari'a." IIFA, supra note 83, at 18.
disapproved the taking of consideration just to present guarantee. In its Arabic issue in more than one place, AAOIFI related the unanimous view of Muslim Shari’ah scholars on the prohibition of that, while in the English issue it mentioned that there is consensus, but elsewhere it said that that was the view of the majority of scholars.  

More than one Muslim jurist has related the consensus on the prohibition of taking consideration. Dr. Sulaiman al-Mulhim said that the accounts of early Sunni scholars forbade the stipulation of consideration in return for presenting guarantee, based on the literature he had access to, whereas contemporary jurists held different views – though not admitting the occurrence of consensus. Al-Mulhim classified the different views on this issue into three main opinions, namely, absolute prohibition, absolute permissibility and the distinction as to whether the guarantee is converted into a loan, in which case the guarantee is not permissible, or it is not converted into a loan, in which case it becomes permissible. Those who rendered it impermissible used some evidence, including the occurrence of consensus, on the prohibition of taking a consideration in return for the guarantee. Those who authorized it cited other evidences, denying the incidence of that consensus, which, if truly held, the view of the opponents would not be considered in the first place. Of those who authorized it is the Shari’ah Advisory Council of the Malaysian Securities Commission permits it according to one of the researchers. AAOIFI states,

Personal guarantees are divided into two types. One type is a guarantee where the guarantor has a right of recourse to the debtor, and this guarantee is offered at the request or with the consent of the debtor.

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848 AAOIFI, in its Shari’ah Standard No. (5) related to Guarantees, states: "[t]he objection to taking consideration for personal guarantees is that giving a guarantee is one of the charitable acts that should be offered without consideration, and this ruling has generated consensus among the Fuqaha. Moreover, a personal guarantee indicates a readiness to give away the amount of a loan, which means that the guarantor will pay the loan (if the principal debtor fails to pay) and have recourse to the guaranteed person for fulfillment. Hence, it is not permissible to take consideration for a guarantee, because it is not permissible to take consideration for giving away the amount of the loan itself, since such consideration is considered to be Riba." AAOIFI, supra note 43, at 140. But in the page (143) of its book, AAOIFI states: "[t]he majority of Fuqaha agree that it is prohibited to take consideration for guarantee. However, issuing the letter of guarantee is a service that justifies charging fees." Id. at 143.

849 See al-Mulhim, supra note 659, at 550.
850 See id. at 530.
851 See id.
852 See id. at 550-60.
853 Chaibou Issoufou & Umar A. Oseni states: "the Shariah Advisory Council of the Malaysian Securities Commission in its 36th meeting held on 6th February 2002, resolved that charging a fee for a third party legal guarantee is permissible (Securities Commission Malaysia, 2002)." Issoufou & Oseni, supra note 842, at 135.
The other type is a non-recourse guarantee, which is offered voluntarily by a third party without the debtor's request or consent (voluntary guarantee).854

The second type is perhaps close to the meaning of "Third Party Guarantee" - used in Mudarabah and Musharakah Sukuk to secure capital or returns in them, even if there is no infringement or negligence on the part of the agent (mudarib) - as the guarantee is offered voluntarily. However, such guarantee is typically offered at the request of the debtor voluntarily.

4.6.3.1.2. Letters of guarantee issued by banks to their customers

One of the contemporary applications of personal guarantee referred to above is the charging of fees on covered and uncovered letters of guarantee - usually issued by banks - whose legal position depends on the legal ruling of the previous matter. Among the Fiqh bodies that prohibited the taking of consideration for issuing letters of guarantee are AAOIFI,855 IIFA856 and the General Secretariat of the Council of Senior Scholars in Saudi Arabia.857

4.6.3.1.3. Taking compensation, charging administrative fees and other expenses associated with issuing the letters of guarantee

The majority of contemporary Muslim jurists permitted the taking of consideration against the administrative expenses and expenses associated with the guarantee, provided that it does not exceed the equivalent fees.858 Among the Shari’ah councils that authorize it are AAOIFI859 and IIFA.860 However, al-Mulhim says that it can be perceived from the words of those who dealt with this issue that there is no disagreement among contemporary jurists regarding the permissibility of taking a fee commensurate with the real expenses.861 But, he stated two

854 AAOIFI, supra note 43, at 126.
855 See id. at 129.
856 See IIFA, supra note 83, at 19.
858 See Dr. Ali A. al-Nadawi, Khitab Aldaman Almasrifii [Letter of Bank Guarantee]. (Contemporary Muslim Magazine, Issue 143, Jan 15, 2012). Available from: https://almuslimalmuaser.org/2012/01/15/%D8%AE%D8%B7%D8%A7%D8%A8-%D8%A7%D9%84%D8%B6%D9%85%D8%A7%D9%86-%D8%A7%D9%84%D9%85%D8%B5%D8%B1%D9%81%D9%8A/%D8%A3%D8%A8%D8%AD%D8%A7%D8%AB/, (accessed on 5th January 2019).
859 See AAOIFI, supra note 43, at 130.
860 See IIFA, supra note 83, at 19.
861 See al-Mulhim, supra note 659, at 593.
Shari’ah controversial issues about combining administrative expenses and guarantee, expressing his inclination to permissibility.\textsuperscript{862}

4.6.3.1.4. The legality of the issuer of the letter of guarantee’ obtaining of a cover

One of the methods associated with letters of guarantee is that the bank asks its customer to provide a cover for this guarantee. Scholars of Shari’ah differed in its characterization, and the dispute resulted in a set of Shari’ah and legal implications. Some characterized the letter of covered guarantee as a form of agency (\textit{wikala}),\textsuperscript{863} so that the customer is the principal (\textit{muwakkil}), and the bank is the agent. This creates no problem for the bank to obtain the cover.

But, if the cover is characterized as a pawn (\textit{rahn}), this gives rise to two controversial issues.\textsuperscript{864} The first is whether the pawn can emerge before the existence of its cause, i.e. the debt, which is created when the guarantor bank pays the beneficiary.\textsuperscript{865} Some have said that scholars upheld two conflicting opinions.\textsuperscript{866} The Hanafis, the Malikis and Ibn al-Khattab from among the Hanbalis permitted the occurrence of the pawn before its cause exists, while the Shafa’is and the Hanbalis forbade it.\textsuperscript{867} AAOIFI approved the pawn before holding the contract that generated the debt or thereafter.\textsuperscript{868}

The second issue is whether the cover required by the bank may be in one of the two precious metals, i.e. gold and silver [and fungibles] and not in-kind or a commodity.\textsuperscript{869} Some of the Maliki jurists disapproved the pawning of gold and silver unless they were marked with a unique sign, so that the mortgagee may not dispose of them and then provide fungibles for them, for fear of being a loan that has incurred a benefit.\textsuperscript{870} Some of the Maliki jurists stressed the exemption of the necessity of marking them with a distinctive sign if the gold, silver or a

\begin{footnotes}
\item[862] See id. at 593-94.
\item[863] See IIFA, supra note 83, at 18.
\item[865] See id.
\item[866] See id.
\item[867] See id. at 247-48.
\item[868] See AAOIFI, supra note 43, at 972.
\item[869] See Radiah, supra note 864, at 248.
\item[870] See id. at 249.
\end{footnotes}
fungible item was entrusted to a trustee.\textsuperscript{871} However, the majority of jurists permitted that\textsuperscript{872} without stipulating the marking of gold, silver or fungibles, and AAOIFI followed suit.\textsuperscript{873}

4.6.3.1.5. The legal ruling on investing funds provided as cover for issuing the letter of guarantee

The bank usually adds the cash cover to its unallocated deposits, and as such it cannot be distinguished when the bank carries out its investment operations, i.e., the cash cover will be indirectly invested.\textsuperscript{874} The question arises here is about the legality of the bank's benefiting from the cash cover deposited by the customer.\textsuperscript{875} The answer depends on the characterization of this cover, either to consider it a pawn, as cash provided to the bank as security to be foreclosed when the beneficiary demands the value of the letter of guarantee\textsuperscript{876} or it may be considered an agency (\textit{wikala}). Each characterization has its effects.

In view of those who considered the cover to be a pawn, the judgment of investing this pawn depends on whether the mortgagee has the right to benefit from the pawned funds,\textsuperscript{877} which is a matter of controversy among Muslim jurists.\textsuperscript{878} According to Amqran Radiah, the Hanafis permitted that with the pawner’s consent and as long as it is not stipulated in the contract or corresponds to custom.\textsuperscript{879} She added that the Malikis permitted it, provided that the cause of the debt is a sale transaction, for instance, and not a loan, that the pawnee must stipulate from the outset its intention to benefit from the pawned object and that the duration of this benefit is determined.\textsuperscript{880} But, the Shafi'is disapproved the issue altogether.\textsuperscript{881} The Hanbalis permitted this with the pawner’s consent, and the cause for the debt was a sale transaction or one of the commutative contracts, whether the benefit obtained is equal to, lower or higher than the rent of the like.\textsuperscript{882} If the cause of the debt is a loan, it is permissible to benefit

\textsuperscript{872} See Radiah, \textit{supra} note 864, at 249.
\textsuperscript{873} AAOIFI states: "[i]n principle, the mortgaged object should be a tangible asset, yet it can be a debt, a cash amount, a fungible asset or a consumable commodity." AAOIFI, \textit{supra} note 43, at 970.
\textsuperscript{874} See Radiah, \textit{supra} note 864, at 249.
\textsuperscript{875} See id.
\textsuperscript{876} See id.
\textsuperscript{877} See id.
\textsuperscript{878} See id.
\textsuperscript{879} See id.
\textsuperscript{880} See id. at 250-51.
\textsuperscript{881} See id. at 251.
\textsuperscript{882} See id. at 251-52.
from the value of the rent of the like only. However, if the pawned object was an animal, that can be labored or milked, for example, it is permissible for the pawnee to benefit from it without the permission if the pawner, in case the pawnee is taking care of it. The General Secretariat of the Council of Senior Scholars in Saudi Arabia banned the guarantor [e.g. the bank] to benefit from the cover provided for it by the client.

But, if the cover is characterized as being collateral presented by the customer so that the bank can foreclose it to pay the beneficiary when requested, this image was linked by a Radiah to a question discussed by Shari’ah scholars, i.e. the guarantor’s liability of the guaranteed object once it has entered into his possession. Then she mentioned that scholars distinguished between two cases. The first case is that if the guarantor obtains the money from the debtor to give it the creditor (i.e. beneficiary), the guarantor here is trustee and is not liable to any loss [if he is not negligent] but he has no right to invest that money. The second case is that the guarantee receives the money from the debtor on the basis of a waiver from this debtor, in which case the guarantor will be liable to any loss, and therefore he has the right to invest it. But, this issue is controversial, even among some of the jurists of the one and same Fiqh school.

4.6.3.1.6. Islamic approaches to letters of guarantee and the alternative to taking compensation in return for issuing letter of guarantee

Dr. al-Siddiq al-Darir, said that Islamic banks have five methods of issuing letters of guarantee. First, they can issue a fully covered letter of guarantee, which is typically affordable by solvent customers. Second, they issue a letter for those who have deposits with the issuing bank, authorizing the bank to withdraw the amount from the customer's account to cover the dues of the beneficiary. Third, they issue a letter of guarantee covered by a mortgage, such as an immovable property. Fourth, they can issue an uncovered letter of guarantee, if the

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883 See id. at 252.
884 See id.
886 See Radiah, supra note 864, at 253.
887 See id.
888 See id.
889 See id.
890 See id. at 256.
891 See id.
892 See id.
893 See id. at 257.
bank trusts its customer without charging any fees for offering the guarantee. Fifth, they can issue a letter of guarantee and consider it part of the participation capital, in which case the bank becomes a partner and not a guarantor with the letter’s applicant in the transaction for which the letter was issued. This is the method adopted by Faisal Islamic Bank of Egypt.

The first three methods require that the customer requested the letter of guarantee from the bank be solvent, and these methods do not involve charging a fee in return for offering the guarantee. The fourth method, which does not involve a cover or charge a fee, depends on the trust of the issuer of the letter in its customer. In the fifth method, the letter of guarantee shall be a contribution from the bank in a participation contract without requiring the customer’s provision of a cover for issuing the letter.

### 4.6.3.1.7. The easiest and most Shari’ah-compliant method that is close to the conventional methods of issuing letter of guarantee

The fourth and fifth methods mentioned above could be the most convenient way for the non-solvent customer requesting the bank to issue a letter of guarantee to present it to the beneficiary. They do not require a full cover or anything similar to it that may be difficult to the customer, or any consideration in return for merely offering the guarantee. Dr. al-Nadawi, explaining the fifth method, says,

> The letter of guarantee is considered to be a method of financing in the form of participation (*musharakah*), if the letter is partially covered. In case the letter is not fully covered, the financing will be on the basis of *Mudarabah*. Consequently, Islamic banks will receive a common share of the profit from the business activity as agreed, and they will bear part of the loss, if any, commensurate with their share in the capital.

However, some commented on the fifth method by saying that converting the debt into capital in the *Musharakah* contract is not valid, making commitment to lending capital in the contract of participation prohibited a priori. Muslim jurists have forbidden the rendering of debt into capital in *Mudarabah*. Ibn Munther said, "all

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894 See id.
895 See id.
896 See id.
897 Al-Nadawi, *supra* note 858.
898 See id.
of the renowned jurists we know unanimously agreed that it is not permissible for a man to convert a debt he has to another into a share of in the Mudarabah capital.\textsuperscript{899} Scholars of the four schools of Fiqh view that it is not permissible to make a debt as part of the capital, except for an equivocal saying attributed to the Hanbalis, though the mainstream view of the Hanbali School does not approve it.\textsuperscript{900} One of the contemporary scholars expressed his inclination to approve the validity of possibility (i.e., permissibility) to do so under certain conditions, inter alia the debtor is solvent and not-procrastinating.\textsuperscript{901} However, this view can be contested by the fact that it is contrary to consensus, if its occurrence is proven. AAOIFI provided that debt must not be made as capital in participation unless the debt was subordinate.\textsuperscript{902}

It can be argued that, in terms of usefulness, this method – admitting its legality – can be conceived in rare cases, such as if the project associated with the letter of guarantee is open to participation (mudarabah or musharakah).

Some contemporary scholars have suggested an alternative in order to avoid the controversy related to Shari’ah issues. Al-Nadawi implied that the letter of guarantee resonates with the rules of the previous issue if the transaction is based on the principle of participation in general.\textsuperscript{903} But, if it was established on the basis of liability or receivables partnership company contract (sharikat Wajooh),\textsuperscript{904} which includes the elements of guarantee and

\textsuperscript{899} AL-KHUWAITER, supra note 106, at 167-68.
\textsuperscript{900} See id. at 169.
\textsuperscript{901} See id.
\textsuperscript{902} AAOIFI, in its Shari’ah Standard No. (12) related to Sharikah (Musharakah), a and Modern Corporations, states: "[i]t is not permitted that debts (receivables) alone be used as a contribution to the Sharikah capital. However, debts may form part of the contribution to the capital where they become inseparable from other assets that can be presented as a contribution to the capital in Sharikah, such as when a manufacturing firm use its net assets as a contribution to the capital. [see Shari’ah Standard No. (21) on Financial Paper]." AAOIFI, supra note 43, at 329.
\textsuperscript{903} See al-Nadawi, supra note 858.
\textsuperscript{904} Wajooh company (liability partnership or receivables partnership) is a contract between two or more persons who have no capital. Building on their reputation and prestige, they buy goods on credit and sell them for immediate payment. They share the financial profits of the business. See AL-BAHUTI, supra note 832, at vol. 2, p. 228. AAOIFI defines Partnership in creditworthiness or reputation (liability partnership) as: "a bilateral agreement between two or more parties to conclude a partnership to buy assets on credit on the basis of their reputation for the purpose of making profit, whereby they undertake to fulfil their obligations according to the percentages determined by the parties. In addition, the parties should determine for each partner the percentage of profit sharing and of liability sharing, which latter may, by agreement, differ, downwards or upwards, from the percentage of profit sharing." AAOIFI, supra note 43, at 337.
the agency, the controversy about its legality disappears.\textsuperscript{905} However, the liability company is an issue of conflict among jurists; it is approved by the Hanafis\textsuperscript{906} and Hanbalis,\textsuperscript{907} but is prohibited by the Malikis\textsuperscript{908} and Shafa‘is.\textsuperscript{909} Some who authorized liability company, such as the Hanafis and the judge Abu Ya’li and Ibn Aqeel (they both are from the Hanbali School), stipulated that the ratio of the profit must be commensurate with the size of the guarantee, and the size of the guarantee must be commensurate with the amount of each part’s share.\textsuperscript{910} This eliminates any benefit to the customer if the cover for the letter was not provided, because the whole profits will go to the bank if the letter of guarantee is validly characterized as a form of liability company and this condition have been implemented. If the bank guaranteed all the debt to the beneficiary, then all the profits will go to the bank - according to this view. Likewise, if it offers guarantee to a certain percentage, the profit will be commensurate with such a percentage.

The Hanbali scholars view that the profits in the liability company are divided based on the agreement between the partners.\textsuperscript{911} This opinion was adopted by AAOIFI.\textsuperscript{912}

\textit{4.6.3.2. Third party guarantee and the legality of a consideration to the third party in return for its voluntary guarantee}

We mentioned above that the third-party guarantee is typically used in Sukuk to mean that a third party undertakes to bear the loss that may occur in the Mudarabah contract. The third-party guarantee has two applications in Musharakah or Mudarabah contract. The first is a voluntary guarantee\textsuperscript{913} provided by the third party to be without a consideration. Muslim scholars differ in the Shari‘ah ruling on this application on two views. The first view is that this application is permissible if Shari‘ah controls are met. In its resolution related to Mudarabah Sukuk, IIFA states,

\begin{itemize}
  \item \textsuperscript{905} See al-Nadawi, supra note 858.
  \item \textsuperscript{906} See IBN’ABDEEN, supra note 712, vol. 4, p. 324.
  \item \textsuperscript{907} See AL-BAHUTI, supra note 832, at vol. 2, p. 228.
  \item \textsuperscript{908} See AL-DOSOQI, supra note 830, at vol. 3, p. 364.
  \item \textsuperscript{909} See ZAKARIA M. AL-ANSARI, ASNAA ALMATALIB FI SHARAH RUD ALTTALIB vol. 2, p. 255 (Dar Al-Kitab Al-Islami, n. d.).
  \item \textsuperscript{910} See al-Nadawi, supra note 858.
  \item \textsuperscript{911} See AL-BAHUTI, supra note 832, at vol. 2, p. 229.
  \item \textsuperscript{912}See AAOIFI, supra note 43, at 337.
  \item \textsuperscript{913} A voluntary guarantee means, in this context, that a guarantor has no right of recourse, at all, to the Mudarib even if a guarantor paid the amount promised to make up a loss of the investors’ capital.
\end{itemize}
"There is nothing in Shari'ah preventing the inclusion of a statement in the prospectus or the Mugaradha certificates, about a promise made by a third party, totally unrelated to the two parties to the contract, in terms of legal personality or financial status, to donate a specific amount, without any counter benefit, to meet losses in a given project, provided such commitment is an independent one, not related to the Mudharaba contract, in the sense that the enforcement of the contract is not conditional to the fulfillment of the promise, or that the promise underlines the terms of the contract. Hence, neither the shareholder nor the Mudharib may invoke this clause to avoid the contract or renege on his commitment, alleging that said commitment made by the third party had been duly taken into consideration in the contract."

With such controls, AAOIFI has also approved third-party guarantee in Musharakah, with a slight difference. However, the opinion of IIFA and AAOIFI is unclear on whether the offering of this guarantee is based on a promise or contract. IIFA uses the word "promise" when addressing the issue of the third party guarantee. AAOIFI, in the Arabic version of its Shari’ah Standards, uses the word "Ta'ahud" when addressing this issue. Some Muslim scholars do not distinguish between Ta'ahud and Wa'ad (promise). In contrast, some jurists make a distinction between them, considering the Ta'ahud to hold almost the same power as a contract. Thus, we do not know which of the two views the AAOIFI adopts. In the English version of Shari’ah Standards, it states: "[a] third party may provide a guarantee to make up a loss of capital of some or all partners." Assuming that AAOIFI and IIFA consider that the provision of a third-party guarantee is based on a promise, they do not state whether it is a legally binding or a non-binding promise.

The second view on the Shari’ah ruling on a third party's voluntary guarantee provided without a consideration is that this guarantee is prohibited by Shari’ah.

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914 IIFA, supra note 83, at 65.
915 See AAOIFI, supra note 43, at 331-32.
916 See AAOIFI, supra note 85, at 330.
917 AAOIFI, supra note 43, at 331-32.
918 See al-Omrani, supra note 132, at 249.
The second application of third-party guarantee is when the third party's voluntary guarantee is provided for a consideration or fee. Some Muslim scholars see that voluntary guarantee\(^{919}\) of the third party that provided for a consideration is not permitted by Shari’ah.\(^{920}\) They state that the reason for the prohibition of taking reward in return for third-party guarantee is that it is considered a form of commercial insurance [conventional insurance], where the third party undertakes to make up a loss of capital of investors in return for the fee paid to him by the administrator or investors.\(^{921}\) In general, contemporary Fiqh bodies have, by consensus, prohibited commercial insurance.\(^{922}\)

**4.6.3.2.1. The standard of separation to approve the third party guarantees**

In view of those who allow a third party's voluntary guarantee in cases provided without a consideration, if the transaction takes place between individuals, it will not need to detail and specify the standards of separation between the parties with legal entities, usually owned by individuals. If a natural person voluntarily offers guarantee to an agent (mudarib) to make up for any loss in the Mudarabah capital, this is permissible in view of the jurists who dealt with this issue. But, as observed in some cases, if the guarantor in the Mudarabah contract is a company owned by the same guaranteed company, or the guarantor is a company that owns the sponsored company, the issue of separation will arise, since the agent is not permitted to guarantee the Mudarabah capital, as this is considered a form of usury (riba). The subject of separation between companies has various Shari’ah provisions, some are relevant to the issue under discussion. For this reason, Muslim jurists have discussed the issue of separation, since in some cases the guaranteed company holds a small stake in the guarantor company. As the third party guarantee is conditional to its separation from the parties to the contract, for example, in view of IIFA, it is necessary to identify the line between separation and non-separation.

Some who dealt with third party guarantee did not elaborated on some provisions. For example, IIFA, when authorizing third party guarantee under certain standards, inter alia, it is separate from both parties to the contract,

\(^{919}\) A voluntary guarantee means, in this context, that a guarantor has no right of recourse, at all, to the Mudarib even if a guarantor paid the amount promised to make up a loss of the investors' capital.

\(^{920}\) See al-Omrani, *supra* note 132, at 254; see also AL-MORSHEDI, *supra* note 106, at 100.

\(^{921}\) See AL-MORSHEDI, *supra* note 106, at 100-01.

\(^{922}\) See *id.* at 101; see also AAOIFI, *supra* note 43, at 678, 690; see also IIFA, *supra* note 83, at 13.
did not explain the meaning of separation. However, it can be implied that the third party is not the owner of any percentage of the guaranteed company or vice versa, i.e. the guaranteed party does not have a stake in the guarantor company. AAOIFI explicated the meaning of separation by saying: "(III) the third party guarantor should not own more than a half of the capital in the entity to be guaranteed, and (IV) the guaranteed entity should not own more than a half of the capital in the entity that undertakes to provide a guarantee." Thus, the percentage of ownership representing the separation between the guarantor and the guaranteed entities is established at 50% or less. However, some researchers see that the standard of separation validating guarantee is that each one of them [the guarantor and the guaranteed] has a separate entity and that neither of them is wholly owned by the other or by a share representing ownership majority, e.g. the guaranteed company's shareholding percentage is 99% of the guarantor company. There are applications of commercial and government entities in the Islamic financial markets authorized by their affiliated Shari’ah committees wherefrom the standards of separation between two legal entities or companies can be perceived. One of the recommendations of the Economic Fiqh Symposium - held between IIFA and the Islamic Development Bank in 1411 AH- is the permissibility of the bank's securing of what it sells to its investment fund, which it manages on the basis of Mudarabah. Here, no percentage was stipulated. Perhaps, the reason for recommending the permissibility of such guarantee is their embracement of an opinion close to the one referred to later by AAOIFI, which is equivocal to the present researcher, because it is open to many possible interpretations. First, it implies the permissibility of the agent - in

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923 Id. at 331.
924 See AL-MORSHEDI, supra note 106, at 100.
925 See id.
926 AAOIFI, in its Shari’ah Standard No. (5) releated to Guarantees, states: "2/2/1 It is not permissible to stipulate in trust (fiduciary) contracts, e.g. agency contracts or contracts of deposits, that a personal guarantee or mortgage of security be produced, because such a stipulation is against the nature of trust (fiduciary) contracts, unless such a stipulation is intended to cover cases of misconduct, negligence or breach of conditions or stipulations. The prohibition against seeking a guarantee in trust contracts is more stringent in Musharakah and Mudarabah contracts, since it is not permitted to require from a manager in the Mudarabah or the Musharakah contract or an investment agent or one of the partners in these contracts to guarantee the capital, or to promise a guaranteed profit. Moreover, it is not permissible for these contracts to be marketed or operated as a guaranteed investment. 2/2/2 It is not permissible to combine agency and personal guarantees in one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other hand), because such a combination conflicts with the nature of these contracts. In addition, a guarantee given by a party acting as an agent in respect of an investment turns the transaction into an interest-based loan, since the capital of the investment is guaranteed in addition to the proceeds of the investment, (i.e. as though the investment agent had taken a loan and repaid it with an additional sum which is tantamount to Riba). But if a guarantee is not stipulated in the agency contract and the agent voluntarily provides a guarantee to his clients independently of the agency contract, the agent becomes a guarantor in a different capacity from that of agent. In this case, such an agent will remain liable as guarantor even if he is discharged from acting as agent." AAOIFI, supra note 43, at 124-25.
his capacity as guarantor – to secure the investors’ capital, even if he was not infringing or negligent – in his
capacity as an agent or a proxy – provided this guarantee is separate from and unstipulated in the agency
agreement. Second, it may also mean the same standards mentioned above, but only in the event of infringement
or negligence, although the agent in his capacity will be liable to any loss if he infringes or contravenes the
conditions laid down. The first meaning is more likely to be intended pursuant to the rule that the establishment
of a rule has more priority than emphasis. Among the recommendations of the Sixth Al Baraka Islamic Economics
Symposium is "Al Baraka Bank's branch in Jeddah can secure investors' funds at Al Baraka Bank in London if
the laws of the country of the guaranteed bank (London Branch) require the guarantee of investors' funds." The
aim is not to discuss whether the existence of certain laws requiring commitment to secure investors' funds is a
justification to consent impermissible transactions. But, here it was permitted for a bank to secure one of its
branches regardless of the percentage of ownership for a reason, i.e. the existence of laws requiring that. In its
decision No. 4/27, Al Baraka Symposium stated, "Regarding the influential capacities affecting the relationship
between companies, Providing guarantee from one company to another in Musharakah, Mudarabah or an
investment agency is not permissible if the joint ownership is one-third or more". It can be concluded that the
standard of separation is that the percentage of ownership is less than one-third. Likewise, the Shari’ah Board of
the Jordan Islamic Bank has permitted the state to secure the funds of endowments invested by the Ministry of
Endowments. Here, the standard of separation could be the existence of a separate financial liability (dhimma
mustaqilla) if each public institution has a separate financial liability.

One of the two researchers suggested that separation that can establish the validity of the guarantee should be
between two companies none of them is owned by the other by any percentage.

The relationship between SPV and its originator can also be included in this discussion, while the issue of
separation is a controversial subject that should be investigated from a Shari’ah point of view.

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927 FAYSAL S. AL-SHAMMARI, MASAYIL FAQHIAN FIT ALSUKUK EARAD WATAQWIM [FIQH ISSUES IN SUKUK PRESENTATION AND
EVALUATION] 81 (SABIC Chair for Islamic Financial Market Studies, Research Chairs Program, Imam Muhammad Ibn Saud Islamic
University: Riyadh, Saudi Arabia, 2016).
928 Id. at 80-1.
929 See AL-MORSHEDI, supra note 106, at 100.
930 See AL-SHAMMARI, supra note 927, at 80
It is worthwhile indicating that few contemporary jurists distinguished between the undertaking/promise of the agent (mudarib) to guarantee the capital and his promise to purchase the securitized assets at the nominal value. In that way, they held the earlier as prohibited, while they permitted the later, as mentioned above. In addition, one of the issues related to the third-party donation is whether that promise is binding or not.

4.6.4. The differences between the personal guarantees (kafala) and guarantee of the Mudarabah capital, widely used in Sukuk, and their viability in the realm of Sukuk

Based on the data available to the present researcher, the difference between the term ‘guarantor’ in general and ‘guarantor’ as used in some types of Sukuk, such as Mudarabah and Musharakah, was not clearly determined. To avoid confusion between them, it is useful to identify the most important Shari’ah differences between them. It is noted that the term "guarantee" (daman or kafala) as employed by contemporary Muslim jurists in contexts outside Sukuk carried many senses, most notably the liability or personal guarantee in which the guarantor undertakes to clear the debt of the debtor when the latter defaults on payment, whether due to insolvency or procrastination with solvency. Many of the researches that investigated third party guarantee in the context of Sukuk used it to stand for securing the capital of Mudarabah and Musharakah Sukuk holders, the returns of those Sukuk, or both of them. A research on Sukuk in English used the "third party guarantee" to refer to the guarantee in which the guarantor undertakes to clear the debt if the debtor defaulted on payment. That research dealt with some issues of the personal guarantee (debt security) with reference to the third party guarantee of the Mudarabah capital.

In fact, there is a difference between the personal guarantee (debt security) and capital and/or profits guarantee. A personal guarantee means the undertaking to clear a debt when the debtor defaults on payment. This sense is closer to the fixed-income Sukuk applications such as Murabahah and Ijarah Sukuk that generate indebtedness. In contrast, third party guarantee is a voluntary undertaking to provide the capital of the Mudarabah or the Musharakah contract when it is lost or damaged, or to provide the expected returns when the Mudarabah or Musharakah project does not generate profits. Hence, third party guarantee is closer to the applications of variable-income Sukuk. It is noted that the question of debt security or personal guaranty in Sukuk did not receive the
same attention given to the third-party guarantee of the capital of investors in Mudarabah or Musharakah Sukuk as an alternative to the undertaking of the agent (mudarib) or the administrator of the Sukuk’s assets to purchase the Sukuk at the nominal value.

The most important differences between the personal guaranty and third party guarantee as discussed in the Mudarabah Sukuk can be summarized as follows:

- First, with regard to research, early and contemporary jurists tackled the issue of personal guarantee in detail, unlike the third party guarantee, which researchers used to refer to the guarantee of the Mudarabah or investment accounts capital.

- The second difference is that personal guarantee is typically used in the financial transactions that generate indebtedness such as Murabahah and Ijarah under which the guarantor undertakes to pay off the debt of the buyer – the debtor – in the deferred payment sale contract, of the lessee in the lease agreement, or of the borrower in the loan agreement. This image can be envisaged in Musharakah or Mudarabah in the event of infringement or negligence of the administrator, who is therefore obliged to repay the investors. Here, the guarantor (kafeel) is obliged to refund that money. Financial transactions involving third party guarantee do not generate a debt, but the guarantor undertakes to pay off investors' capital or profits when the project, which is object of Mudarabah or Musharakah, is lost, even if the mudarib or administrator was not infringing or negligent in the project.

- The third difference lies in the right of recourse. Originally, in the personal guarantee, the guarantor has the right of recourse to the debtor, in which case the relationship between them turns into a loan relationship, unless the guarantor intended to make the payment as a voluntary contribution or the debtor did not consent him to do so. Some branches of this question were a point of dispute between Shari’ah scholars. In contrast, in third party guarantee, the guarantor has no right of recourse to the debtor, otherwise the transaction would involve usury, for which the agent (mudarib) is not permitted to guarantee investors’ capital. However, it is possible that those who made a distinction between buying at the nominal value and guaranteeing the Mudarabah capital, which is the view of few contemporary scholars – that we consider a weak opinion – have approved the recourse to the agent.
• The fourth difference is related to separation. It is not necessary to determine whether the guarantor is separate from the debtor or the creditor in the personal guarantee, unlike the third party guarantee of the Mudarabah capital.

• The fifth difference between them is that the guarantee can be stipulated in the contract that creates a debt, such as the deferred payment sale agreement, while the stipulation of the third party guarantee of Mudarabah capital in the Mudarabah contract is not valid.

4.6.5. Adequacy and effectiveness of the guarantee and the third party guarantee in Sukuk

All previous applications of guarantorship (kafala) and third party guarantee can apply to sukuk, and their legal rulings in this regard are contingent upon the Shari’ah provisions related to them as mentioned. Despite their importance in the conventional markets in reassuring investors and creditors and facilitating the businesses of sponsored parties, sukuk faces some obstacles in implementing these two propositions. Moreover, reliance on them alone to counter credit and bankruptcy risks is insufficient to protect sukuk holders from the investment perspective.

One of these obstacles are the Shari’ah dispute over some issues, such as the dispute over charging fees for offering guarantee and third-party guarantee, which is banned in sukuk by the majority of contemporary jurists; the dispute over the bank’s benefiting from the funds or assets covering the letter of guarantee; the dispute over the criterion of separation between the third-party guarantor of the Mudarabah capital, the agent (mudarib) and the investors; and dispute over the third-party guarantee, even if he contributed it as a donation. It may be difficult to find a bank or a company, even an Islamic one, that acts as a guarantor - without charging a fee - of the sukuk originator, even if it has the right of recourse to him when paying off his debt, or to be a third-party guarantor by way of donation - admitting the view of those who authorize that. It is also inconceivable that the bank will not invest the funds deposited with it as a cover for issuing the letter of guarantee. If the competent Shari’ah court or the Shari’ah arbitration committee considered that the sukuk involves the provision of an invalid item that revokes the contract, it shall render all the sukuk as invalid. The question of charging fees for offering guarantee is a point of controversy among scholars – though some jurists reported a consensus on its prohibition – with regard to its effects on the contract itself. Some of them have revoked the item only, while others rendered the contract that
included this item invalid. In addition, some investors may also be reluctant to invest in sukuk that include that item for religious reasons or for fear of legal risks.

It is noteworthy that some jurists have worked hard to find Shari’ah alternatives to charging fees for merely offering sponsorship or letters of guarantee. One of the most Shari’ah-compliant alternatives that is far away from the possibility of being rejected by the court, especially in Saudi Arabia, is reliance on the Wojooh partnership. However, this alternative may not appeal to conventional banks, as they are not accustomed to it. The biggest burden will be on Islamic banks in cherishing such alternatives and demonstrating their usefulness in order to encourage conventional banks to contribute to the development of the sukuk industry, though the shift in the system of conventional banks is difficult. Besides, the assets of Islamic banks are too weak to absorb and respond to the need of the sukuk market to letters of guarantee or sponsorship.

One of the potential disadvantages of sponsorship and third-party guarantee is that they - especially third-party guarantee when offered by way of donation – may entice the obligor or agent of sukuk to slacken their obligations to investors or to dawdle over the management of the project - for which he sought financing through sukuk – as he would rely on a sponsor or a third-party guarantor to redress any loss in the capital of Musharakah or Mudarabah. Further, the sponsor or the third-party guarantor may encounter unfortunate financial conditions that hinder or delay the payment of the dues of the sukuk holders when the guaranteed party (the originator) defaults in Murabahah or Ijarah Sukuk (or when the originator loses the investor's capital or the actual returns are less than the expected returns), as was the case in the Nakheel Sukuk, of which the Government of Dubai was the guarantor of the originator.

4.7. Increasing return margin or price of assets with a stipulation of partial waive if payments are on time

4.7.1. Introduction

One suggested method the researcher considers economically effective in mediating the default risk of an originator in debt-like Sukuk is for the originator and investors to agree, when entering into contract, to raise the price, yield, and/or returns with a stipulation to partially waive, (as if the Sukuk stood at the current market price)
provided that the originator pays all periodic returns and amounts of maturity/redemption on time. In this section, we discuss the feasibility of this proposal in the three types of Sukuk (Murabahah, Ijarah, and Musharakah), its legitimacy according to the Shari’ah, as well as its adequacy and effectiveness.

### 4.7.2. The importance and fields of this proposal

This proposal can be considered a useful alternative to what is practiced in traditional debt markets and can reduce probability of failure of rescheduling arrangements of Sukuk debt. In traditional debt markets, debt restructuring typically involves interest/usury due to delayed payment of outstanding debts. Typically, the potential of interest being involved in debt restructuring is stipulated in the initial legal documents when subscribing the bond or is agreed upon in debt restructuring negotiations when default has occurred or is imminent.

However, this proposal can only be applied in the original contract underlying Sukuk or, within some applications of Sukuk, in a new contract that fulfills the promise of purchasing the assets by the maturity/redemption date.

To illustrate the proposal through example, if a Murabahah margin in the market is 4%, investors can agree with the originator to sell the Murabahah commodity with a profit margin of 8%, with a stipulation to waive 4% of the profit margin after paying the last amount owed by the obligor if he has never delayed payment of periodic return or of the amount of redemption which is usually equal to the principal in bonds.

An example of Sukuk of lease ending with ownership is that if the rent margin (usually equal in practice to the market interest rate) is at 4%, the two parties could agree that the investors will lease the assets to the originator/future lessee with an 8% return margin, including a stipulation in the contract underlying Sukuk, to reduce the margin by 4% in the case that he pays the periodic rentals and the amount of redemption, (usually the face value of Sukuk) on time.

Here the difference between the Ijarah and Murabahah Sukuk is noted. When the promise is made by the lessee to repurchase (or purchase) the Ijarah assets, either in face or market value, a new contract must be drafted at the end of Ijarah Sukuk agreement as required by AAOIFI, with the exception of a few cases which were mentioned
before. This is unlike Murabahah Sukuk, in which the originator/buyer's promise to buy back Murabahah assets is not envisaged because he became the owner of assets.

With regard to Musharakah Sukuk, the present research considers that this proposal cannot be applied in the contract underlying Sukuk, because these types of variable income instruments are based on the principle of a profit and loss contract which does not, in general, create debt. The proposal can be applied in contracts that generate debt whether it is the basic contract or the contract relating to the fulfillment of Sukuk asset purchase promise at the redemption date.

However, it should be noted that in a Mudarabah contract, one type of Musharakah, debts are conceivable if there is infringement, tort or negligence by the mudarib (profit-sharing agent). In this case, the mudarib would be liable for the investors' capital, therefore the mudarib would be a debtor until the capital is returned. The contracts of Musharakah and Mudarabah can also end up in debt if the opinion of scholars and Fiqh councils is taken into account, as they endorse the unilateral binding promise to buy back Musharakah or Mudarabah assets at market value as it's bound legally and is in accordance with Shari’ah. According to this view, the mudarib, who made a binding promise on his part to repurchase the assets at market value at the date of maturity, is forced religiously and legally to fulfill that promise by entering into a new contract if the investors (who have not made a binding promise to sell the assets) agree to exercise the right of this option. When the new contract is concluded, the mudarib will be obliged to pay the market value of those assets.

Hence, one can argue that this proposal could be envisaged in cases of Musharakah or Mudarabah Sukuk structure including such promises, and when the maturity date arrives, the investors agree to sell the assets to mudarib on credit instead of the pre-supposed cash.931 Here, this proposal can be viable.

This argument can be feasible in many applications of Sukuk. For example, the proposed item could be applied in the Ijarah and Musharakah Sukuk in the case of an application that includes a unilateral binding promise, in the view of those who consider the unilateral promise permissible and bound by Shari’ah, for the purchase of the

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931 We will soon refer to the Shari’ah ruling on the fulfillment of the promise through a credit-sale contract.
securitized assets by the maturity date at the value\textsuperscript{932} agreed upon in the contract underlying Sukuk, or the applications that include a bilateral binding promise, in the view of those who consider the bilateral promise permissible and bound by Shari’ah, for the purchase of the securitized assets by the maturity date at the value agreed upon. In this instance the proposal could be applied at the time of fulfillment of the promise asset purchase if the parties agree that the purchase of the assets will be on the basis of a contract of forward-sale, instead of the pre-supposed cash sale, and they agree to change the agreed value or price to more than the agreed value price. For the proposal to be applied, price of assets shall be more than the market price of the forward-sales. In this forward-sale contract, the parties could stipulate that if the debtor/originator pays on time, the seller/investors will waive part of the debt/price.

This proposal can be also conceived in Ijarah and Musharakah Sukuk in the case of an application that does not include any promise, relying on what has been proposed in the third chapter of the present research, concerning ideal standards which include the avoidance of binding promises. This proposal could be applied if the parties voluntarily agree at the end of the Sukuk period to enter into a new contract to purchase a Sukuk asset, and this contract is on a forward-sale basis. Here, investors sell assets to the originator at a price higher than the market price of forward-sales, with a stipulation in the contract that in the event of the debt being paid off regularly, a specified part of such debt would be waived. However, this proposal cannot be applied in Murabahah Sukuk at the end of the Sukuk period because the originator becomes the owner of the Sukuk assets in the post-IPO stage of Islamic Sukuk at the point the investors sold Murabahah assets to him.

It is important to refer to the Shari’ah ruling on making changes in the promise with the consent of the parties concerned so that the promise is fulfilled through a credit-sale contract– regardless of if our proposal is included or not - rather than an immediate sale. AAOIFI mentions sporadic Shari’ah controls, in its book of Shari’ah Standards for repurchase transaction and transactions involving promise, to avoid the parties falling into Riba and 'Inah.\textsuperscript{933} For example, AAOIFI, in its Shari’ah standard concerning repurchase, states that the fulfillment of the

\textsuperscript{932} The value agreed upon in the contract underlying Sukuk might be market value, nominal value, or fair value, or price agreed by the parties to the contract underlying Sukuk in IPO period, or price agreed by the parties at the maturity date. Some of these methods are controversial among those (Shari’ah scholars) who see that the undertakings are binding and permissible.

\textsuperscript{933} See AAOIFI, supra note 43, at 1165; see also AAOIFI, supra note 85, at 1359-365.
promise to repurchase assets should be through an immediate-sale contract (i.e. the promisor should repurchase assets on spot) in the case of the buyer/promisor in this contract being the original seller of assets [such as the assets to be securitized].\textsuperscript{934} It also states that the new contract must be concluded after a period in which the character/quality (\textit{sifah}) and value of the sold assets had changed.\textsuperscript{935} It also states that the original contract that included the sale of the assets to be securitized should be concluded on the basis of an immediate sale contract.\textsuperscript{936} Perhaps the best way out of this Shari'ah/legal problem is to encourage investors to buy assets to be securitized from a third party that has no relevance to the originator/company seeking financing through Sukuk. The purchase of assets to be securitized from a third party in all Sukuk structures reduces the likelihood of Shari'ah/legal risk, especially regarding 'Inah and Riba.

In summary, this proposal could be utilized prior to the IPO of certain Sukuk applications by stipulating the clause (waiving part of the debt/returns if the originator pays on time) in some of the underlying contracts. The proposal may also be applied at the end of the Sukuk period in the applications of some Sukuk types in the event that the parties want to change the promise, provided in the prospectus or legal documents of those applications, relating to the purchase of the Sukuk assets being executed on the basis of the credit sale contract, or in the event that the parties want to enter into a credit sale contract for the purchase of assets of Sukuk which are free from any promise. In the last two cases, the buyer in the new contract (credit sale) should not be the original seller who sold the assets to be securitized as mentioned above.

\textbf{4.7.3. Compliance of this proposal with Islamic Shari’ah and the scope of its work}

After searching and investigating, the researcher did not find anyone who refers to this method in the area of Sukuk or any field, except, to some extent, in two contemporary answers (Fatwas) to two questions posed to two Shari’ah Committees of two Islamic banks related to the Murabahah contract. The Shari’ah Supervisory Board of Qatar Islamic Bank was asked about the Shari’ah ruling on the imposition of a fine in a Murabahah contract on customers who were late in paying the installments due because the delay was not matched by any kind of penalty,
and the legal proceedings against them before the courts takes several years, leading to the bank experiencing large losses.\textsuperscript{937} It states in its legal opinion (\textit{fatwa}),

This is not permissible. The Committee sees the possibility that the bank increases the percentage of profit, and in the case of the customer's commitment to pay in time, the bank gives the customer a percentage of the profit already taken [to the bank] to encourage him to pay on time, availing itself and exercising the arbitration clause in case of delayed payment by the customer…\textsuperscript{938}

However, Fatwa is not clear on whether a Murabahah contract can include these details, such as increasing the profit with stipulation that if the customer continues to pay, the bank will give him a percentage of high profit. Thus, this opinion of providing the customer a percentage of profit might be legally and characterized in Shari’ah as merely a reward/gift or perhaps a binding commitment, regardless of the Shari’ah ruling on this Fiqh characterization. This opinion also does not clarify if the amount of percentage, which may be given to the customer, should be specified.

Regarding the other Fatwa example, the Fatwa and Shari'ah Supervisory Board of the Kuwait Finance House was asked about the Shari'ah ruling on adding a percentage on top of the original/fair price of a contract of forward-sale to face any delay in payment so that such percentage will be taken, with the price, in the event of delay, and if there is no delay, that percentage will be deducted from the client.\textsuperscript{939} It states,

It is not permissible to agree with the customer on a condition, whether is is noticeable or uttered, to cancel part of the deferred price upon its acceleration. But in the case of accelerating payment [after the contract was concluded, i.e. when the contract does not include a deduction clause], the appropriate deduction can be calculated according to the management's opinion. This is permissible on condition that the contract does


\textsuperscript{938} \textit{Shari'ah Supervisory Board of Qatar Islamic Bank (Fatwa No. 64), supra note 937, vol. 3, p. 391; see also Shari'ah Supervisory Board of Qatar Islamic Bank (Fatwa No. 64), supra note 937.}

not contain two specified prices; a price for the period [in credit sales for example] and a price in the instance of delay in paying off the deferred debt (procrastination in payment). What is regarded as a reserve for delaying payment could be combined with the price and deduction can be made as mentioned above.940

However, it seems likely that there is no connection between the Committee's Fatwa and the question posed to it. There is also ambiguity in the relationship between the question posed to the Committee and the proposal at hand. The question relates, as it is understood, to the Shari'ah ruling on increasing price, for example, of goods that will be sold on bases of credit sales, to more than the original/fair price of a contract of forward-sale, and if the debtor pays by due dates, such increase will be deducted. The question does not refer to the issue of waiving part of the deferred debt when it is paid ahead of the due date while the Committee addresses the Shari'ah ruling of this issue, as the details mentioned by the Commission. The Committee also addresses ruling on a contract containing two prices - one of which is the price of the commodity sold on credit and the other is the price that can be applied in the event of a delayed deferred payment. As to the relationship between the question posed to the Committee and the issue in this proposal, the question was not precise. The inquirer did not clarify if the deduction is a clause stipulated in the contract or that the deduction is not mentioned in the contract, but is given to the customer as a reward.

With regard to the Commission Fatwa concerning the prevention of two prices in the contract, one might argue that the Committee's legal opinion might include this proposal. This argument could be based on the fact that this point of concern involves two prices. The first is the price raised above the original/fair price. The second is the price (original price) before the increase that will be deducted in case of the debt being paid off on time. Although this is a remote possibility because the Committee explained the meaning of the two prices.

The proposal includes one specific price in contracts that generates a debt that is not disputed by Shari’ah, but that price is higher than the market price. This method could be included in the original contract underlying Sukuk, the contract drafted at the end of the Sukuk period for fulfillment of unilateral binding promises after changing

940 FATWA AND SHARI’AH SUPERVISORY BOARD OF KUWAIT FINANCE HOUSE (FATWA NO. 85), supra note 939, at vol. 3, p. 55; see also Fatwa and Shari'ah Supervisory Board of Kuwait Finance House (Fatwa No. 85), supra note 939.
the promises of the contract to be on the base of the forward-sale, or in the contract drafted at the end of the period of Sukuk that do not include binding promises but the parties voluntarily want to enter into an assets repurchase contract on the base of the forward-sale. In the event of the originator/debtor in the Sukuk being late in payment, the return margin or the price shall remain as they are without any increase or decrease. However if the originator continues to pay on time - which is different from the accelerating debt - creditors will waive the added percentage - which is combined with the price - to the extent that the price is equal to the market price at the time of subscription of investors to these Sukuk.

It should be noted that the price of a commodity of Murabahah, for example, must be specific and known. In Shari'ah, it is not permissible to sell one commodity at two different prices, one for cash and one for credit, without specifying which price or method is chosen by the parties. This is one of the interpretations of "two sales in one sale" (bai'atan fi bai'ah) which is prohibited in Shari'ah.

This proposal would likely raise concern as it considers the transaction as if it has two prices; a certain price - in the event of delay in paying off the debt - agreed upon in the contract to be higher than the market price, and the price in the case of paying off the debt on time. It is important to mention these two issues on which the Shari'ah jurists may base their ruling on this proposal.

4.7.3.1. The matter of what is called "waive part of the debt and bring forward repayment" (da’ wa ta’ajjal)

The scholars may invalidate the proposal by analogy (qiyas) with some applications of this matter. It is important to discuss the da’ wa ta’ajjal to decipher the relationship between it and the proposal. This matter has several applications in which the Shari'ah ruling differs. The first is related to the due debt. According to AAOIFI, the due debt is "a debt that is immediately payable or that is payable on the creditor’s demand, whether on its original due date or, if it has been rescheduled and deferred, on its rescheduled due date."941 Its example could be that when the due debt is $1,000, the creditor says to the debtor, if you pay $500 now, or at specific time, I will

941 AAOIFI, supra note 43, at 117.
waive the rest of it. This application is permitted by jurists.\textsuperscript{942} One of the jurists related the consensus on the legality of that in Shari'ah.\textsuperscript{943} However, the researcher, based on the data available, did not find any scholars who touch on the Shari'ah ruling if the debtor is the initiator in this example.

It should be noted that the view of the majority of Muslim scholars is that the loan is due debt by its nature, and therefore a substitute (\textit{badal}) of the loan should be returned on demand even if there is a stipulation in the contract to return it at a specified date, while the Malikis and some jurists see that if the contract provides a stipulation of a period in loan, the borrower is under no obligation to return the substitute prior to the end of the period.\textsuperscript{944} The Shari'ah ruling on deferred debts that become due is similar to the ruling on loan in the view of the scholars majority in that matter, unlike the Malikis who see that if the parties agree to postpone the deferred debts - that become due – to a specified date, the debtor is not bound to repay the debt before that date.\textsuperscript{945} The Hanafis agree with the Malikis in some reasons for the debts.\textsuperscript{946} Thus, based on the opinion of the majority, it is permissible in the loan to make a deduction from the substitute of the loan for the purpose of acceleration.\textsuperscript{947} It is also permissible in deferred debt - that becomes due - to make a deduction from the debt to accelerate paying off the remainder of the debt. The difference between case in this matter and our proposal is that the latter contains a stipulation in the contract underlying the Sukuk that if the entire debt is paid without delay, the investors/creditors - after the specified time allotted to pay off such debt - will deduct from the debt the amount of the increase that was combined with the original market price when entering into the contract underlying Sukuk, while in this case, the deduction is in due debt without a stipulation for deduction in the original contract that created the debt. The question here is whether this difference between them is an affective difference that prevents Shari'ah analogy (\textit{qiyas}).

\textsuperscript{942} See Farahat B. al-Kaseh, \textit{al-Hatt min al-Thaman al-Muajal Mqabl Taejilih (da’ wa ta’ajjal) [Waive Part of the Debt in Return for Bringing forward the Repayment] 263-64 (Majallat al-’Ulum al-Shariyyah, Alasmarya Islamic University, Issue No. 4, pages: 259-300, October 2017). Available from: https://www.asmarya.edu.ly/journal/wp-content/uploads/2018/02/9%D8%B6%D8%B9-%D9%88%D8%AA%D8%B9%D8%AC%D9%84-%D9%81%D8%B1%D8%AD%D8%A7%D8%AA-%D8%A7%D9%84%D8%83%D8%B3%D8%AD.pdf (accessed on 15th January 2019).
\textsuperscript{943} See id.
\textsuperscript{944} See id. at 264.
\textsuperscript{945} See id.
\textsuperscript{946} See id.
\textsuperscript{947} See id. at 264-65.
The second application is related to deferred debt. It is defined as: "a debt the payment thereof is due at a certain time in the future, and it may also be due in periodic instalments over time."  

This situation has two cases. The first case is that the deferred debt repayment is accelerated without a stipulation - in the original contract or at the time of accelerating - of waiving part of such debt, or that waiving part of the deferred debt is done without a stipulation - in the original contract or in the time of waiving - of acceleration of such debt. This transaction is permitted by the majority of scholars and fiqh schools (Hanafi, Shafa'i, Hanbali, and Dhahiri schools). As for the Maliks, they forbid it so as to prevent the means that lead to the Riba (interest or usury). For example, if the value of the deferred debt is $1,000, and is due in a month and the debtor paid $700 today, while urging the creditor to waive the rest or part of the remainder of it, and he willingly and voluntary did, this method is permissible according to the majority of jurists. The debtor here brought forward repayment of part of the deferred debt without a stipulation of waiving the rest or part of the remainder of such debt, so the creditor is not obliged to waive part of the debt when the debtor urged him because there is no stipulation for the waiving, neither in the contract that created this debt nor during the acceleration.

The second case is waiving part of the deferred debt in return for bringing forward repayment as well as the opposite (i.e. bringing forward repayment in return for waiving part of it). For example, if the value of the deferred debt is $1,000, and is due in a month, and the debtor says to the creditor that he will pay $700 now, if $300 of the debt is waived. In this instance, bringing forward repayment is conditional on waiving part of the deferred debt. This case is prohibited by the majority of Muslim scholars (the Hanafi, Maliki and Shafa'i scholars), as it is the view of the Hanbali school, while this is permitted by one of the two narrations of the Hanbalis, Ibn Taymiyah, Ibn al-Qayyim, and others. Also, IIFA allows "if it is not based on an advance agreement and as long as the relationship between the creditor and the debtor are bilateral." Each party determines opinion based on its own evidence and reasons.

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948 AAOIFI, supra note 43, at 117.
949 See al-Kaseh, supra note 942, at 261.
950 See id. at 262.
951 See id. at 266, 272.
952 IIFA states: "[t]o reduce a deferred debt with the aim of accelerating its repayment, whether at the request of the creditor or of the debtor (pay less but ahead of time), is permissible in Shari'a and does not fall within the province of Riba (which is forbidden) if it is
It is difficult to predict the opinion of Saudi Arabian courts on the issue of *da’ wa ta’ajjal*. Although the majority of scholars, including Hanbalis, forbid it, the permission of Ibn Taymiyah, Ibn al-Qayyim (who are two of Hanbali), IIFA, and others on this issue makes it difficult to predict what the courts would rule.

The difference between our proposal and *da’ wa ta’ajjal* is that the latter includes waiving part of the deferred debt, conditional on the acceleration of such debt as well as the opposite, and this condition applies when one of the parties wants one of two things: waiving or acceleration. While the contract containing this proposal provides the stipulation of paying full debt without delay to waive part of the debt.

The concern in *da’ wa ta’aj jal* is the possibility that the Shari’ah court may annul the application of *da’ wa ta’ajjal*, especially if it considers that the transaction includes Riba. The same may happen in this proposal because of the similarity between it and the case in some aspects, but perhaps the risk of non-compliance with Shari’ah is less in this proposal because of the differences between them.

### 4.7.3.2. The relationship of unfairness in price in the proposal with both the option to revoke on grounds of price gouging (khiyar al-ghabn)\(^9\) and the risk of non-compliance with Shari'ah

In the Shari’ah, one of the rules of exchange (*mu’awadat*) contracts, such as the sale contract, is that the price (the consideration due item) and the sale object (commodity) should be fixed and known to the parties, which generally have the right to determine the price (or rentals in the case of Ijarah contract), but the proposal might also face the risk of non-compliance with Shari’ah which may lead to the annulment of the Sukuk.

It is also possible that the proposal could face the lesser probability that the originator (who can be, for example, the buyer of the assets in Sukuk based on the Murabahah, or the lessee of the assets) may claim the right to annul the underlying Sukuk contract of sale or leasing that includes increasing the consideration more than the fair market price/rentals, especially if such increase is gross. The possibility of the right to cancelation is based on the

fact that the transaction might be described as an unfair transaction (al-ghabn) even if the originator enters into a transaction knowing that the consideration is unfair.

The Muslim scholars mention several cases of deals that are regarded as unfair or cheating (al-ghabn), such as one buying a commodity more than the real or fair price, or someone selling a commodity for less than the real or fair price. Al-Ghabn has several applications. The only application that will be discussed here is in the instance of the parties having been aware of price gouging at the inception of the contract. Dr. Ali Abu al-Basal states that the view of the majority of Muslim scholars (Hanafi, Maliki, Shafa'i, Hanbali schools) maintain that in the case of someone who has experience and is aware of the real and fair price/consideration of the object of sale, but enters into a transaction knowing that the price is unfair, or in the case of someone who accepts to sell the item knowing that the real value of the item is more than the price, the parties do not have the right to annul the deal, because there was no cheating or deceit in this case.954 This case is also permitted by AAOIFI.955 The permanent Committee for Scholarly Research and Ifta in Saudi Arabian states that profits in trade are allowed to be unlimited in Shari'ah.956 Dr. Abu al-Basal states that the second opinion is that the transaction that involves unfairness in the price is void and not permitted even if the parties were aware of this when contracting. He says that this is the view of some scholars of the Dhahiri school.957 On the contrary, Ibn Hazm, one of the most crucial pillars of the Dhahiri school, allows it according to Dr. Abu al-Basal 958 The possibility of relying on the second opinion to prohibit and invalidate Sukuk that include this proposal is probably unlikely, especially in the courts or arbitration in Saudi Arabia. Also, the originator/debtor in Sukuk, who paid all debts on time, would retrieve the difference between the price provided for the Sukuk and the market price of securitized assets at the time of the issuance of the Sukuk.

955 AAOIFI, in its Shari‘ah Standard No (48) regarding Options to Terminate Due to Breach of Trust Trust-Based Options, states: "[p]rerequisite [of khiyar al-ghabn (option to revoke on grounds of price gouging) is that] [t]he buyer must be unaware of price gouging at the inception of the contract." AAOIFI, supra note 43, at 1152-153.
956 See THE PERMANENT COMMITTEE FOR SCHOLARLY RESEARCH AND IFTA, supra note 742, at vol. 13, p. 91.
957 See Abu al-Basal, supra note 954.
958 See id.
4.7.4. Is the norm in Islamic Shari’ah in regard to contracts and conditions that of permissibility, validity and bindingness, except for exemptions established by Shari’ah rulings?

With the absence of both case law and Shari’ah research on this issue, it is difficult to predict with certainty which ruling the Shari’ah courts or arbitration, which have jurisdiction over Sukuk, would impose on this proposal, as it is possible to annul the item in the contract underlying Sukuk, or to annul the entire transaction, or to deem the proposal is not in violation of Shari’ah. However, it is important here to refer to an Islamic legal maxim debated by jurists, i.e., whether the norm in the Shari’ah regarding contracts and conditions is that of permissibility, validity and commitment unless a Shari’ah evidence proves their prohibition, or that the norm in that is prohibition and banning unless a Shari’ah evidence establishes their permissibility. Scholars and jurists differ with regard to the classification and number of valid stances on this issue, and take disparate views in relation the attribution of opinions to their sources.

Some scholars, such as Ibn Al-Qayyim and others, attribute the opinion that claims that the norm in contracts and conditions is that of permissibility and validity to the majority of jurists.959 Ibn Rajab, the Hanbali scholar, -after subscribing to the view that permissibility is the original state (al-aslu fil ash’yaal al-ibaaha) as confirmed by Shari’ah proofs - says: "some of them [jurists] have reported the occurrence of consensus on that."960 Ibn Taymiyah, the Hanbali jurist, says:

But, Ahmad [the founder of the Hanbali School, which the Saudi courts mainly rely on its view more than other Fiqh schools] validated more conditions than other jurists. None of the four leading jurists [the founders of the four main Fiqh Schools] was more inclined to validate conditions than him.961

Some scholars attribute the other view, i.e., that the norm in regard to contracts and conditions is that of prohibition and invalidity to few specific jurists. As Ibn Qayyim attributed the opinion that the norm in regard to contracts is that of permissibility and validity to the majority of Islamic jurists, it can be conceived that those who say otherwise are the minority.

In contrast, some researchers attributed to the majority of jurists that they see [explicitly or implicitly] that the norm in contracts and conditions is that of prohibition and invalidity. They attributed to few jurists that they see the norm in that matter as permissibility and validity. One researcher added a third opinion: consideration and examination of the matter, pointing out that the validity or invalidity of the contract can only be established by a Shari’ah proof. He attributed that opinion to one of the jurists. Because that rule falls outside of the focus of the present research, we will not dwell on the investigation of its Shari’ah position and the attribution of relevant opinions to their sources.

The rule of the norm in contracts and conditions being that of permissibility is considered as one of the judicial principles in Saudi Arabia. According to this view, whoever believes that some transactions are prohibited by the Shari’ah should substantiate his claim with Shari’ah proofs. As such, in view of those who see that the norm in regard to contracts and conditions is that of permissibility, validity and bindingness, those who render a transaction or condition as prohibited or invalid must provide the evidence to prove their claim. In contrast, whoever believes that the norm in that is prohibition and invalidation require the opponents to provide the Shari’ah evidence to prove that.

4.7.5. How the dispute arose over that proposal

The dispute over the proposal between the two parties is conceivable in several cases with a disparity in these cases driving the force of the dispute. Some cases are only conceived in some applications and types of Sukuk.

962 See Ibhees, supra note 959, at 23.
964 See id.
965 See Ibhees, supra note 959, at 25.
966 See id.
967 See al-Mabaad’a Walqararat, supra note 686, at 35-6.
The first case is that the dispute may arise when the originator/debtor pays on time without delay and the Sukuk holders refuse to implement the clause related to the proposal (i.e. waiving part of the debt/price/returns), wanting not to waive part of the price/return which is higher than the market price/return, claiming it is invalid by Shari’ah. This dispute can be raised if investors believe that the competent jurisdiction of the Sukuk will not invalidate the contract underlying Sukuk which includes this clause; otherwise they would not file a claim because in Shari’ah, if a contract is to be annulled, all implications of it would have to be revoked, requiring each party to claim back what it has provided. For example, by revoking the Murabahah Sukuk, investors recover the securitized assets which were structured to be on the base of sale on credit to the buyer/originator, and thus investors have to give back the returns/profits already paid to them.

The second case is that the dispute can occur when meeting the following circumstances together: if the originator paid on time without delay, and the securitized assets have significantly increased in value, higher than they were in the IPO period of Sukuk, and if investors believe that the competent court or arbitration will probably void the contract for the existence of the clause related to this proposal. Here, investors may seek to sue, due to alleged breach of the Shari'ah, hoping to recover the assets.

The third case of dispute can occur in certain types of Sukuk such as a lease ending with ownership transfer (Ijarah Muntahia Bittamleek), if the originator/debtor - who has made an unilateral binding promise to purchase the securitized assets at nominal value at the maturity date - does not want to fulfill the promise either because he does not have sufficient liquidity or because the market value of the assets decreased significantly below the nominal value at the date of maturity. In that instance, he may file a claim to cancel the contract underlying Sukuk which includes the proposal.

The fourth case of dispute may arise if the originator does not pay on time. Here, the originator, in order not to pay the difference between the price (and/or profit/rentals) agreed upon in the contract underlying Sukuk and the market margin at the time of concluding such the contract, may file a claim to revoke it. It is possible that he requests only to revoke the item relating to the proposal in order to pay only the equivalent of the market price at the time of subscription of the Sukuk.
Regarding the revocation of the entire transaction or the proposed item, the lawsuit concerning the proposal, which could be filed by either the investor or the originator, might be based on Riba or al-Ghabn, or the proposed clause could fall within the invalid conditions stipulated in the contracts. It is important to note that Muslim jurists differ in Shari’ah ruling on some conditions, as they differ in opinion on which conditions invalidate contracts and which do not. If the competent court ruled that the contract - which includes a condition that requires investors to waive part of the debt if there is no delay in payment - is correct, but ruled to invalidate this clause or condition, it would be in the interest of the Sukuk holders. This condition would be as if it did not exist, and investors would have the entire price/returns stipulated in the contract. Therefore, the risk of invalidating only this clause would be borne solely by the originator.

4.7.6. The adequacy and effectiveness of the proposal

This proposed solution to combat the default risks associated with Sukuk has multiple advantages for the parties involved, especially the investors, and it can be applied - admitting its legality in Shari’ah – prior to the IPO period in some of the contracts underlying Sukuk and/or in the new contracts which are related to the fulfillment of the Sukuk assets purchase promise at the maturity date. The proposal could be seen as an appropriate alternative to the advantages of debt restructuring in traditional markets, which usually include interest/Riba for rescheduling debt that also stipulated interest. It can be motivating for the obligor/originator in Islamic securitization to continue to pay on time in order to obtain the agreed waiver. It also aids in successful debt rescheduling negotiations - without any interest/Riba - in, for example, Murabahah and some types of Ijarah Sukuk.

When the originator/obligor is late in paying receivables in the Sukuk - which are based on fixed income instruments - investors take into account the possibility that the obligor will delay in paying off the deferred debt by raising the price of assets and/or margins to more than market price or returns. Thus, this proposal puts them in a better position than investors in defaulted Sukuk - that are free of this proposal - in which investors may either resort to restructuring debt without interest/Riba because it is forbidden by Shari’ah and because investors want to avoid Shari’ah risks that may lead to the cancellation of the entire transaction, or they may resort to restructuring
debt in the traditional way that involves Riba, which also exposes them to the Shari’ah risks. Such action could also harm their reputation in working with Islamic law-based transaction and the commission of what is prohibited - in Islamic law – potentially leading to self-reproach for entering into transactions prohibited in Islamic law.

The Sukuk price and/or returns margin, which is higher than the market price/margin, would reduce the negative effects of the length of the trial in the case that the investors prefer to file a claim with the courts or arbitration. The trial may take several years, and the investors will not receive interest (as a compensation for late payment) if the Shari’ah court has jurisdiction over this dispute. This would mean they would lose the chance to reinvest their funds and capital. When calculating and evaluating yield margins and/or selling asset prices, the length of time that the judicial rulings with rulings enforcement may take must be taken into account. Furthermore, the new duration of the potential restructuring of debt, and the time it takes to enter into a new contract on the basis of the forward sale related to fulfillment of the asset purchase promise should be taken into account when calculating the returns and/or the price of sale for the Sukuk assets, on the assumption that the debtor may default on payment and request a debt rescheduling. The reason for the appropriate margin or price calculation is the likelihood that investors will want one of these two methods when default occurs (litigation/arbitration or approval of debt rescheduling).

The proposal would also be useful even if Sukuk include a binding unilateral promise - as permitted by some scholars - by the originator (provided that he is not the original seller who sold the assets to be securitized as mentioned above)\(^968\) to purchase the Sukuk assets at the maturity date when he is suffering from a financial crisis preventing purchase on the basis of cash sale. Here, the parties could agree to enter into a credit sale agreement to sell the assets, that are supposed to be sold in cash, to the originator. It is also useful when the Sukuk include a bilateral binding promise - as permitted by few scholars - by the two parties (i.e. the originator, who is not the original seller who sales the assets to be securitized, promises to buy the assets at the maturity date and the investors promise to sell them to him)\(^969\) that in the case of the promise of purchase, the Sukuk assets should be

\(^{968}\) See p. 35.
\(^{969}\) See p. 35-36, 274.
fulfilled by entering into a new contract - as required by some Fiqh councils such as AAOIFI and some scholars \textsuperscript{970} that includes the exchange of the offer and acceptance, so such contract is not automatically effected at the maturity date. This case requires approval from the Sukuk holders to implement this change so that fulfillment of the promise would be on the basis of a credit sale agreement instead of a spot contract. The proposal may also be effective in spurring the promisor to fulfill the promise at the agreed time in applications involving the condition/clause that if the Sukuk asset purchase promise is fulfilled at the maturity date, part of the value/price, determined in the contract underlying Sukuk, would be waived.

On another hand, this proposal may face Shari'ah and economic questions. Based on the data available, the present research does not encounter scholars who discuss and permit the proposal except a brief Fatwa from one of the Shari'ah committees of the bank.

According to some Muslim jurists and researchers, the majority of Muslim jurists see that the basic principle regarding transactions, contracts and conditions is that they are permissible and legal in Shari'ah, unless there is proof to show that they are not valid in Shari'ah. However, the proposal or the entire transaction that includes the proposal could be invalid and revoked for four reasons.

The first reason is that the Shari'ah and Saudi Arabian courts or Shari'ah and Saudi Arabian arbitration committees may see that the main clause in the proposal is similar to the clause in the transaction so called "da' wa ta'ajjal" (waiving part of the debt in return for bringing forward repayment) which is forbidden by the majority of jurists, although there are differences between them mentioned above. The second reason is that a few jurists forbid price gouging (one type of al-ghabn) even if both parties, when entering into contract, know that the transaction includes unfair price but agree to it. Contrarily, the possibility that the Shraiah judicial ruling will rely on this opinion is very weak for the reasons mentioned above. The third reason is that the proposal might be considered to include two prices in one sale, one for credit and another for cash, without specifying one of them, which is prohibited in Shari'ah. The fourth reason is that the proposal might be considered to fall under "invalid conditions" in contracts.

\textsuperscript{970} See p. 35-6.
In the economic and investment sense, even if the Sukuk includes this proposal, there is a possibility that the Sukuk obligor will fail to meet his obligations when facing critical financial circumstances, therefore exceeding the time limits taken into consideration by the investors when calculating and/or raising the returns margin and/or price. The proposal would also not be useful in the case of the obligor/debtor going bankrupt if he does not own enough assets to cover the debt.

4.8. Conclusion

Because the main purpose of this dissertation is to improve the protection of Sukuk holders’ interests from default, bankruptcy, and risks associated with non-compliance with Shari’ah, this chapter focuses on potential reinforcing solutions – with the avoidance of what is, or would be, by consensus, prohibited in Shari'ah. The proposed and suggested solutions potentially decrease these risks and aid in successful debt-restructuring negotiations and so on, in a manner that does not harm the interests of investors and that reduces some discrepancies between Sukuk and conventional debt and investment instruments, while considering the current research discussed in the previous chapter.

This chapter presents the pros and cons - from Shari'ah and economic perspectives - of each proposed solution and suggestions designed to combat the credit and bankruptcy risks of Sukuk. The proposed solutions are not in a single pattern.

Some are direct and some are indirect, some of them could be applied before the IPO period in Sukuk, some could be applied after default or when default is imminent, and some of them could be stipulated in legal documents. These diverse solutions, coupled with the improvements proposed by the present research documented in the previous chapter, determine remedies for Shari’ah, legal and economic compliance. Some are effective in avoiding or reducing credit risks, some are useful to combat risks of bankruptcy and protect the capital of investors. Some are useful in the success of debt-rescheduling negotiations when defaults occur or when default is imminent. Some could help to induce the obligor/originator to pay on time if he has liquidity. Some may be useful in periodic returns and payments (coupon). Some are only conceived in some Sukuk types, while some are useful in almost every circumstance.
Among the reasons for diversification of solutions is the controversy among Muslim scholars - or the potential for controversy - on the Shari'ah ruling on some proposed and an attempt to provide compatibility to convictions and beliefs of investors who would perhaps reject a solution due to its illegitimacy in Shari'ah. These beliefs could come as a result of the process of independent reasoning (ijtihad) or imitation (taqlid).

The other reason to provide several, diverse solutions is that some companies seeking funding may not be able to work on some proposed solutions for religious, technical or economical reasons, so it is appropriate to provide several options for companies to choose from. Further reasons for diversifying the nature of solutions and suggestions is that some of them may be criticized. In addition, some suggestions depend on the maturity of the capital and debt markets, the status of market structure, investor culture, jurisdiction, political will, or the modification of some relevant laws and some may entail financial costs. Some proposals may face the risk of non-compliance with Shari'ah for reasons such as different schools of jurisprudence in Shari'ah, reflecting on judges and arbitrators if they rule in accordance with Islamic law.
Chapter 5: Challenges and Obstacles Facing Some Propositions and Developments Suggested by the Researcher to Deal with Default and Bankruptcy Risks of Sukuk

5.1. Introduction

Most of the proposed solutions and developments aiming to protect sukuk holders from the risk of default and bankruptcy of the Sukuk originator face Shari’ah, cultural and legislative challenges. Some of these proposals face one, two or all of these challenges. In addition, these challenges are related not only to the propositions presented in this dissertation, but they also include other propositions and investment applications outside the field of Sukuk and financial transactions that do not fit under the focus of this dissertation.

The seriousness of the Shari’ah and cultural challenges, the impact of jurists’ controversy over a financial transaction causing reluctance to invest in it, the role of Shari’ah jurists in orienting the Saudi Arabian investors, and the importance of granting a wide authority to the Shari’ah committees are evidenced, for example, by the model of the "AlAhli Bank [National Commercial Bank (NCB)]" located in Saudi Arabia as a Saudi Arabian Joint Stock Company. Although this conventional bank is on its way to Islamize its transactions and appoint a Shari’ah committee, the turnout for its IPO - which was in 2014 - was significantly low compared to its counterparts. The number of subscribers in the IPO of its 500 million shares offering, representing 25% of its capital, reached only 1.26 million, though the size of that IPO was described in 2014 as the largest ever not only in the Saudi Arabia but also in the Middle East and as the second-biggest IPO in the world for 2014.971 Most Muslim jurists - including the Permanent Committee for Fatwa affiliated to the Council of Senior Scholars in Saudi Arabia - forbidden underwriting and subscription in this bank, explaining that it deals with prohibited financial transactions such as bonds (sanadat).972


In contrast, in 2005, AlBilad Bank [which is established in Saudi Arabia as a Saudi Arabian Joint Stock Company and is described as an Islamic bank] issued 30 million shares for IPO, and the number of subscribers in the subscription reached approximately 8.8 million. Perhaps, the three most important reasons for this high turnout is the existence of a Shari’ah committee affiliated with the Bank but separate from it that exercises a wide authority over its financial transactions and activities; the non-existence of significant opposition from the Shari’ah jurists to the legitimacy of the subscription; and the Bank's non-involvement in financial activities prohibited by Islamic Shari’ah. In this part of the study, we will focus on these challenges and the methods of dealing with them. We will also relate the potential criticisms posed against these methods, without details, as they require an independent research.

5.2. Shari’ah challenges

Shari’ah challenges to the propositions suggested in the context of Sukuk that fall within the jurisdiction of Shari'ah courts or Shari'ah arbitration authorities, for example, refer to the probable revocation of a contract underlying the Sukuk or a contract underlying it and containing some forbidden clauses or items. They arise because of the disputed legality of some of these clauses or items among jurists or their agreement on the prohibition of some of them.

One of these challenges is the possible revocation of a contract involving the existence of more than one item, even if they are originally Shari’ah-compliant, in view of those banning this case; are in the interest of concluding the contract, such as the combination of a pawn (rahn) and guarantee (kafala) agreements in the same contract; or derive a benefit to the seller, such as his stipulation in the contract of selling his house that he resides in it for a month before moving out, or to the buyer, such as his stipulation that the seller carries the purchased firewood for him or trims it. These items are permitted by some jurists, provided they do not exceed more than one

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974 See p. 51-2.
condition, while others approved them unrestrictedly as long as they are made for a legally valid and objective reason. The correct view of the Hanbali Fiqh School in this regard is that the conditions made in the interest of the contract, such as pawning and guarantee, are permissible, regardless of their number.\textsuperscript{975} This is the view of AAOIFI\textsuperscript{976} and other bodies.

When considering the adequacy and effectiveness of each proposition - or some of its applications -, we underlined the reasons of its ineffectiveness, limitations and probable criticisms raised against it, including the Shari’ah dispute - if any - which the researcher sees as one of the most significant obstacles to endorsing the propositions and developments suggested in this dissertation. The legality of many of the solutions proposed here is disputed among jurists, either due to a text (\textit{nass}) or by way of analogy to some Shari’ah rulings derived from similar cases. The main body of Islamic Fiqh contains questions and rulings that are disputed between Fiqh schools and even among the jurists of the same school. Further, it is unrealistic to form a unified opinion regarding a legal question about which a dispute had already taken place, especially in controversial matters where the dispute vacillates between permissibility and prohibition. In fact, the present researcher could not find a legal view that obligated the abandonment of Fiqh disputes, but we will see later that jurists recommended the desertion of controversy. In contrast, jurists have warned the public of choosing the lenient views of jurists when a dispute over a legal matter arises. Some of them considered that this is an act of heresy in religion, while others argued that this is a relinquishment of the Shari’ah obligations, as will be pointed out later. We have mentioned in more than one place the disagreement among jurists about the legality of a contract or a condition therein, whether the invalid condition revokes the contract, and the types of conditions that invalidate the contract.

The risks of non-compliance with Shari'ah in financial transactions, including Sukuk – in case the judicial jurisdiction, such as Shari’ah courts and arbitration, complies to the Shari'ah provisions - include the possibility of revoking the contract for being prohibited itself or for involving an invalid condition, or revoking the condition


\textsuperscript{976} AAOIFI, in its Shari'ah Standard No. (5) related to Guarantees, states: "2/1/2 There is no objection in Shari’ah to include a number of guarantees in one contract, such as incorporating a personal guarantee together with a mortgage of security in the same contract." AAOIFI, supra note 43, at 124.
only, subject to the question and the type of disputed condition or clause. Hence, the relationship – as pointed out earlier - between the risk of non-compliance with Islamic Shari’ah and credit risk is clear. The court judgment that revokes the Sukuk structured under a defective contract or the annulment of some of its clauses would inevitably affect the returns and capital of the Sukuk holders.

5.2.1. Shari’ah methods of dealing with the Shari’ah-related disputes

We can refer here to some viable Shari’ah methods977 of dealing with the Shari’ah-related disputes - which may reflect on the Shari’ah and Saudi Arabian courts or Islamic and Saudi Arabian arbitration - with some analysis and discussion of their efficiency. These methods are represented in avoiding some financial transactions as described below, considering the ruler’s imposition of certain standards on the judges to adhere to, in view of those who approved that right, and resorting to Shari’ah arbitration.

5.2.2. Avoiding specific financial transactions

The four eminent jurists of Fiqh Schools unanimously confirmed that the evidence can only be established by the Shari’ah texts. In case their opinions have contradicted the Shari’ah texts, they should not be followed. It is with greater reason that non-imitation is observed by jurists who have the tools of ijtihad and are familiar with the wisdom of Shari’ah rulings. Therefore, acts and financial transactions that are categorically prohibited by texts of proven authenticity and meaning - though permitted by few jurists -, forbidden by consensus of jurists or by the majority of them, though their legality is weakly disputed, and odd Fiqh opinions should be abandoned. In the same vein, both IIFA and AAOIFI issued some resolutions.978 The former viewed that the resolutions of the Fiqh Councils must be taken into consideration. In another position, it obliged the Shari’ah committees to abide by the resolutions of this Council.979 AAOIFI, on the other hand, called for benefiting from the resolutions of the Fiqh Councils.980

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977 By “viable Shari’ah methods” the researcher means feasible ways, since the efficacy and outcome of some of these methods or their applications are hard to predict. In addition, these methods are still tentative to the present researcher, because the legality and effectiveness of some of them have not been categorically established.
978 See AAOIFI, supra note 43, at 740; see also IIFA, supra note 79, at 345.
979 See IIFA, supra note 79, at 346, 410.
980 See AAOIFI, supra note 43, at 740.
Among the applications that should be avoided are those transactions most likely judged as containing interest (riba), excessive uncertainty (gharar fahish) or applications involving binding promises by the two parties, i.e. investors and the obligor in Sukuk. Some propositions, such as financial compensation for late payment, will most likely be resonated to these measures.

As mentioned earlier, consensus, in the event of verifying its occurrence and meeting its standards, constitutes a binding authority and should not be neglected. The opinion of the majority of jurists is not an authority by itself, yet it has consideration and significance by many jurists and contemporary scholars, especially on newly occurring legal matters (nawazil). This may include the Fiqh Councils and contemporary Shari'ah bodies - whose resolutions are formed by a majority of their members - if they agree on a Shari’ah ruling on an application or financial transaction, while not excluding non-members who may excel some members in knowledge and experience. However, the problem remains concerning the occurrence of differences among jurists on the meaning of some Shari’ah texts, what is included in them and what is not and the contemporary issues that can be analogized to them, while agreeing on the veneration of those texts and the obligation to act according to the unequivocal parts thereof. To achieve the best results in this regard, experts in Shari’ah should be consulted. Islamic financial institutions should not solely assume this task, because of their lack of Shari’ah expertise.

5.2.2.1. The role of the Shari’ah committees and audition committees, and the importance of legal and linguistic qualification of their members

Many of the provisions and theoretical characterizations of Islamic financial products and applications are different from what is actually practiced. It can be claimed that one of the reasons for this is the absence of both the Shari’ah committees issuing the fatwas and the audition committees or one of them only. In order to ensure the maximum compliance with Shari'ah and dealing with Shari’ah disputes, Shari’ah committees that oversee the products of Islamic financial institutions, whether affiliated to or independent from them, should be appointed. The resolutions and members of these committees must not be influenced by anyone, including the institutions with which the Shari’ah committee is affiliated. We have discussed some aspects related to these committees in
this regard in the chapter on the assessment and evaluation of financial guarantees and preventive measures currently provided to the Sukuk holders in dealing with credit and bankruptcy risks.

To avoid the applications prohibited by Shari’ah or as forbidden by some Shari’ah committees affiliated with Islamic financial institutions, it is useful to appoint Shari’ah auditing committees, and not to be satisfied with the Shari’ah committees that assess the applications of banks or companies and scrutinize their financial transactions. The IIFA referred to the need for Shari’ah monitoring system of three levels: Shari'ah Supervisory Board, which is mandated to issuing fatwas on the activities and transactions of Islamic financial institutions; internal Shari’ah Supervisory Board, whose function is to adopt the necessary procedures to ensure the proper implementation of the Board’s resolutions; and the central Shari’ah Supervisory Board, whose functions are to oversee and monitor the Shari’ah Supervisory Boards and to establish the regulations governing the mechanism of appointing and dismissal of members of the Bodies. IIFA provides that the resolutions of the Shari'ah Supervisory Board are binding. The same view is adopted by AAOIFI. It is noted that there are no central Supervisory boards in some countries, including Saudi Arabia. The pressing need for appointing auditing committees is evidenced by the fact that one case study discussed in this dissertation was based on a reverse ‘Inah sale contract banned by the majority of jurists and yet approved by the Shafi’is as mentioned above. The Shari'ah Advisory Council of Bank Negara Malaysia approves ‘Inah sale contract with various conditions as mentioned above. The question that arises here is whether this Committee approves a reverse ‘Inah sale contract with like conditions of ‘Inah sale contract. If that the case, these conditions were not honored in one of the case studies, though this transaction had a Shari’ah advisor.

This may be due to the nonexistence of two committees: a Shari’ah committee and an auditing committee, whose members are literate in English. Illiteracy of the Shari’ah committees’ members - in general - in English, which is the dominant language of most of the Sukuk issuance prospectuses and legal documents, is one of the most significant reasons for non-compliance of Sukuk and other Islamic financial products with Shari’ah

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981 IIFA, supra note 79, at 409-11.
982 See id. at 409.
983 See AAOIFI, supra note 43, at 739.
provisions. The translation provided to the committee may differ from the original text. The standards and Shari’ah views issued by the committees in Arabic may be contrary to the content of the English version of the prospectus or the legal documents due to the weak Shari’ah expertise of the translators who are not familiar with the legitimate terms and the meaning intended by the muftis (jurisconsults). We have pointed out in more than one place that the AAOIFI’s standards in Arabic are occasionally different from the standards as expressed in English version, despite the good quality of translation as a whole. The need for the members of the relevant committees’ familiarity with English is further evidenced by the fact that the parties to the Sukuk are often multi-national and include English-speaking parties who use it as means of conversation and writing, whether they are potential investors or sponsors. A conference organized by AAOIFI raised the issue of the need of the members of the Shari'ah committees to be conversant with the language in which the Sukuk is issued.984

5.2.3. The ruler or his representative’s imposition of a juristic opinion to be adhered by the judges

Jurists of Shari’ah discussed a number of issues and questions related to dealing with the legal dispute. Among the most prominent issues are the ruler or his representative’s imposition of a particular juristic view on the people on a contended Shari’ah issue; the ruler’s imposition of a particular juristic view that judges must follow; and the question of reasoning (ijtihad) and imitation (taqlid). In this dissertation, we will investigate the last two issues as they are closely related to the developments and propositions we have made.

5.2.3.1. Ruling on the ruler or his representative’s imposition of a contended juristic view on judges and the ruling on the codification of Shari’ah rulings

Among the possible solutions for dealing with the Shari’ah contestations among jurists on the provisions and applications of financial transactions and the subsequent investment remedies and financial and preventive guarantees is the codification of the Shari’ah rulings that the ruler or his representative consent their authenticity and obliging the judges to adhere to them.

It should be noted first that the issue of codification of Shari’ah rulings in the form of items, as observed in conventional laws, without making them binding is a point of reservation to a few jurists, according to the literature available to the present researcher. As to the codification of the rulings and their imposition on judges by the ruler, it is a highly contentious issue among jurists. In the chapter dealing with the legal system in Saudi Arabia, we mentioned the position of the Board of Senior Scholars about this matter and the prohibition of doing so. There are some laws in Saudi Arabia that some judges do not adopt if proved contrary to Islamic Shari’ah. For this reason, beside other possible ones, quasi-judicial committees competent with settling disputes related to insurance, banks and other issues were formed, since judges in the Shari’ah courts reject some images of insurance and financial transactions that involve interest, although some images of the above have been legislated.

Dr. Bakr Abuzayd reviewed the proofs of the proponents and the opponents of obliging the judges to follow a particular Fiqh school or view, but he did not state the number of opinions. It can be conceived from his account that he noted two views only concerning this question: permission or prohibition. He limited the dispute to the imitating and not the scholarly independent judge, confirming the occurrence of consensus on that matter and quoting his source. He further considered that the core of the dispute lies in the imposition of codified rulings that are not backed by explicitly decisive Shari’ah proofs and established rules.

Layaida Hadjer devoted an entire section to discuss the question of obliging the judges, both mujtahid and muqallid, to adhere to the views of a certain Islamic juristic school, and another section to obliging the judges to follow a particular Fiqh ruling adopted by the scholars of a certain Islamic juristic school – which in another position she called ‘juristic codification’ (taqnin fiqhi). She related the scholarly disputes of each case and mentioned five opinions on the latter case. She was inclined to believe that the legal position of juristic


987 See *id.* at 13.

988 See *id*.

989 See Hadjer, *supra* note 985, at 92, 100, 103.

990 See *id.* at 92-133.
codification varies depending on the nature of each country, the type of the judicial system, and whether the judge is mujtahid or muqallid.991

With regard to the question of obliging the mujtahid judge to follow a particular Fiqh school, she stated two opinions: prohibition and permissibility, quoting some statements of the jurists that prove – in her opinion – the existence of a disagreement among them.992 She indicated that the first opinion, which she attributed to the view of the majority of jurists of the Maaliki, Shaafi’i and Hanbali schools, disapproved obliging the mujtahid judge to adhere to a specific Fiqh school.993 It will appear later that scholars unanimously agreed that if the mujtahid has independently reached an opinion on a controversial issue, he should not adopt a different one. This was one of the most important elements on which the opponents of the issue have relied. Then, she mentioned the second opinion, which she attributed to one of the scholars of the Maliki School and some of the late Hanafis, that approved the issue.994 Next, she discussed the question of the position of obliging the muqallid judge to follow a certain Fiqh school, pointing out that the jurists held two opinions about this issue.995 The first opinion, which she attributed to one saying of the Malikis and the mainstream view of the Shafaa’is and the Hanbalis, is prohibition.996 The second view, which she attributed to the Hanafis and one saying of the Malikis, is permissibility.997 After that, she stated an opinion attributed to Ibn Taymiyah in which he permitted the case if evil/harm/corruption (mafsadah) is feared,998 which means there are three opinions in the case. Perhaps those who disapproved the case and weighed between maslahah (benefit/interests) and mafsadah (evil/harm/corruption) support the same view adopted by Ibn Taymiyah.

991 See id. at 132-33.
992 See id. at 103-11.
993 See id. at 92-100.
994 See id. at 96-7.
995 See id. at 100.
996 See id.
997 See id.
998 See id.
999 See id. We quote here Ibn Taymiyah’s view, on which the researcher relied in relation to the view she attributed to him, "if the ruler imposed a condition on the judge, or the judge obliged his deputy, that he makes his judgements conform to a certain Fiqh school, the condition is revoked ... There is no doubt that if judges can settle disputes relying on their Shari’ah knowledge and justice without complying with this condition (they should do). But, if it was ascertained that non-compliance with that condition would cause fasad (evil, harm, or corruption) as a result of ignorance and injustice greater than conforming to it, they should implement the condition in order to curb the gravest of the two causes of corruption by adopting the least harmful option." AHMAD A. IBN TAYMIYAH, MAIMU’ AL-FATAWA vol. 31, p. 73-4 (Saudi Ministry of Islamic Affairs, Dawah and Guidance, King Fahd Complex for the Printing of the Holy Quran: Riyadh, Saudi Arabia, 2004).
5.2.3.2. The standards that should be observed by the ruler or his representative when selecting an opinion in a controversial question and imposing it on the judges, if obligation is permissible

We see that there is an objective difference - in some cases - between the rulers’ obliging of judges or people to follow a particular Fiqh school on one hand and the codification of the Shari’ah rulings by choosing a set of opinions from various Fiqh schools and obliging judges or people with them on the other hand. The four Fiqh schools commonly deal with questions of Shari’ah in view of the rules of ijtihad and imitation, while the case may differ when the legal rulings are codified. The ruler or his representative may not abide by the methodology of *ijtihad* and *taqlid* that is adopted by jurists. The ruler may select a judge who considers and weighs between different views in contested Fiqh questions from among the judges who are not known as mujtahid. Likewise, he may select judges from among imitators who do not adhere to the rules of *taqlid* and who adopt some opinions that contradict the views of jurists whom they are supposed to imitate. In general, we did not find any literature that addressed this issue in detail or in an independent research. Yet, some jurists have pointed to what can be considered as some standards of this issue. For example, Ibn Taymiyah say: "[a]s to the ruler’s imposition of a juristic opinion that has no foundation in the Qur'an or the Sunnah, especially regarding controversial matters, this is not permissible according to the consensus of Muslim jurists." 999

Mustafa al-Zarqa views that the ruler has the right to command the adoption of a weak and less preferable opinion if the temporal interest required that. 1000 He states that the statements of "jurists reveal that if the ruler gave a command regarding a debatable matter (i.e. open for reasoning, and not conflicting with unequivocal texts of the Shari’ah) it is a duty in Islamic Shari’ah to obey and implement it." 1001 He raises a possible question that may be posed by the opponents of this view by saying:

Giving this power to the ruler may lead to capricious acts by changing the scholarly independent rulings or restricting them with commands or laws issued by him. He may not be concerned with the compliance of

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1000 Al-Zarqa, supra note 545, at vol. 1, p. 215.
1001 Id.
these rulings with the Shari’ah provisions, or he may be ignorant or a sinner who does not care about the abandonment of the Shari’ah. So, how should he be obeyed in these cases?"\textsuperscript{1002}

To answer this, he replies:

These Fiqh statements can be compulsory in one of two cases: first, the ruler himself is a scholar whose piety and scholarly knowledge of Shari’ah are attested, as was in the early Islamic era, (in which case his commands must be obeyed) ... or he may not be a mujtahid scholar, in which case his commands may not be obeyed, unless issued after dedicated consultation from and consent of scholars of Shari’ah."\textsuperscript{1003}

Abdullah al-Mazroua, after reviewing the proofs and statements of those who approve that the ruler has the right to impose one juristic view on the people in public affairs disputed among jurists, recounts the standards adopted by those who say that 'the view of the ruler ends the dispute regarding public interests'. Among those standards are that "the ruler should be a scholar and a mujtahid, or his ruling should be formed after sincere consultation with scholars who are mujtahid ... and that his ruling should not be in conflict with the Qur’an, the Sunnah or consensus of jurists."\textsuperscript{1004} That research is not intended to support the ruler’s right of obliging the judges to follow a particular juristic opinion. Yet, there are some similarities between obliging the judges and obliging the people to adopt a particular juristic view in some aspects, such as the conditions of the ruler’s selection of a specific juristic ruling.

Apart from what is mentioned above, the present researcher did not find any research dedicated to this issue or explicitly determining that the ruler or his representative should be subject to the rules of \textit{ijtihad} and \textit{taqlid} - which will be discussed in this chapter - when nominating a Fiqh school or opinion for a particular case and obliging people with it. Most preponderantly, their views must be observed. If the ruler, the sultan, the president, or those commissioned with issuing regulations and legislations have fulfilled the conditions of \textit{ijtihad} and understanding of the Shari’ah provisions, and they see that a particular legal opinion about an issue is more sound and rightful, their view must be observed. If they were imitators and did not reach the status of \textit{ijtihad}, they should

\textsuperscript{1002} \textit{id.} at 221.
\textsuperscript{1003} \textit{id.} at 222.
\textsuperscript{1004} ABDULLAH M. AL-MAZROUA ‘ILZAM WLYI AL’AMR WA’ATHARAH FI ALMASAYIL ALKHALAFIA 82 (Al-Bayan Magazine: Riyadh, Saudi Arabia, 1st ed. 1434 AH).

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not be tempted to choose the easiest and advantageous view for controversial matters, as this leads to adoption of
relaxed Fiqh concessions (*tatabbu` al-rukhas*), which is forbidden by the majority of scholars, while some related
scholars’ consensus on its prohibition, as will be shown later. All this is based to the view that supports the
permissibility of the ruler’s obliging of the nation or judges with a specific Fiqh school. It is noted that the school
here does not necessarily refer to one of the four famous Fiqh schools; it includes the juristic views of any
acknowledged Fiqh scholar. An account of some rules of *ijtihad* and *taqlid* will be presented below.

5.2.4. Seeking Islamic/Shari’ah and Saudi Arabian Arbitration

Shari’ah arbitration is one of the tools possibly used when dealing with Fiqh controversies and their
ramifications on the opinions of judges in the Shari’ah courts, who may differ in their judgements depending on
those differences. As will be seen below, past scholars dealt with Shari’ah arbitration and permitted it in principle,
though they differed regarding some of its provisions. We shall refer below to some of these differences without
dwelling on them. In addition, we will mention some provisions and standards of arbitration and the cases in
which its judgements should not be implemented - with particular reference to the Saudi Arbitration Law – given
the relationship between the effectiveness of arbitration in dealing with juristic disputes and the probability to
enforce the judgments issued by the arbitrators.

5.2.4.1. Importance of Islamic arbitration

Arbitration, whether Shari’ah-based or non-Shari’ah-based (conventional arbitration) has some advantages
whose details fall outside the focus of the present research. However, among the benefits of arbitration related to
this research is that it mitigates the effects of the non-implementation of some of the propositions presented in
this dissertation, which are banned by many contemporary scholars, such as financial compensation for delay in
payment, though the availability of compensation standards provided by the proponents. The judgments of
arbitrators are usually faster - as supposed - than the judgements of courts. Therefore, the delay that might occur
in courts competent to hear disputes and whose judgements are more likely to be appealed against than the
judgements of arbitration would be avoided. Also, Shari’ah arbitration encourages both companies and investors
who deal only with Islamic financial transactions to seek finance through and invest in Sukuk. The existence of a
non-Shari'ah-compliant judiciary system may dissuade them from engaging in financial transactions - albeit with legal controls - that are not subject to the jurisdiction of the Shari'ah courts. Moreover, some investors in countries not governed by Shari’ah prefer Shari’ah arbitration in Sukuk transactions and other forms of structured financing because Shari’ah provisions, in their opinion, are in their own interest. Another benefit is that it is an effective method of dealing with the differences among Shari’ah scholars about some applications of the disputed financial transactions, as in some financial guarantees and precautionary measures developed and proposed for dealing with credit and bankruptcy risks in Sukuk.

5.2.4.2. Legal position of arbitration

Dr. Zaid al-Zaid said that the majority of scholars [the Hanafis, the Malikis, some the Shafii's and the Hanbalis] held arbitration as permissible, while some of the Shafii's as well as Ali Ahmad Ibn Hazm rendered it as forbidden. In this sense, the prohibition is absolute. But, in another place, after giving a detailed account of the legal position of arbitration - mentioning that the first opinion is the view of the Hanafis and the Malikis, and that most of the Shafii's consented it, while quoting some as saying that this opinion is the most preponderant in the Shafi’i School – he said that the second opinion does not endorse arbitration in case there is a judge in the country. He attributed this opinion to some Shafii's views, saying "perhaps, it is the view of Ibn Hazm, as it appears from his statements." In this way, it appears that prohibition is not absolute, but it is restricted to the situation where there is a judge in the country. Dr. Ali al-Qarada added a third opinion he attributed to some Shafi’i jurists that arbitration is not permissible absolutely.

1005 See Dr. Zaid A. al-Zaid, Mashrueiat Altahkim Fi Alfaqih Al'iislamii [Validity Arbitration in Islamic Figh] 8 (Al-Bahith al-Tlmi, 1t ed. 2003). Available from: http://k-tb.com/book/Figh05423-%D9%85%D8%B4%D8%B1%D9%88%D8%B9%D9%8A%D8%A9-%D8%A7%D9%84%D8%AA%D8%AD%D9%83%D9%8A%D9%85-%D9%81%D9%8A-%D8%A7%D9%84%D9%81%D9%82%D9%87-%D8%A7%D9%84%D8%A5%D8%B3%D9%84%D8%A7%D9%85%D9%8A. (accessed on 15th May 2019).
1006 See id. At 8, 11.
1007 Id.
Yahiya al-Nawawi and others related jurists’ consensus on its permissibility. Among the contemporary Fiqh councils that approved arbitration are AAOIFI and IIFA. However, Saudi Arabia has a particular Law of arbitration, which we will refer to some of its items in the course of this dissertation.

### 5.2.4.3. Standards of arbitration and the need for it from the Islamic Shari’ah perspective

Muslim jurists and contemporary Fiqh councils have set some conditions for arbitration and its related matters, such as the conditions and qualities of arbitrators and the suits he is eligible to adjudicate. Some of these conditions are unanimously agreed on by jurists, while others are disputed. For example, jurists differed concerning the judgements of arbitration, whether they are binding on the contracting parties and revocable. We will not dwell on all aspects of this issue, but we will study some of the most important conditions and rules related to the feasibility of arbitration in the Sukuk as a way of dealing with the Shari’ah disputes on the Sukuk.

Dr. Khalid al-Sulaiman mentions five conditions of arbitration that he believed they were unanimously embraced by jurists in general. The first condition is that all terms of the contract be met. The second condition is that the arbitrator is eligible for arbitration. He indicated that this condition in this formula is consensually agreed on by jurists, but they disagreed with regard to the conditions of this eligibility. He stated that the arbitrator must be eligible for exercising Ijtihad and for the judiciary capacity. According to Dr. Mohamad al-Zuhayli, the arbitrator’s fulfillment of the conditions of the judge is the view of most jurists of the four Islamic Fiqh Schools. He added that according to the majority of jurists, there are ten conditions for the judge, inter

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1010 See AAOIFI, supra note 43, at 794.

1011 See IIFA, supra note 83, at 198.

1012 See Dr. Khalid A. al-Sulaiman, Haqiqat Altahkim Fi Alshryet Walqanuni [the Actuality of Arbitration in Shariah and Law] 11 (A working paper submitted to the International Conference on Judiciary and Arbitration, organized by the High Judicial Institute, Riyadh, Saudi Arabia, 28-29 / 12 / 1436 AH). (King Fahd University of Petroleum and Minerals, n.d.). Available from: [https://faculty.kfupm.edu.sa/ias/khaledan/docs/research/%D8%AD%D9%82%D9%8A%D9%82%D8%A9%20%D8%A7%D9%84%D8%AA%D8%AD%D9%83%D9%8A%D9%85%20%D9%81%D9%8A%D8%A7%D9%84%D8%B4%D8%B1%D9%8A%D8%B9%20%D9%88%D8%A7%D9%84%D9%82%D8%A7%D9%86%D9%88%D9%86%20.pdf](https://faculty.kfupm.edu.sa/ias/khaledan/docs/research/%D8%AD%D9%82%D9%8A%D9%82%D8%A9%20%D8%A7%D9%84%D8%AA%D8%AD%D9%83%D9%8A%D9%85%20%D9%81%D9%8A%D8%A7%D9%84%D8%B4%D8%B1%D9%8A%D8%B9%20%D9%88%D8%A7%D9%84%D9%82%D8%A7%D9%86%D9%88%D9%86%20.pdf) (accessed on 15th May 2019).

1013 See id.

1014 See al-Zuhayli, supra note 1009, at 375.
alia the exercise of ijtihad, justice, Islam and masculinity. In corroboration of his account, some Fiqh schools, such as Hanbalis, see that the conditions of the judge are ten. But, in the Hanbali school another saying did not require these conditions in the arbitrator. The IIFA considered that the arbitrator must fulfill all conditions required for the judge, but it did not identify those conditions from its point of view. It then mentioned a legal ruling that implies the permissibility of the arbitrator being a non-Muslim, if that serves to reach a permissible settlement under Shari‘ah provisions, if there is no Muslim arbitrator available. In contrast, the AAOIFI was more relax about the conditions of the arbitrator; it only required that the arbitrator must meet the eligibility conditions of full dispensation. It declared that the default in the arbitrator is to be a Muslim, but he may be a non-Muslim if necessity warrants that in order to reach a ruling permissible by the Shari’ah, while in all cases the judgement issued must comply with the principles and provisions of Shari’ah.

The Saudi Arabian Arbitration Law provides that the arbitrator must have full capacity, be of good personal conduct and fame and have a university degree in Shari‘ah or law. In case the arbitration committee includes more than one arbitrator, at least its president must satisfy the last condition. However, this sparks off a controversy, as the judgement may be issued by a majority representing two arbitrators who do not have a suitable academic degree, while the president of the committee who holds the required academic degree is inclined to a different opinion. As such, the judgement becomes vulnerable to the conflict with Shari‘ah or the applicable law due to the members’ lack of the necessary qualification. While the Law provides that the judgement be issued by the majority, it neither stipulates the oddness of the number of the members of the preponderant opinion nor

1015 See id. at 375 n.5.
1016 See AL-BAHUTI, supra note 250, at vol. 6, p. 294-95.
1017 See id. at 309.
1018 IIFA, in its Resolution No (91) Concerning the Principle of Arbitration in Islamic Fiqh, states: "[t]he norm is that an arbitrator must meet the prescriptive conditions for qualifying as a judge." IIFA, supra note 83, at 199.
1019 IIFA states: "[i]n the absence of any international Islamic Court, Islamic States or institutions may seek arbitration from non-Islamic courts in a quest for a Shari‘a-compatible settlement." Id.
1020 See AAOIFI, supra note 43, at 796.
1021 AAOIFI states"[i]n principle, an arbitrator shall be a Muslim. However, a non-Muslim arbitrator could be appointed when acute need so requires, in order to arrive at a Shari‘ah-accepted verdict (in this regard, item 11/1 below shall be observed)." Id. At 769. It also states: "[a] valid arbitration decision should lead to a verdict that conform to the rules of Shari‘ah." Id. At 799.
1023 See id.
1024 See id. §§ 39, 42.
specifies a particular number. An exemption to this is the case requiring that the judgement be made by the unanimous consent of the arbitrators, i.e. that the arbitration committee is commissioned to bring about reconciliation.\textsuperscript{1025} The Law provides that in the absence of a casting vote, the committee would be entitled to select one. Otherwise, the competent court would select a casting vote.\textsuperscript{1026} In both cases, the Law does not specify whether the casting vote must have the required scientific degree, which implies that it is not a requisite, especially if a chairman of the committee meets all conditions stipulated by the Law.

5.2.4.4. The binding authority of arbitration,\textsuperscript{1027} its revocation and the dismissal of the arbitrator

Arbitration may pass through three stages: the selection of the arbitrator and his existence before the occurrence of the dispute between the parties concerned; the consideration of the dispute when it occurs and before the judgment is issued; and the of issuing the judgment. In the latter stage, the disputants may consent the judgement or reject it. Also, one of the parties concerned may express its wish to change the committee of arbitration or announce its disapproval of the judgement before its issuing.

With regard to the issue of the litigants’ revocation of arbitration, or whether the dispute involves a binding contract, such as a sale contract, or a permissible contract, such as deputyship (\textit{wakala}) – i.e., arbitration and the dismissal of the arbitrator are legally revocable, Muslim jurists held different views.

On this issue, Dr. Ali al-Qarada mentioned four opinions. We will relate what he said without following his order. In his account, he stated that the proponents of one opinion argued that the contract is not binding at all unless the parties concerned have approved the arbitrator's judgment.\textsuperscript{1028} He attributed this opinion to one view by the Shafi’is.\textsuperscript{1029} He also states that the proponents of the second opinion see that the arbitration contract becomes binding once the offer and acceptance are made, if the conditions of the contract are fulfilled.\textsuperscript{1030} He

\textsuperscript{1025} \textit{See id.} § 39.
\textsuperscript{1026} \textit{See id.}
\textsuperscript{1027} Here, we focus on the Shari’ah ruling concerning the arbitration agreement, particularly its bindingness on the litigants and not the arbitrator in order to avoid time prolongation.
\textsuperscript{1028} \textit{See al-Qarada, supra} note 1008.
\textsuperscript{1029} \textit{See id.}
\textsuperscript{1030} \textit{See id.}
attributed this view to one of the Maliki scholars.\textsuperscript{1031} The AAOIFI has adopted a view close to this opinion.\textsuperscript{1032} It can be conceived from the Saudi Arbitration Law that it provides that the arbitration judgement is binding by default as long as it does not contravene the rules of the Law, but it does not give much details whether this applies before or after the commencement of the arbitration proceedings. The Arbitration Law provides that arbitration judgements issued in accordance with its provisions cannot be appealed against except in "the suits of the invalidity of the arbitration judgement."\textsuperscript{1033} The Law specifies the cases that invalidate the judgments.\textsuperscript{1034} It defines the cases that the competent court, which is hearing the suit, may automatically revoke, including non-compliance with Shari’ah provisions or violation of the terms agreed upon by the two contracting parties (i.e. litigants).\textsuperscript{1035} It also provides that the judgements of arbitration are enforceable if issued in accordance with its provisions.\textsuperscript{1036} The Arbitration Law also states that the dismissal of the arbitrator is possible in two cases. The first is in the event that he is unable to carry out his task, he has not proceeded with it, or ceased from performing it, leading to an unjustified postponement of the arbitration proceedings, and he did not step down and the parties to the arbitration did not agree to dismiss him. In this situation, the competent court may dismiss him at the request of one of the parties concerned.\textsuperscript{1037} The second case is in the event that the arbitrator was not appointed by the competent court, and he can be dismissed if the parties agreed to do so without breaching the provisions mentioned in the first case.\textsuperscript{1038} It can be conceived from this that he cannot be dismissed, even if the two contracting parties (i.e. litigants) agreed to that, if arbitrator has assumed his work and he did not cause any delay without justification. Dr. Ali states that exponents of the third opinion see that the contract of arbitration is not binding unless the procedures of arbitration, such as the submission of required documents/data, have been established.\textsuperscript{1039} He attributed this view to the majority of the Malikis and the Hanbalis, according to the latter’s popular

\begin{footnotes}
\footnotetext[1031]{See id.}
\footnotetext[1032]{AAOIFI, in its Shari’ah Standard No. (32) related to Arbitration, states: "[a]rbitration is binding in the following cases: a) When it is stipulated as a condition in the contract b) When the two parties agree on seeking arbitration on dispute, and pledge to observe its verdicts." AAOIFI, supra note 43, at 795.}
\footnotetext[1033]{Arbitration Law, supra note 1022, § 49.}
\footnotetext[1034]{See id. § 50.}
\footnotetext[1035]{See id. § 52.}
\footnotetext[1036]{See id. § 18.}
\footnotetext[1037]{See id.}
\footnotetext[1038]{See id.}
\footnotetext[1039]{See al-Qarada, supra note 1008.}
\end{footnotes}
The IIFA has adopted this view. Dr. Ali states that the proponents of the fourth opinion see that the contract of arbitration is not binding unless the judgement was issued, in which case it becomes binding. He attributed this opinion to the Hanafi scholars, the Shafi‘is according to one of their most authentic sayings, some of the Maliki scholars and some Hanbalis.

5.2.4.5. The applicability of Ijtihad or imitation (taqlid) to the arbitrator and the litigants when selecting the arbitration committee

We did not find any research that addressed the issue of whether the arbitrator should abide by the rules of ijtihad or imitation, some of whose provisions will be propped when dealing with cultural challenges.

Since some jurists stipulate that the arbitrator should meet the conditions of the judge, it should be noted that the judge required to be mujtahid, in the view of the majority of jurists as mentioned earlier. So, those who stipulate the arbitrator’s fulfillment of the conditions of a judge and see that one of the conditions of the judge is Ijtihad, require that an arbitrator should be mujtahid. Ali al-Mardawi states: "Ibn Hazm said: 'the scholars unanimously see that he [the judge] should be mujtahid.'" As will be seen below, Muslim jurists unanimously agreed that the mujtahid whose reasoning has led him to produce a certain ruling on a controversial issue is not to adopt the opinion of anyone else instead. In view of those who permitted that the judge be an imitator of a particular Fiqh school or those who exempted the arbitrator from fulfilling the requirement of ijtihad, the arbitrator should abide by the controls mentioned in the question of imitation, some of whose aspects will be discussed when dealing with cultural challenges. As such, he should not select the more convenient opinions and base his judgements on them or seek the more relaxed Shari‘ah rules of concession.

Moreover, we did not find any work that provided that the disputants or contracting parties must adhere to the rules of ijtihad or imitation when selecting the arbitrator. Yet, based on their respective provisions, they should abide by the rules of ijtihad and imitation, as will be seen below.

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1040 See id.
1041 See IIFA, supra note 83, at 198.
1042 See al-Qarada, supra note 1008.
1043 See id.
1044 AL-MARDAWI, supra note 975, at vol. 11, p. 177.
5.2.4.6. The rule of obliging the arbitrator to judge according to a particular Fiqh school or law

This issue is related to the account mentioned in the previous question. The sukuk holders may consider that a certain legal system or Fiqh school permits some of the propositions we have suggested and require that the arbitrator judge in accordance with that legal system or Fiqh School. The AAOIFI has approved this on condition that it does not conflict with Islamic Shari’ah. However, this is a more general statement that requires details. For, the adoption of one Fiqh view regarding a controversial issue may be deemed by some jurists - who support different opinions - contrary to the Shari’ah. The Saudi Arbitration Law also permitted that the contracting parties (i.e. litigants) may agree on observing a certain law in the substantive rules and not the rules relevant to the conflict of laws, unless otherwise agreed, subject to compliance with the provisions of Islamic Shari’ah.

However, based on what Muslim jurists had established about the methodology of ijtihad and imitation, it is more appropriate that the case is judged according to the position of the Fiqh School or legal system selected and the conditions of the contracting parties (i.e. litigants) and the arbitrator. In case the selected legal system or Fiqh school consists of items/articles and matters that are permitted unanimously by scholars, there is no problem here. Otherwise, the situation is judged in accordance with the conditions of the two contracting parties (i.e. litigants) and the arbitrator. As to the contracting parties, when selecting an arbitrator, they can either be qualified jurists capable of exercising Ijtihad, or they are imitators and followers of others. If they are qualified mujtahids, they may either be mujtahids who see that a particular law or Fiqh school corresponds to their opinion, in which case there is no problem in obliging the arbitrator to adhere to it, as long as there is no conflict about the validity of this condition (i.e., that the arbitrator should judge the case based on a particular Fiqh school or Law) in principle; or they may be mujtahids whose Fiqh opinion on the case is contrary to the chosen particular law or Fiqh school, in which case it is more evident not to require the arbitrator to rule according to that Fiqh school. The second case is that they are imitators and do not have the tools of Ijtihad and Shar‘iah studies. This can be divided into two cases:

AAOIFI, in its Shari’ah Standard No. (32) related to Arbitration, states: "[t]he arbitrator should apply the rulings of Shari’ah. If he is obliged to apply a certain law, he should still not violate the rulings of Shari’ah…two parties of the arbitration have the right to impose any permissible limitation on the arbitration so as to serve a permissible purpose of their own. Permissible limitations may include, for instance: issuance of the verdict within a specific time limit or in view of a certain School of Fiqh or a certain law that does not contradict the Shari’ah; or consultation with exerts specified in name or by description." AAOIFI, supra note 43, at 801.

See Arbitration Law, supra note 1022, § 38.
cases. The first case is that the Fiqh School or legal system is in accordance with the opinion of the imitators – in line with the methodology mentioned by many jurists – in which case it is permissible to request the arbitrator to adhere to it., if the arbitrator – by way of Ijtihad or imitation, in view of those approving that the arbitrator be an imitator – assents to the permissibility of the selected law of Fiqh school determined by the litigants. The second case, which is that they are imitators and do not possess the tools of Ijtihad and Shari’ah consideration, is that it is not permissible to do so, especially if this is a custom for them. The same account can apply to the arbitrator who is requested to adhere to a particular Fiqh School or law. However, this issue should be examined further in order to understand the Shari’ah rule about it.

5.2.4.7. Enforcement of arbitration judgements

We mentioned above the dispute among jurists on whether arbitration is binding or non-binding. AAOIFI stated that the default is that the parties concerned should enforce the arbitrators' judgment voluntarily. In case one of them refused to do so, the other party has the right to resort to the court to implement it. As for the Saudi Arbitration Law, we previously indicated that the judgments are enforceable if they were issued in accordance with its provisions. In addition, the Law states that the judgement cannot be implemented unless after the verification of some issues. For example, it does not contravene a judgment or decision issued by a court, committee or body competent to adjudicate the lawsuit in Saudi Arabia, and it does not involve anything that contravenes the provisions of the Shari’ah. It is also possible to divide the judgement into sections and implement the section that does not breach its provisions. The enforcement of the judgements of foreign arbitration committees in Saudi Arabia is the jurisdiction of the enforcement judge, except in relation to administrative and criminal lawsuits. The Saudi Arabian Enforcement Law provides that the enforcement judge may only enforce the judgments of arbitrators issued in a foreign country in case of reciprocity and after verification of some issues, inter alia, they are not in conflict with a judgement or an order issued by a competent

1047 See AAOIFI, supra note 43, at 801.
1048 See id.
1049 See Arbitration Law, supra note 1022, § 55.
1050 See id.
judicial authority in Saudi Arabia, and they do not involve anything contrary to the provisions of the public order.\textsuperscript{1052} With reference to the executive regulation of that Law, public order here stands for Islamic Shari’ah as stated in the regulation.\textsuperscript{1053}

5.2.4.8. Efficacy of Shari’ah arbitration in dealing with Shari’ah disputes concerning the proposed remedies for dealing with Shari’ah-related risks and juristic disputes

Based on the account above, it appears that recourse to arbitration can be useful and effective in certain cases. However, it faces some challenges concerning Shari’ah dispute over some of its cases and provisions, such as going back on arbitration, the conditions of the arbitrator and the compliance with Islamic Shari’ah, which includes some controversial matters and applications among Shari’ah scholars. The challenges become evidently obvious if an arbitration law according to which arbitrators, disputants and courts have to act is not in place, in view of the opinion that the ruler or his representative – with consideration of conditions of Ijtihad and Taqlid - has the right to oblige the judges or people to abide by a controversial legal view. Or, an arbitration law may be in place, but some judges of courts competent with arbitration and its enforcement did not abide by it, in view of the opinion that judges should not be obliged to abide by a particular law system or Fiqh school, especially if they fulfill the conditions of Ijtihad. For example, if the arbitrator and the disputants are engaged in a transaction that requires compliance with the provisions of Shari’ah and no arbitration law is in place, one of the parties may withdraw from the arbitration agreement before commencing its proceedings, before the occurrence of the dispute, after the commencement of its proceedings or even after a judgment has been issued, relying on a legal opinion about this controversial suit based on ijtihad or a imitation. As such, one of the disputants, like the originator of the sukuk, may adopt, by means of ijtihad or imitation, a legal opinion that entitles him to withdraw from arbitration before proceeding with it, even if it is stipulated in the contract. This may be given priority, benefiting from the juristic dispute - and not based on ijtihad or imitation - concerning one of the items in the Sukuk prospectus or the legal documents, when he considers that it is not in his interest.

\textsuperscript{1052} See id. §§ 11, 12.  
\textsuperscript{1053} See Implementing Regulations of Enforcement Law, Resolution No. (9892) SA § 11(3). (2013).
If an arbitration law that determines its provisions and rules is in place, including that the arbitrator's judgement is not in conflict with the provisions of the Shari'ah, as stipulated in the Saudi Arbitration Law, the arbitrator may render a judgment on a controversial suit, while the competent court may adopt another opinion about it, which may lead to the revocation of the arbitrator's judgement on account that it contravenes the provisions of Shari’ah from the point of view of that court.

One of the issues that may reduce the efficacy of arbitration in Saudi Arabia is that the judges of the competent court may rule in line with the opinion that permits the disputants to withdraw from arbitration before its commencement, with the opinion of those who approve the withdrawal after the initiation of arbitration and before a rendering the judgment, with the opinion of those who do not absolutely make it binding or with the opinion of those who make it binding but with the parties’ consent. Therefore, they do not enforce the judgment, although it is conceived from the Law that the arbitration judgement is binding and cannot be revoked if it is in accordance with the provisions of the Law. The judges' argument relies on the opinion that does not oblige the judges - especially the mujtahids - to abide by a particular Fiqh School or Law whose items involve a controversy among Shari’ah scholars. Recourse to arbitration usually takes place in one of three cases, a) when the dispute arises, b) when it is stated in advance upon entering into an agreement or c) by legal imposition on the two parties. The provision of the arbitrator’s obligation in the contract is more likely to cause one of the parties to the contract to dismiss the arbitrator before the occurrence of the dispute, since this is underpinned by a large number of Shari’ah scholars. It is less likely that the arbitrator will be dismissed when the case is considered and after the dispute has occurred, or his judgment will not be binding and enforceable. Even with a lower probability, this can occur after the judgement has been rendered, if one of the disputants is not satisfied with it.

Among the things that limit the efficacy of Shari’ah arbitration are the conditions set by many Shari’ah scholars, such as being Muslim and eligible for exercising Ijtihad. On the other hand, the judges of the competent court, which hears the suit of and decides the invalidation of the arbitration judgement, may consider the existence of these conditions mandatory to execute the judgements of Saudi Arbitration Law, although the Saudi Arbitration

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1054 See AAOIFI, supra note 43, at 794.
Law did not stipulate them. They may base their arguments on the opinion that does not permit the imposition of the views of a particular Fiqh school or law system on judges. The same applies to the enforcement judge who has the power to execute the judgments of foreign arbitrators. They may base it too on the fact that the Arbitration Law stipulated that the Shari’ah should not be contravened in order to execute the judgements of arbitrators, even though it did not stipulate such conditions. It appears that they saw that there is a contradiction in this, and, as a result, they recourse to the reference, i.e. the Shari’ah.

Another problem related to the efficacy of arbitration, in the event that the arbitration agreement does not require adherence to a specific Fiqh school or system that is not in conflict with the Shari’ah - either due to reluctance of the two contracting partis (i.e. litigants), their ignorance of its importance, their negligence of it or its impermissibility in view of some – is that the arbitrator may see the inadmissibility of some of the propositions suggested in this dissertation to deal with credit and bankruptcy risks facing investors, whether provided in a contract, including one of the contracts on which the sukuk under discussion is based or which investors resort to after the originator of the sukuk defaults on payment, considering them as non-compliant with the Shari’ah according to his opinion.

5.3. Cultural challenges

The cultural challenges in this context involve the potential cultural barriers – that tend to hinder the propositions suggested in this dissertation to deal with the fiduciary and bankruptcy risks of the sukuk – that are rooted in the behavior of Muslim investors and the traditions they must honor from Islamic Fiqh perspective. Some of these challenges, pertinent to religious and Shari’ah aspects, are closer to cultural and social aspects than to legal and judicial concerns, because what we will discuss in this regard seems to be related to the behaviors, customs and convictions of many Muslim investors, whether they are individuals, organizations and institutions, such as banks and companies.

The controversy over the legality of the financial applications, including the sukuk, has discouraged some investors from investing in and dealing with it, as evidenced by many examples. There are companies in Saudi Arabia - whose activities are originally Shari’ah compliant, yet they are involved in some financial prohibitions,
such as interest-based loans - that have discouraged investors. This is because some Shari’ah scholars have disapproved investing in them when some of their shares were offered for public subscription in Saudi Arabia, though they were permitted by other scholars. Other companies, originally dealing in insurance, which is disputable among Fiqh scholars, did not attract many Saudi investors in their shares, as evidenced by the requests of subscription, compared to others. Therefore, many companies in Saudi Arabia keenly seek consultations and fatwas from Shari’ah scholars, especially those who have a wide reputation, to ensure subscription to the offered shares. This culture has led to the emergence of the so-called ‘pure companies’ (sharikat naqiyya) and ‘mixed companies’ (sharikat mukhtalata), the latter referring to companies involved in some transactions contrary to the Shari’ah, with variant degrees of the irregularities. Due to that culture of people and in response to their wishes, many conventional banks have converted to Islamic banks or at least opened Islamic branches. This culture can be traced to the rules of ijtihad and imitation, the matter of getting out of the Fiqh conflict (al-khuruj min al-khilaf), the low recognition of Islamic debt markets and the possible tools of dealing with their credit and financial risks.

5.3.1. Rules of Ijtihad (independent reasoning) and Taqlid (imitation)

Investors interested in dealing in Islamic transactions are either scholars who fulfil the conditions of Ijtihad and consideration of Islamic Shari’ah, imitators of scholars in judging such transactions, or followers of the Shari’ah proofs by way of following (ittibaa’), in view of those who disapprove of blind imitation. According to most scholars, the latter category applies to those who are ignorant of the Shari’ah rulings and, therefore, ask their imams to give them fatwas about the legal matters furnished with the proofs. Here, we will briefly discuss the methodology and provisions of Ijtihad and imitation.

5.3.2. Ijtihad and its rules

One of the many terminological definitions of Ijtihad was given by Ali al-Aamidi. He defined it as: “the exercise of the utmost juristic effort for seeking knowledge of the Shari’ah rulings so that one has become almost
sure that he can not go any further.” Ahmed al-Harani, a Hanbali scholar, has categorized Muslim Mujtahids/jurists into absolute Mujtahid (mujtahid muftaq), doctrinal Mujtahid (mujtahid fi al-madhab) [who follows the methodology of the Imam of his madhab], a Mujtahid in a branch [i.e. field] of Shari’ah sciences and a Mujtahid in a [Shari’ah] question (s). Other scholars categorized mujtahids in similar or different ways, and each following some approaches whose details fall outside the scope of the present research.

Scholars stated various conditions for the Mujtahid. Dr. Iyad al-Sulami viewed that the conditions of ijtihad are: Islam, reason, puberty, thorough knowledge of the verses and the hadiths clearly establishing the rulings of Shari’ah, knowledge of the genuine and the fabricated of those hadiths, knowledge of the abrogating and abrogated Shari’ah rulings, knowledge of the established incidents of consensus (ijma’) so as not to contradict them, knowledge of other approaches pertinent to Fiqh fundamentals and methods of using them in deriving the Shari’ah rulings, knowledge of the semantics of the words and expertise in the stylistics of Arabic, which is the language of the Qur’an and Sunnah, justice and reliability of narration, knowledge of the hierarchy of proofs and methods of combining or comparing them in case of contradiction, which can not be real but illusionary in the mind of some scholars. Close to these conditions, the IIFA provided the conditions to be fulfilled by the mufti.

Ali al-Amidi states,

If an adult Muslim, who is fully eligible for Ijtihad, has diligently exercised Ijtihad in a legal matter and reached a ruling on it, scholars have unanimously said that it is not permissible for him to abandon his ijtihad and imitate others’ rulings. But, if he had not exercised Ijtihad, scholars held different opinions about that.

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1057 See AL-SULAMI, supra note 1, at 451-54. For more details about these conditions, see MUHAMMAD A. IBN AL-NAJJAR, SHARH AL-KAWKAB AL-MUNEER AL-MUSAMMA BI-MUKHTASAR AL-TAHIR, AW, AL-MUKHTABAR AL-MUBTAKAR SHARH AL-MUKHTASAR FI USUL AL-FIQH vol. 4, p. 459-66. Edited by Mohamad al-Zuhayli & Nazih Hammad. (Saudi Ministry of Islamic Affairs, Dawah and Guidance & Obeikan Bookstore, 1t ed. 1993); see also Wahbah M. al-zuhayli, Usul Alfiqh Alislami vol. 2, p. 1043-051.
1058 See IIFA, supra note 79, at 344-45.
1059 AL-AMIDI, supra note 1055, at vol. 4, p. 204.
Consensus on this issue was reported by many scholars. Hence, those in charge of Islamic financial institutions investing in sukuk or interested in securitization to seek financing, along with their Shari’ah committees, must legally adhere to this ruling. It is not permissible for them to engage in a financial transaction that they render as impermissible, even if other jurists held it as permissible. Yet, if this contravention of the Shari’ah was made, it would be difficult to discover because it would require knowledge of the intentions. If they had a relevant published fatwa, they could evade it by claiming that they have modified the fatwa.

5.3.3. Imitation in the Fiqh branches and its rules

It is inconceivable that the vast majority of people would meet the conditions of ijtihad and consideration of the principles of Fiqh. Therefore, they adopt the views of Shari’ah scholars in subordinate practical questions, such as financial transactions, including sukuk. One of the conventional definitions of imitation is: "the adoption of the legal views of scholars without knowing their proofs."\footnote{AL-SULAMI, supra note 1, at 477.} It is also defined as: "accepting the legal opinion of scholars without a proof."\footnote{\textit{Id.} at 476.} Al-Sulami states: "[t]his definition involves a problematic issue, which is: their saying: 'without a proof' Does this mean that acceptance of the legal opinion has no proof? or, that the legal opinion itself is not supported by a proof? If it means that acceptance has no proof, then the common person’s following of the scholar’s opinion is valid, given the Qur’anic command: ﴿فاسألوا أهل الذكر إن كنتم لا تعلمون﴾ [“So, ask the people of the message if you do not know.”] [Al-Nahl 43]. Besides, there is consensus on the validity of the common person to consult the scholar. In case the intended meaning is that the legal opinion has no valid proof, it creates a problem. For, it is established among the majority of scholars that the legal opinion that is not supported by a valid proof should not be followed. A consensus was even reported in this regard." \textit{Id.}

\footnote{\textit{Id.} at 478; see also MUHAMMAD A. AL-SHAWKANI, IRSHAAD AL-FUHOOL ILA TAHJEEQ AL-HAQQ MIN ILM AL-USOOL vol. 2, p. 1091. Edited by Sami A. al-Athari. (Dar al-Fadila: Riyadh, Saudi Arabia, 1t ed. 2000).}

\footnote{See AL-SULAMI, supra note 1, at 278-79.}

They attributed the prohibition to the view of the majority of scholars.\footnote{\textit{Id.} at 476; see also MUHAMMAD A. AL-SHAWKANI, IRSHAAD AL-FUHOOL ILA TAHJEEQ AL-HAQQ MIN ILM AL-USOOL vol. 2, p. 1091. Edited by Sami A. al-Athari. (Dar al-Fadila: Riyadh, Saudi Arabia, 1t ed. 2000).} Dr. al-Sulami implies that this ban does not mean the prohibition of the laymen from consulting the scholars, which is unanimously permitted if the scholars gave fatwas based on a proof.\footnote{See AL-SULAMI, supra note 1, at 278-79.} Muhammad al-Shawkani reported the scholars’ consensus that it is permissible for a Muslim to consult an eligible scholar (\textit{mufti}).\footnote{See AL-SHAWKANI, supra note 1062, at vol. 2, p. 1082.} Al-Sulami said that Ibn Hazm had enjoined the

\footnote{\textit{Id.} at 476; see also MUHAMMAD A. AL-SHAWKANI, IRSHAAD AL-FUHOOL ILA TAHJEEQ AL-HAQQ MIN ILM AL-USOOL vol. 2, p. 1091. Edited by Sami A. al-Athari. (Dar al-Fadila: Riyadh, Saudi Arabia, 1t ed. 2000).}

\footnote{See AL-SULAMI, supra note 1, at 278-79.}

\footnote{See AL-SHAWKANI, supra note 1062, at vol. 2, p. 1082.}
laymen to ask the scholar about his proof, and they should not accept his fatwa unless he mentioned the proof or said that this is Allah’s ruling.  

5.3.3.1. Ruling on imitation in the branches of Fiqh

Muslim jurists differed concerning the ruling on imitation in matters related to the branches of Fiqh. Dr. Saad al-Shethri, concluded that jurists held three opinions about that. He said: "the majority of scholars said that imitation is permissible. There is rather consensus reported to support that." The second opinion, he said, banned imitation until the validity of the ruling is established by its proof. The third saying, which he attributed to al-Jubba'i [who belongs to the Mu'tazilah], viewed the permissibility of imitation in matters that are open for Ijtihad (al-Masail al-Ijthadiyah). Al-Sulami, in contrast, mentioned two views about this issue. He attributed its permissibility to the opinion of the majority of scholars, while attributing the ban to Ibn Hazm and al-Shawkani.

Wahbah al-Zuhayli provided another division of the views about that matter: ban of imitation, obligation of imitation, and consideration of the situation. In the latter case, if the person is mujtahid, it is not permissible for him to imitate others. If he is not mujtahid, he must imitate an eligible scholar. al-Zuhayli attributed this view to many reliable researchers.

Perhaps, the reason that those who banned imitation attributed this saying to the view of the majority of scholars is the way they conceived its meaning, which is most likely to adopt the opinion of the mujtahid not necessarily supported by proofs, as required by some, while some mentioned that the mujtahid must provide the

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1065 See AL-SULAMI, supra note 1, at 479.
1066 See DR. SAAD N. AL-SHEHRI, Al-Taqlid Wahkamuh 71 (Dar al-Watan for Printing & Publishing: Riyadh, Saudi Arabia, 1t ed.
1416 AH).
1067 Id. at 71-2; see also IBN AL-NAJJAR, supra note 1057, at vol. 4, p. 539.
1068 See Al-Shehri, supra note 1067, at 72.
1069 See id. Some scholars differentiate between independent-reasoning questions (al-Masail al-Ijthadiyah) and disputed questions (al-Masail al-Khilafiah).
1070 See AL-SULAMI, supra note 1, at 482.
1071 See id.
1072 See AL-ZUHAYLI, supra note 5, at vol. 2, p. 1126-127.
1073 See id.
1074 See id.
1075 See id. Some of the scholars of Fundamentals of Islamic Jurisprudence have another classification of the sayings that they differed in attributing them to their sources. Some of the sources mentioned here present a response to them.
proof or say that this is the Shari’ah ruling. In contrast, some scholars stressed that the imitator must verify the validity of the ruling. In fact, verification of the ruling is hard to achieve, even if the layman believes it to be the case, because this belief is illusionary, especially debatable issues that need thorough understanding of Shari’ah as well as other secondary sciences, such as the sciences of Hadith and Arabic language.

In addition, scholars differed on many issues related to imitation. For example, they differed on the ruling that the imitator should adhere to a certain doctrine. Al-Sulami attributed permissibility to the majority of scholars. They also differed on the imitation of the Mufti who himself is an imitator. Those who have permitted adherence to a particular Fiqh school have differed on the imitation of other than the four leading Imams of Fiqh.

The reality of many Muslims around the world in general is that they adhere to the views of one of the four Fiqh schools or the scholars who belong to one of these schools in legal matters and issues that are recurrent since the emergence of the Islamic Shari’ah and imitate contemporary scholars in contemporary financial applications and recent transactions. Many Islamic financial institutions have Shari’ah committees composed of jurists in Islamic Fiqh. Their mission is to ensure the compliance of the institution with Islamic financing provisions and scrutinize their contracts, though the variation in the authority and capacity of these committees.

It has been mentioned above that scholars permitted people to ask jurists about the Shari’ah rulings of transactions and incidents. However, the present researcher did not find any work that banned the image in which a lay person asked a scholar about a subsidiary Shari’ah question supported by the legal proofs, and the lay person has verified and ascertained the validity of the Shari’ah ruling. In fact, the verification of the Shari’ah ruling is inconceivable in many legal questions and applications, as the non-specialist in Shari’ah is not eligible to verify the validity of many rulings. If he thought that he has conceived it, he would be disillusioned, because he does not possess the necessary elements of Ijtihad and Shari’ah sciences. As for those who required the mentioning of the Shari’ah proofs, there is no point in mentioning them for the imitator, particularly if the proofs relate to

1076 See AL-SHETHRI, supra note 1067, at 142.
1077 See AL-SULAMI, supra note 1, at 483.
1078 See IBN AL-NAJJAR, supra note 1057, at vol. 4, p. 557-63.
complex and hard-to-conceive legal matters, unless it is to ascertain that the mujtahid did not give a ruling out of pure reasoning. Further, mentioning the proof does not exclude him from being an imitator. It is assumed that the mujtahid or the scholar is to judge cases based on a Shari’ah proof. But, if the imitator knew that the mujtahid, the scholar or the mufti had expressed his opinion without a Shari’ah proof, then it would be prohibited to imitate him. For, in view of the majority of scholars, the mujtahid or the Mufti is not infallible, and he is not considered a Shari’ah authority by himself. Perhaps, the reason that made those who have banned imitation forbid it is to avoid bias to the juristic opinions that proved to be incorrect; the belief that the scholar or mujtahid is an authority by himself; or the closure of the door of ijtihad to those eligible for it and meeting its conditions.

5.3.3.2. Ruling on seeking of Fiqh concessions (tatabbu’ al-rukhas al-faqhia) and the advantageous Fiqh views

Some of the propositions presented in this dissertation face controversy over their Shari’ah legality or the legality of some of their applications and branches. Each one of these propositions has been consented by some jurists, while disapproved by others. But, no specific jurist has approved all these propositions as a whole. If the imitators of the jurists - who authorized some of these propositions – from among the sukuk holders adopted them by recommending them in the prospectus or by resorting to them in the restructuring negotiations, the provisions that we have mentioned in the context of the ruling on imitation would apply to them. The researcher is inclined to consider that those who are not equipped with the tools of Ijtihad in Shari’ah must follow the views of jurists, and they are not bound to adhere to a particular Fiqh school. However, the question that arises here is the ruling when the imitating investor abandons the views of his imam, or when the Islamic bank does not act upon the opinion of its Shari’ah committee. In that case, he/it would adopt the propositions approved by some jurists, even if they contradict the views expressed by the mufti or the scholar he/it imitates or decided by the Shari’ah committee he/it had selected. In this way, investors, sukuk holders or sponsors can consider all propositions made in this dissertation to deal with the credit and financial risks of sukuk and to attract investors.
5.3.3.2.1. Shari'ah ruling on seeking of Fiqh concessions

Before investigating this issue, it should be noted first that Muslim jurists forbade that the mufti would be excessively lenient in giving the fatwa, and consensus was reported in this regard. Jurists also banned the lay people to imitate the muftis who are known to be permissive.\footnote{See AL-SHETHRI, supra note 1067, at 154.} As to the meaning of the adoption of Fiqh concessions (\textit{tatabbu’ al-rukhas al-faqhia}) and seeking of scholars exemptions (\textit{tatabbu’ rukhs al-ulama’}) underlined by jurists, al-Sulami defined it as: "the adoption of the most lenient legal opinions concerning the disputed matters (\textit{al-masail al-khilafiah})[among Muslim scholars]."\footnote{AL-SULAMI, supra note 1, at 492.} This applies to the imitator who is aware of the different opinions of jurists on a juristic question or application whose legality or controls are contentious and he embraces the most lenient of them or chooses the opinion that is in his interest or has more advantages than other opinions.

5.3.3.2.2. Discussion of the controversy

Concessions or exemptions referred to here do not stand for Shari’ah licenses (\textit{al-rukhas al-shar’iyah}), which are evidently permitted by Islamic Shari'ah when legal excuses exist. Examples of these licenses are permission to shorten the prayer when traveling, and consumption of dead meat (meat of an animal not slaughtered according to religious requirements) when necessary. However, concessions meant here refer to the permissions given by jurists of Fiqh schools (\textit{al-rukhas al-faqhia}). For instance, a dispute may arise among jurists over a particular legal question, which is permitted by some jurists, while others render it as impermissible, and there is no valid consensus on its permissibility or prohibition. Dr. Hisham al-Saeed says:

Muslim jurists are in agreement that the transfer, if intended for footle and useless amusement, is absolutely forbidden, because footle is prohibited by categorical texts, as when a Hanafi school adherent follows the view of Imam al-Shafa'i in permitting playing chess in order to justify his practice. Imam Ahmad Ibn Hanbal and others stated that it is not for anyone to believe that something as obligatory or forbidden and then renders it to the contrary and indulges in/refrains from it only because this pleases his caprice…For
example, one may seek the right of pre-emption (shuf’a) believing that it is an established right for him. But, when another person seeks the same right from him, he does not hold it as an established right following the view of another scholar. Such attitude is unanimously impermissible…It should also be acknowledged that if a mujtahid has independently reached a legal opinion regarding a juristic matter, he is not to relinquish it; he must adhere to the opinion he constituted based on his Ijtihad.  

It has been previously referred to the consensus that if a mujtahid has reached an opinion, he is not to act upon other opinions. IIFA has prohibited the adoption of Fiqh exemptions for the sake of personal whims, as will be seen below. If such consensuses are proven, then the dispute will be limited to other questions.

Scholars of Shari’ah differed concerning the ruling on seeking of Fiqh concessions. Some researchers stated that Ibn Hazm had reported a consensus regarding its impermissibility. Al-Shethri related three views on this question. The first view, which is attributed to the majority of scholars, is prohibition. They based this view on some proofs, inter alia, the consensus of scholars on this matter before the dispute has occurred; and it leads to the negligence of Shari’ah injunctions in matters, applications and transactions, which are contested among jurists. They prevented some of them and authorized others, or they make them obligatory, while others do not. Second, al-Shethri said that some of the later Hanafi jurists permitted it. Then, the third view is that the act itself should be investigated: if it is commonly recognized as forbidden in Shari’ah, he will be a sinner. Otherwise, there is no sin in that. Then, he commented on it, saying that there is no proof to support it, therefore it has no consideration. Al-Saeed related the same previous division of views, except the third one, stating that his fellow researchers permit the adoption of Fiqh concessions/exemptions with different conditions, citing the


1084 See AL-SHETHRI, supra note 1067, at 154.

1085 See id.

1086 See id.

1087 See AL-SULAMI, supra note 1, at 492.

1088 See AL-SHETHRI, supra note 1067, at 156.

1089 See id. at 156-57.

1090 See id.
conditions of each of them. Al-Saeed commented on IIFA’s conditions after mentioning jurists’ opinions regarding the ruling on seeking concessions, saying: "[t]he latter [i.e., the opinion of this council] seems to be the preponderant view - and Allah knows best. However, absolute prohibition or permissibility should not be made. It is evident that the proponents of prohibition permitted the adoption of Fiqh concessions with the stated controls, though they did not say that explicitly. Likewise, exponents of permissibility stipulated certain controls. As such, the question – with investigation of the disputed question - is close to be concordant, and the core of the dispute lies in the issue on which the question of seeking concessions was built, i.e. the issue of the adherence of common people to a particular Fiqh school. In contrast, AAOIFI prohibited seeking of Fiqh concessions, unless specific controls were existent. According to AAOIFI, Islamic financial institutions are prohibited from acting upon fatwas issued by any body except their Shari’ah committees, unless with their consent, in order to avoid fabrications (talfiq) and seeking of concessions without observing their controls.

See al-Saeed, supra note 1082.

IIFA, in its Resolution No (70) concerning Exemption: its Applicability and its Rules, states: "2. Fiqh exemptions are to mean the various religious Schools interpretations authorizing a certain matter as opposed to other interpretations prohibiting it. Availing of the scholars' exemptions, in applying the less restrictive of their opinions, is legitimate from a Shari’a perspective, under the following terms ( as listed in Article 4). 3. Exemptions with respect to general matters are handled on a par with core Fiqh issues as long as they achieve a Shari’a acknowledged benefit and are the result of a collective effort of interpretation undertaken by competent people reputed for their piety and scholarly integrity. 4. Exemption allowed by the various Fiqh schools is not permissible to availed solely on one's desire, for that would lead to ordained duties being shed . Rather, exemptions are to be taken up under the following terms: a) That the scholars' articulated views evoked for exemption are Shari’a - acknowledged and have not been qualified as departing from the norm. b) That there arises a need for the exemption so as to stave off hardship, whether for the common private or individual need. c) That the exempted is capable of decision making or that he relies in the matter on a party known for its aptitude. d) That availing of the exemption may not result in any of the unauthorized fakery interpretations as listed under article 6. e) That availing of the exemption is not taken as a pretext to achieve unlawful goals. f) That the exempted feels at ease with the exemption and readily accepts it." IIFA, supra note 83, at 151-52.

See al-Saeed, supra note 1082.

AAOIFI, in its Shari’ah Standard No. (29) related to Stipulations and Ethics of Fatwa in the Institutional Framework, states: "8/4 Fatwa issuers shall not always pursue Shari’ah exemptions to make matters easier for Institutions. A Shari’ah exemption should be sought only when it results from thorough examination of the issue and appropriate reasoning. Moreover, it has to be ensured that making use of the Shari’ah exemption does not embody a related act that the Fuqaha unanimously consider as prohibited or lead to issuing different Fatwas for two identical incidences. Misuse of Shari’ah exemptions in this manner is known in Fiqh as “Talfiq” (fabrication)." AAOIFI, supra note 43, at 742.

AAOIFI states: "6/3 The institution should not follow the Fatwas of other Shari’ah Advisory Boards except with permission of its own Board.” Id. at 740. It also states: "[p]reventing the Institution to adopt the Fatwas of other boards, except when allowed by its own board to do so, stems from the need to bar the way to any tendency of fabrication or attempt to pursue Shari’ah exemptions without observing their relevant controls or their context and circumstances, an act which leads to adoption of irrelevant Fatwas." Id. at 749.
5.3.3.3. *Cases and controls of embracing the easiest and most lenient views as supported by the sayings of some scholars*

This question is scholarly close to the question of seeking Fiqh concessions. Some jurists have pointed to the earlier question when dealing with other questions. A group of Shari’ah scholars saw that the seeker of a legal opinion may choose the easiest legal view in cases some of which - from the present researcher’s point of view - come under the opinion that permits seeking Fiqh concessions with some conditions. For instance, some jurists permitted embracing the easiest legal view when two mujtahids seem equal in their knowledge and Shari’ah to the inquirer. One of the jurists stated that there are three views about this matter: choosing either of the two opinions, adopting the strictest opinion or embracing the easier of the two opinions. Then, he stated that it is possible to refer the question to a third mujtahid, if any, constituting a fourth view.

Mohammed al-Othaimeen, who was a member of the Council of Senior Scholars of Saudi Arabia, permitted the adoption of the most lenient opinion if the inquirer could not ascertain whichever of the two scholars is the more knowledgeable and righteous, as long as this does not lead to *mafsadah* (evil/harm/corruption). He forbade the inquirer who had asked an acknowledged and profound scholar yet his opinion did not appeal to him to ask a second and a third scholar, and so on, explaining that this leads to the habit of seeking Fiqh concessions and manipulation of religion.

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1097 *See id.*
1099 He was asked: "is it permissible to seek fatwas from more than one scholar? If the fatwas differ, should the one who is seeking a fatwa choose the easiest or the most prudent?", and he answered: "it is not permissible for a person, if he has asked a scholar whose view he trusts for a fatwa, to ask someone else, because this leads to toying with the religion of Allah and seeking out concessions, as the person may ask one scholar, then if the answer does not suit him, he asks another one, and if his answer does not suit him, he asks a third scholar, and so on. The scholars stated that seeking out concessions is evil. But sometimes a person may have access to only one scholar, so he asks him out of necessity, but his intention is that, if he meets a scholar who is more trustworthy in terms of his knowledge and religious commitment than the first one, he will ask him. In this case there is nothing wrong with him asking the first one out of necessity, then if he finds one who has more knowledge than him, he may ask him. If the scholars give him different fatwas, or if there is a difference in what he hears of their exhortations and advice – for example – then he may look for someone who he thinks is closer to the truth in terms of his knowledge and religious commitment. If the two men are equal in terms of knowledge and religious commitment, in his view, then in this case some of the scholars said that he should follow that which is more prudent, which is which is more strict. However it was also suggested that he should follow that which is easier, and this is the correct view, because if the fatwas are equal in terms of evidence, then you should follow that which is easier, because the religion of Allah, may He be glorified and exalted, is based on ease and simplicity, not on hardship. ‘Aa’ishah (may Allah be pleased with her) said, describing the Prophet (blessings and peace of Allah be upon him): he was never given the choice between two things but he chose the easier of the two, so long as it was not a sin." *If He Follows a Scholar who is Known for Being Knowledgeable and Honest, He is not*
different opinions, provided a close account to that. He viewed that the inquirer should first ask whichever is more knowledgeable among the scholars. If they seem equal to him, he should ask the most righteous of them. In case he cannot decide whichever is more knowledgeable and righteous of them, he should ask those familiar with them about their knowledge and righteousness. Accordingly, he should select the opinion of the one he most likely considers the most knowledgeable or righteous of them.\textsuperscript{1100} However, on another occasion, when talking about the ruling on seeking of Fiqh concessions and embracing the most lenient opinion – when there is a need (\textit{hajah})\textsuperscript{1101} - about an issue or two, he said that it is based on the previous question, i.e., how the lay person should act if he asked more than one scholar and found that they are in disagreement. He suggested that the inquirer should refer the question to the most knowledgeable or the most pious scholar.\textsuperscript{1102} In case both of them seem equal, he should refer the matter to a third scholar.\textsuperscript{1103} Yet, he did not refer to this opinion and its preponderance to him when dealing with the previous question. He also said: "It should be observed that the seeking of Fiqh concessions is realized in relation to the individual who constantly acts in that way in disputed legal matters."\textsuperscript{1104} From the troubled view of al-Sulami, having scrutinized his comment that followed his account we quoted, it appears that he does not permit the embracement of the most lenient view in one or two questions, even when a need (\textit{hajah}) exists.\textsuperscript{1105} Ali al-Sabki says,

It is permissible for the ignorant to imitate and adopt the concessions as given in the opinions of scholars on some occasions when there a need (\textit{hajah}) exists, but without deliberately seeking the concession. In this way, it was rightfully said: "disagreement among scholars is a means of bringing about mercy"; for, concessions (\textit{al-rukhas}) are intended to bring about facilitation.\textsuperscript{1106}


\textsuperscript{1100} See AL-SULAMI, supra note 1, at 486-87.

\textsuperscript{1101} Shari‘ah scholars make a distinction between need (\textit{hajah}) and necessity (\textit{daroura}) as shown and discussed in the literature and books of the fundamentals of Islamic jurisprudence (Usul al-Fiqh).

\textsuperscript{1102} See AL-SULAMI, supra note 1, at 486-87.

\textsuperscript{1103} See id. at 492.

\textsuperscript{1104} Id.

\textsuperscript{1105} See id.

Based on the above mentioned regarding the ruling on seeking Fiqh concessions and the inquirer’s adoption of the most lenient views, and in the light of the provisions of Ijtihad and imitation stated above, the researcher, from the Shari’ah perspective, has some reservations on the methodology adopted by some contemporary researchers in their studies of Shari’ah controversial questions. Some researchers, when examining contemporary financial transactions whose legality or the legality of other analogous transactions debated by early jurists was contested among jurists of Fiqh schools, and which these researchers used as baseline in their researches, mention some views that explicitly permitted those transactions or associate them with applications approved by one of the jurists or Fiqh schools by way of analogy or derivation of Shari’ah rulings on emerging cases from doctrinal or school Fundamentals (al-takhrij al-fiqhî) but without verifying their compliance with Shari’ah, if they are eligible for doing that. Some cases involve a controversy, yet they did not discuss it. But, if it is agreed that their Shari’ah opinion produced through research and study and governed by the Shari’ah controls corresponds to those opinions, there seems to be no wrong in that. Perhaps, the reason of conveying those views is to prove that they did not express a new opinion. The majority of jurists banned introducing a new statement in controversial matters.\textsuperscript{1107} It is rare - if not impossible - that all the views of each of these researchers formed through Ijtihad and consideration, for example, about the legality and the provisions of the disputed financial transactions are consistent with all the juristic opinions that were characterized by facilitation and the interest of investors.

If they are imitators of a Fiqh school, the reference to the views of that school concerning those transactions does not appear problematic to the present researcher. But, some researchers do not clearly state whether their researches are based on their findings through Ijtihad or imitation, or whether their researches deal with contemporary financial transactions from the perspective of that school when dealing with the rulings pertaining to those transactions. This suggests that their methodology is based on the adoption of the most convenient opinions among the disputed ones, which is in the interest of financial institutions. It is rare, if not impossible, to find a profound jurist who permitted all disputed questions. If that happened, and one of those researchers has imitated that jurist, it would be permissible, in view of those who permit imitation and some of its applications,

\textsuperscript{1107} See AL-TUFÎ, supra note 1096, at vol. 3, p. 88.
as in the case of imitating a late jurist. Given that situation, i.e., the non-existence of a jurist who did so, it becomes clear that the methodology of these scholars contradicts the approaches established by many Shari’ah scholars regarding the methodology of Ijtihad and imitation, which we have discussed some of its rulings, and contradicts the views of all scholars in some of their applications, especially if these consensuses proved to have occurred.

**5.3.3.4. Some conditions of the Mufti and the ruling about consenting Fiqh concessions and views expressed by other jurists but contradicting the opinion he reached through ijtihad or imitation**

These two issues are worth discussing briefly here because they are related to the attitude of leniency in issuing fatwas and facilitating the transactions and products of Islamic banks and other financial institutions, which may cause harm to the reputation of Islamic finance and elimination of the fundamental differences between it and conventional financing with its various financing tools. However, we do not intend to dwell on the provisions of the two issues, as they were dealt with in many books of the fundamentals of Islamic jurisprudence. We will only mention some of their provisions and refer to the opinion of some Fiqh councils.

**5.3.3.4.1. Some conditions of Muftis (members of the Shar’iah committees)**

Shari’ah committees - which oversee Islamic sukuk or institutions or those affiliated with the sukuk holders - have jurisconsults (muftis) who are expected to have fulfilled all conditions of ijtihad or are, all or some of them, likely to be imitators. The terms laid down by jurists required for the muftis differed. Some jurists did not stipulate that the mufti should be a mujtahid, but they gave some descriptions that varied from one jurist to another. Some mentioned conditions, most of which apply to the conditions of the mujtahid. Others clearly stated that the mufti must be a mujtahid, while some saw that the mufti might be a mujtahid in the Fiqh School of the imam he imitates. For instance, some jurists such as Ibn Hazm and others stipulated that the mufti should be a mujtahid, and it seems that they were referring to an absolute mujtahid. Ibn Hazm apparently rejected the notion of imitation in principle, and it cannot be imagined that he recognized doctrinal mujtahid, i.e. whose ijtihad is restricted to a particular Fiqh school. Some jurists permitted the mufti who is a mujtahid in the Fiqh school of his imam to

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1108 See AL-MARDAWI, supra note 975, at vol. 11, p. 177; see also IBN AL-NAJJAR, supra note 1057, at vol. 4, p. 557.
exercise fatwas in four cases they mentioned. Some also permitted the mufti to give fatwas within the area he is familiar with in the fields of Fiqh. Some have permitted that the mufti be imitator for a necessity (darurah). Some permitted that the mufti be an imitator but with some controls. Others provided that the mufti should not issue fatwas unless "his fatwas are clearly supported by an evidence from the Qur'an, the Sunnah or consensus, or any other method that is consistent with such evidence." This is close to the meaning of ijtihad rather than imitation.

IIFA and AAOIFI do not expressly provide that the mufti must be a mujtahid, i.e. he fulfills the conditions of ijtihad, and did not clearly state that he may be imitating, i.e. follow the opinion of the scholar he imitates. Sometimes, they mentioned some controls that are considered close to the conditions of ijtihad, while later they mentioned some descriptions close to those of the imitating Mufti. At one of its sessions, the IIFA provided that the mufti must satisfy certain conditions, which are close to the conditions of the mujtahid mentioned above. It also provided for calling all those involved in issuing fatwas, including the committee members and scholars, to take the resolutions of the Fiqh councils into consideration in order to control and unify the process of issuing the fatwas in the Islamic world. However, at a later session, where it issued its Resolution No. 177, it provided that one of the rules of ijtihad and issuing fatwas in the Shari'ah bodies [i.e. those affiliated with the Islamic financial institutions] is: "to abide by the resolutions of the International Islamic Fiqh Academy, while considering

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1110 See id. at 90.

1111 See IBN AL-NAJJAR, supra note 1057, at vol. 4, p. 558.

1112 See id.


1114 IIFA, in its Resolution No (153) concerning on Issuing Fatwa: its Conditions and Morals, states: "[s]econd: the conditions for issuing difatwa. It is impermissible for one to undertake the issuing difatwa if he has not realized the established conditions in this field, and the most important among them are: 1- Knowledge of the Book of God and the Sunnah of His Messenger, may God bless him and grant him peace, as well as related disciplines. 2- Knowledge of the fields of consensus (ijma’) and disagreement, the schools of Islamic Jurisprudence (mathahib), and legal opinion. 3- Complete knowledge of jurisprudence (usul al-fiqh), its origins and its rules, the goals of sharia, as well as disciplines which contribute to this such as grammar and syntax, rhetoric, linguistics, logic, and so forth. 4- Knowledge of people’s circumstances and their customs, the conditions and developments of the time, with due regard to how they change insofar as this concerns [law] that is derived from a relevant custom (‘urf) that does not contradict a source text (nass). 5- The ability to derive rulings in the Shari’ah (Islamic law) from the source texts. 6- Consultation with experts on various specialized topics in order to formulate the answer to the question, such as medical, economic, and similar questions.” IIFA, supra note 79, at 344-45.

1115 See id. at 346.

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the resolutions of other councils and collective Ijtihad bodies, provided that there is no contradiction with the resolutions of the International Islamic Fiqh Academy.”

What this council stated makes it conceivable that the mufti is in fact an imitator, and that seems to be contrary to what it stated earlier about the conditions of the mufti. For, the mujtahid does not imitate others, but he strives and assesses the case, on condition that he does not introduce a new opinion on a contested legal question that has specific views, given the inadmissibility of creating a new opinion as mentioned above, according to the opinion of the majority of jurists.

AACOFF in its standard (29) stated a similar ambiguous account. In the course of its talk about the conditions of the mufti, it mentioned certain conditions some of which are consistent with the conditions of the imitator, while some apply to the conditions of the mujtahid. In the same standard, when talking about the method and means of issuing the fatwa, it mentioned what can be described as conditions for the mujtahid. However, in another position, when presenting the fatwa controls, it mentioned what appears to be conditions pertinent to the imitating mufti.

1116 Id. at 410.
1117 AAOIFI, in its Shari’ah Standard No. (29) related to Stipulations and Ethics of Fatwa in the Institutional Framework, states: “5. Conditions on Mufti (Fatwa Issuers) 5/1 A board member shall be well versed in Fiqh (Islamic Jurisprudence), well informed of the contributions of diligent Fiqh scholars, and has the ability to use the Shari’ah-accepted methods of deriving reasonable rulings on emerging issues. He shall also be known for his discernment, cautiousness and knowledge about the circumstances and traditions of people, and should always remain alert against the different means of human misbehavior. Competence in Fiqh is usually manifested by the vast reputation of the scholar or his distinguishable contributions especially in the area of financial transactions performed by institutions. 5/2 Issuing Fatwa to institutions does not require competence in all areas of Fiqh. Fatwa can be issued by a scholar who is competent only in the area of financial transactions performed by institutions. 5/3 The member of the Board shall have no personal interest in the matter for which the Institution seeks Fatwa.” AAOIFI, supra note 43, at 739.

1118 AAOIFI, when addressing Methods and Means of Fatwa, states: “7/1 Fatwa should basically be founded on what has been explicitly stated in the Qur’an and the Sunnah along with what has been supported by Ijma’ (consensus of Fuqaha) or proved by Qiyas (analogical deduction). After resorting to the preceding sources, the judgment of the Mufti (issuer of the Fatwa) with regard to the different viewpoints of the Fuqaha (scholars of Fiqh); i.e, Istihsan (Shari’ah approbation) and Maslahah Mursalah (public interest) may be considered as the basis for issuance of Fatwa. 7/2 Fatwa should not be based on a personal viewpoint that does not cater for the sources referred to in item (1/7) above, or contradict with the general texts of the Qur’an and the Sunnah that have explicit indications. Moreover, Fatwa shall also not fall in disparity with well-established Ijma’ or the general rules derived from the Qur’an and the Sunnah. 7/3 Absence of explicit directives in the Qur’an and Sunnah on a given issue, or non-existence of the issue in the prevailing Fiqh literature, do not justify refraining from seeking Fatwa on that issue. Fatwa in this case may be derived through Shari’ah-sanctioned rules and methods of deduction… 7/5/2 Tracing the Shari’ah ruling on the issue in the different schools of Fiqh, and exerting due endeavors to ascertain if the issue encounters the existence of contradicting proofs, or it is an issue that has not been specifically dealt with in the Qur’an and the Sunnah or discussed by the Fuqaha.” Id. at 740-41.

1119 AAOIFI states: “8/2 Fatwa issuers, while issuing the Fatwa, shall signify keenness to quote Ijma’ and opinions of diligent Fuqaha from their accredited sources, as well as concentration on those opinions which have gained more accreditation in each School of Fiqh, and should resort to available Fiqh literature on principles of issuing Fatwa.” Id. at 742.
5.3.3.5. Shari'ah ruling on the Shari'ah Committees’ choosing of opinions that contradict their adopted views

The question that can be raised here is: what is the ruling if a Shari’ah Committee issued a legal fatwa on a debated question consistent with a juristic opinion that contradicts its established views reached through Ijtihad or imitation, in view of those permitting the latter? To answer, the mufti can be either a mujtahid or an imitator, in view of those permitting imitation. If he is a mujtahid, we have mentioned that jurists forbade him from adopting any opinion concerning a controversial matter that contradicts his opinion reached through independent reasoning (ijtihad). If he is an imitator, admitting the permissibility of imitation, he should abide by the controls of imitation we have mentioned and refrain from deliberate seeking of Fiqh concessions and sayings that are most likely in the interest of those with whom these committees are affiliated.

5.3.3.6. Ruling on the financial institutions’ employment of arbitrators or muftis who have fatwas, books or articles that permit many financial transactions related to the products of banks to work in their Shari'ah committees

To avoid the problem of the prohibition of deliberately seeking Fiqh concessions and other restrictions, such as the resolutions of some Fiqh councils that stressed adherence to the resolutions and fatwas of the Shari’ah committees affiliated with Islamic institutions, and to meet the terms laid down by some legislations, such as the independence of the members of the Shari’ah committees, their non-subjection to the interests of Islamic banks and institutions and the restrictions made on their dismissal, some Islamic banks and institutions may take measures to screen the opinions of jurists as mentioned in their books, researches or fatwas issued in their interviews. When these Islamic banks and institutions see that the legal views of any of the jurists are compatible with their products and transactions, they employ them to work in their Shari’ah committees. It seems that this question as presented in this image is one of the newly emerging legal matters that need thorough legal research, since those elected to work in the committees are entrusted with issuing fatwas binding to the banks and institutions. However, it is possible to anticipate some conclusions and determine the legal ruling of this act. First, the ruling on this question is likely to be contingent upon the question of the ruling of the imitator’s desertion of
the Fiqh school of the jurist he imitates. Secondly, some scholars - in principle - have obliged the inquirers to choose the jurists whom they are certain of their knowledge or righteousness.\textsuperscript{1120} However, some jurists approve of consulting the less knowledgeable, though the existence of the more knowledgeable, and the inquirer has the option to choose the views that appeal to him.\textsuperscript{1121} Yet, this does not oppose what we mentioned previously about the ban of seeking of Fiqh concessions expressed by jurists, regarding disputed questions, which are more lenient to the inquirer and conform to his interests. In general, jurists, as mentioned earlier, forbade people to consult scholars who are known for their lenient fatwas.

### 5.3.4. Following (ittiba’) and its controls

Some jurists, such as Ibn Hazm, al-Shawkani, Ibn al-Qayyim and Ibn 'Abd al-Barr, have suggested third section between ijtihad and imitation. Ibn 'Abd al-Barr says,

Imitation (taqlid) according to jurists is different from following (ittibaa’). As for ittiba’, it is to follow a scholar by virtue of the merit of his views and soundness of his doctrine. Taqlid, in contrast, is to imitate his views, though one is not cognizant of his proofs or their interpretation, and is not willing to imitate anyone else. Or, when one has realized the error of the scholar and yet he still imitates him for fear of opposing his views, despite the apparent corruption of his views. This is forbidden.\textsuperscript{1122}

He defined the conception of these two terms from the perspective of one of the scholars, saying:

Abu Abdullah bin Khweiz Mendad al-Basri al-Maliki said: "taqlid conventionally means the embracement of a legal view of a scholar who has no proof to support it. This attitude is forbidden in the Shari’ah. Following, in contrast, is to adopt a scholar’s legal view substantiated by a valid proof.” In another place of his book, he said: "every scholar you follow his views without being supported by a proof justifying that, you are imitating him. Imitation in Shari’ah is not acceptable. Whoever you are enjoined by a proof to embrace his views, you are following him. Follow is permissible in Shari’ah, while imitation is forbidden.”\textsuperscript{1123}

\textsuperscript{1120} See AL-TUFI, supra note 1096, at vol. 3, p. 666-67.
\textsuperscript{1121} See id.
\textsuperscript{1122} IBN 'ABD AL-BARR, supra note 1113, at vol. 1, p. 787.
\textsuperscript{1123} Id. at vol. 2, p. 993.
Some researchers attributed to Ibn 'Abd al-Barr that he forbade imitation while permitted following. It may be conceived from this that he disapproved it categorically, but this is not true. Ibn 'Abd al-Barr sees that imitation is forbidden to scholars but not the public. Perhaps, the reason for this misunderstanding is that in some of his works he stressed the ban of imitation unrestrictedly. In one of his books, after quoting the statements of jurists who forbade imitation, he says:

All of this applies to the scholarly groups. As to the common people, they should imitate their scholars when a misfortune befalls them, since they are not qualified to recognize the proof and they do not have the mental capability to conceive the matter. The scholars are in agreement that the common people should imitate their scholars... [and] the scholars are in agreement that the common people may not exercise the issuing of fatwas ..."1125

The Fiqh councils we could find, such as AAOIFI and IIFA, do not differentiate between following and imitation. AAOIFI states: "[i]n principle, mentioning the proof is not an underlying condition for issuing the Fatwa, and the Institution has no right to impose it as a condition for accepting it. However, the board has to refer to the bases of its Fatwa."1126 The present researcher is inclined to believe that the correct view is that the common people who do not fulfill the conditions of Ijtihad must imitate the views of scholars in subsidiary matters of Fiqh, unless they knew that these views are not based on proofs, or they knew that those scholars are permissive in their fatwas and do not abide by the legal rules of fatwa. To avoid some aspects of the conflict in this matter, it is more appropriate for the scholar when issuing the fatwa to provide his proof and declare that this is the ruling as prescribed by Allah or His Messenger.

5.3.5. Getting out of the Fiqh Conflict (al-Khuruj Min al-Khilaf)

Among the cultural challenges is that some investors may not be inclined to engage in financial transactions that involve disputed legal matters among Shar’iah scholars, especially if the juristic dispute concerns transactions involving interest (riba) or are forbidden by the majority of scholars. Investors, including individuals and  

1124 See AL-SHEETHRI, supra note 1066, at 32.
1125 IBN 'ABD AL-BARR, supra note 1113, at vol. 2, p. 989.
1126 AAOIFI, supra note 43, at 743.
institutions such as Islamic banks that have Shari’ah committees, may be reluctant to buy or subscribe to Sukuk whose prospectus comprises items we proposed for dealing with credit and bankruptcy risks, because the legality of some of them are controversial among jurists. That way, their motive is to get out of the dispute as recommended (mustahab) by Muslim jurists, in case that dispute can be avoided.

The dispute can be categorized into some types, but what is meant here is the application or the juristic question that involves a dispute about its prohibition or permissibility. In this way, the way out is to refrain from it. Dr. Khalid al-Musleh defines its reality as: "the embracement of the most precautionary approach in case of resemblance of the proofs in terms of strength and consideration."

The sense intended by the scholars by saying 'getting out of the Fiqh conflict is recommended' is to do a thing or leave it – subject to the Fiqh branch – so that it does not lead to engaging in prohibition or abhorrence, in view of the two different Fiqh schools. In other words, if the inquirer seeking the way out the dispute referred his act to the two different jurists, they would rule that he is not a sinner or liable to punishment.

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1127 Some of Muslim jurists do not differentiate between the legal maxim of "getting out of the conflict" (al-khuruj min al-khilaf) and the legal maxim of "shepherding differences" (mura'at al-khilaf). They deem the two rules to have one meaning, and they use them interchangeably when dealing with questions and provisions related to these two rules. See Khalid A. al-Musleh, *Murā’at al-Khilaf fi al-Fatwa Tasilaan wa Tatbiqaan [Shepherding Differences in the Fatwa: its Roots and Applications]* 36 (Majallat al-Buhūth al-Islāmīyah [Islamic Research Journal], issued by the General Presidency of Scholarly Research and Ifta affiliated to the General Secretariat of Council of Senior Scholars in Saudi Arabia: Riyadh, Saudi Arabia, Issue No. 118, pages: 27-66, Jumada I, Jumada II, Rajab, Sha‘ban, 1440 AH). Available from: [http://www.ssa.gov.sa/download/%d9%85%d8%b1%d8%a7%d8%b9%d8%a7%d8%a9-%d8%a7%d9%84%d8%ae%d9%84%d8%a7%d9%81-%d9%81%d9%8a-%d8%a7%d9%84%d9%81%d8%aa%d9%88%d9%89-%d8%aa%d8%a3%d8%b5%d9%8a%d9%84%d8%a7-%d9%88%d8%aa%d8%b7%d8%a8%d9%8a%d9%82/?wpdmdl=8819&refresh=5d7935025dcaf1568224514](http://www.ssa.gov.sa/download/%d9%85%d8%b1%d8%a7%d8%b9%d8%a7%d8%a9-%d8%a7%d9%84%d8%ae%d9%84%d8%a7%d9%81-%d9%81%d9%8a-%d8%a7%d9%84%d9%81%d8%aa%d9%88%d9%89-%d8%aa%d8%a3%d8%b5%d9%8a%d9%84%d8%a7-%d9%88%d8%aa%d8%b7%d8%a8%d9%8a%d9%82/?wpdmdl=8819&refresh=5d7935025dcaf1568224514) [accessed on 15th May 2019]; see also 'Allal al-Dakhlawi, *Qaeda Mur'aat al-Khilaf fi al-Fatwa in the Maliki School [the legal maxim of Shepherding Differences in the Fatwa in the Maliki School]*. (Alukah, Nov. 11, 2017). Available from: [https://www.alukah.net/sharia/0/122850](https://www.alukah.net/sharia/0/122850) [accessed on 15th May 2019]. Some jurists, especially the Malikis, differentiate between the two rules, giving each one an independent meaning. They rendered the rule of ‘shepherding differences’ as one of their underpinnings and sources of legislation. See al-Musleh, 36, 41; see also al-Dakhlawi. Al-Musleh says that Muslim jurists agree to considering maxim of ‘shepherding difference’ in the fatwa and judiciary if such difference is due to diversity of habits and customs. See al-Musleh, at 39. He adds that if the difference is related to the meanings and significances of the Shariah texts, the maxim of ‘shepherding difference’ is considered by the majority of the jurists of the four Fiqh schools and others, and that it is the subject of dispute among some scholars. See al-Musleh, at 39. Ibrahim al-Shatby defined ‘shepherding differences’ as: “giving each of them [i.e., the two conflicting proofs of the two conflicting opinions] all or some of what the other requires.” IBRAHIM M. AL-SHATBY, AL-MUWAFAQAAAT [CORRESPONDING ISSUES] vol. 5, p. 107. Edited by Mashhour H. al-Salman. (Dar Ibn Affan for Publishing and Distribution: Khobar, Saudi Arabia, 1t ed. 1997).


1129 Al-Dakhlawi, *supra* note 1127.
5.3.5.1. Ruling on getting out of disagreement

Getting out of the juristic dispute is recommended by jurists. Some, like Yahiya al-Nawawi, even claimed that there is consensus on that.\footnote{See AL-NAWAWI, supra note 1009, at vol. 2, p. 23.} Abualkalam al-Qasimi quotes two jurists who claim that getting out of the Fiqh dispute is recommended.\footnote{See Abualkalam S. al-Qasimi, Sharah Qaeda: Yastahabu al-Khuruj Min al-Khilaf [The Explanation of Legal Maxim of that Getting out of the Conflict is Recommended]. (Alukah, Sep 6, 2015). Available from: https://www.alukah.net/sharia/0/91373/#_ftnref4, (accessed on 15th May 2019).} Some have set some conditions for getting out of the juristic dispute. But, the present researcher sees that they do not apply to questions or applications wherein the juristic dispute is limited to prohibition or permissibility.

The fear from engaging in prohibitions of Shari’ah and the keenness to getting out of juristic disputes may make some investors or Sukuk originators reluctant to include any controversial items in the Sukuk prospectus or the legal documents, such as the promise to buy back the securitized assets - one of the forms of amortizing the sukuk; to seek compensation or demand the maturity of installments in upon payment default; to invest in sukuk structured under the ‘Inah sale; to resort to uncovered letters of guarantee, if they are issued against a fee; as well as other propositions we made here, which constitute a dispute among the jurists.

It can be claimed that this attitude may eventually hinder investment in sukuk because there is hardly any application free of juristic dispute. The response to this is that reducing the controversial items may help eliminate the chances of refraining from investing in Sukuk, especially those involving a clear conflict with the Shar’iah texts or are rendered as forbidden by the majority of jurists or contemporary Fiqh councils. In practice, there are sukuk containing controversial clauses, yet this did not hamper subscription in them. For example, we find that investors subscribe for the shares of mixed companies the origin of whose activities is permissible. Yet, they deal, for instance, with interest (riba), although some jurists banned subscription in them while others permitted it. It may be argued that this is because many investors are convinced that calling some financial products as sukuk is sufficient to ensure their legality. However, there is no doubt that the lesser the controversial items in sukuk, the more the positive impact on the size of the subscription in them or their purchase will be, parallel to the pure companies that enjoy a high demand of investors' subscription in their shares compared to the mixed companies.
5.3.6. Weak recognition of Islamic debt markets and lack of awareness with the tools and methods of dealing with their credit and financial risks

One of the significant cultural challenges facing our propositions in this study is weakness of public awareness of debt instruments, including Sukuk, in the GCC, compared to stock market. It is with greater reason that the lack of awareness of preventive measures, financial guarantees and the best ways of restructuring the debts arising from Islamic sukuk constitute another challenge. Much of what has been developed and proposed in this dissertation is almost currently debated within the Shari’ah academic circles, but not financial or market circles. Perhaps, the lack of Sukuk transactions that comprise the propositions we suggested and the novelty of the Sukuk experience and Islamic capital markets presented to the public are among the most important reasons. However, the recent GCC government's attitude toward the Sukuk markets and its local and international reputation, with ongoing facilities and exclusive Sukuk legislation, can raise the level of recognition of these securities and the tools of dealing with their credit and bankruptcy risks at the local, regional and international levels.

5.4. Legislative challenges

The legislative challenges in this context refer to the obstacles related to legislations that do not conflict with Shari'ah provisions in principle. Some of the propositions made in this dissertation and other related issues need legislations that exclude them from satisfying existing legislative requirements, such as the enactment of a Sukuk law in Saudi Arabia, as some countries have done, that takes into account its particularity and uniqueness and excludes it from the Capital Market Law. Some propositions require the amendment of a number of existing legislations, such as the Companies Law, the Capital Market Law and their related regulations, in order to permit the limited liability companies to issue Sukuk, to allow for a favorable environment for attracting non-bank financial institutions and to amend Credit rating agencies so as to include other aspects such as Shari’ah rating and not to solely focus on credit rating.

5.6. Conclusion

Some of the proposed solutions to address credit and bankruptcy risks face Shari’ah, cultural and legislative challenges. A Fiqh dispute over a particular financial transaction may cause the court to revoke it or revoke some
items of its contract. It is therefore important to consider this issue and deal with it in order to avoid it or reduce the probability of its arising. One way of dealing with this would be to avoid transactions that a consensus was reported on their prohibition, or if the prohibition is the opinion of the majority of scholars, especially if the reason of the prohibition is the involvement in interest (*riba*) or excessive of uncertainty (*gharar*). We studied and analyzed whether judges could be obliged to do so and the counter arguments related to that. We also discussed the effectiveness of relying on Shari’ah arbitration and the relevant criticisms and challenges it faces.

The investment and Shari’ah culture of investors may be major obstacles to the implementation of the proposed solutions - of dealing with credit and bankruptcy risks – over which a conflict among jurists occurred or is likely to occur. Muslim investors most likely adhere to the rules of *ijtihad* and imitation. Those who are eligible to consider the rulings of the Shari’ah and regard that one of these solutions is not permissible should, from a Shari’ah perspective, avoid the transactions that include that proposed solution. Those who are imitators and are not trained in the Shari’ah law should consult or imitate those they trust soundness of their religion and profound knowledge. According to the majority of jurists - as some scholars attributed to them - or according to the consensus of jurists - as some scholars attributed to them – it is forbidden to the inquirer who is ignorant of the Shari’ah rulings pertinent to the applications and transactions whose permissibility is disputed among jurists to deliberately follow the views that fit into his interests. We also discussed the possibility of reluctance of some investors – in view of some jurists who claim that getting out of the conflict is recommended - to engage in transactions that were prohibited by some jurists while permitted by others. One of the challenges related to investment culture is that the tradition of dealing in debt instruments is weak compared to shares.

Finally, some of the proposed solutions may encounter legislative challenges, especially in Saudi Arabia. For example, some solutions require - directly or indirectly - amendments to some existing laws or the enactment of laws, as pointed out above, in a way that does not break the Shari’ah laws. However, these solutions may face with reservations from the legislative environment or be subject to a time consuming study, especially as amendment of some laws entails the amendment of other laws, for the connection and overlap between them.
Recommendations

Recommendations for investors/potential Sukuk holders/financiers

• Sukuk should not be perceived merely by the type based on profits and loss sharing contracts. Many Sukuk structures are based on debt, and some Musharakah and Mudharabah structures have potential to end in debt. The default and bankruptcy risks, financial guarantees, precautionary measures, and means provided to combat these risks depend on the nature of each structure, although it is important to recognize some commonalities among the types of Sukuk.

• When securitizing assets, assets should have a fair market valuation. 1132

• When pricing Sukuk, involved parties, especially investors, should consider default and bankruptcy risks with their effects, the effects of Shari’ah restrictions on certain issues related to Sukuk, and the expected market value of assets at the redemption stage.

• A legal adviser should be appointed to investors in order to analyze the prospectus or the legal documents to verify whether the results of what is discussed in this dissertation has been taken into account, particularly with respect to protections provided to investors, the governing law and jurisdiction.

• Ensuring that the representative to investors has no interest in common with the sponsor/originator/obligor, and that there is no engagement with Sukuk issued by SPV, which originated by the sponsor. A SPV must be originated by investors or a representative, neither of which have interests with the sponsor who would usually serve as the obligor.

• No type of Sukuk should be subscribed unless there are financial guarantees, preventive measures and potential investment remedies in place that are appropriate in dealing with credit and bankruptcy risks of the Sukuk.

• Emphasis should be placed on financial guarantees and protections in which there are no disputes concerning legitimacy among Shari’ah scholars or if the dispute is weak, taking into account the opinions of the relevant Islamic jurisprudential schools and considering the corresponding court jurisdiction.

1132 Assets that are valued at more than their fair value should be avoided even if the obligor/sponsor has made a binding promise to repurchase them on the date of the so-called amortization/redemption/maturity. One judicial principle in the Saudi Arabian courts is that a binding promise to enter into contract in the future is not binding legally.
• The rating of existing credit agencies should be considered but should be not relied on, regardless of the securities or their issuers having been given a high or low rating.

• The attention on credit rating of the Sukuk should include structures based on profit and loss sharing contracts, especially if such Sukuk include binding promise by the obligor to purchase or repurchase the securitized assets as permitted by some jurists who consider a unilateral binding promise as permissible and binding.

• Attention should be paid to Shari’ah rating if possible. The Sukuk should not be subscribed unless the credit rating grants, along with Sukuk or their issuers, are to the originator who would hold the most important obligations throughout the Sukuk period. If the grantors of rating are outside the country where the Sukuk is issued, it should be ensured that there are no political dimensions in their ratings or conflicts of interest that may affect fair credit ratings.1133

• The Sukuk process, especially in fixed-income instruments, should include at least one of the following protections: collateral or guarantorship.

• Investors may utilize the proposed solutions in this dissertation if the conditions and rules mentioned in this dissertation are met, including the rules of Ijtihad and Taqlid and the legal reference of the courts or arbitration that hold the jurisdiction to consider any dispute related to Sukuk.

• Any bilateral binding undertaking or promise between the parties to purchase or repurchase the Sukuk assets should be avoided, especially if the jurisdiction is subject to, or the governing law is, the Shari’ah, such as Saudi Arabia.

• Assets to be securitized should be purchased from a third party (a market separate from the originator) in order to avoid transactions of 'Inah, Riba and fictitious selling and buying as well as to comply with the conditions of those who allow a repurchase transaction and a binding unilateral promise under specific conditions. Also, one of the solutions proposed to dealing with credit risk requires that the original seller of the assets be securitized is a third party.

1133 The possibility of political dimensions is less likely if the sponsor or issuer of Sukuk is a private entity and not a governmental entity.
The ideal standards or plausible standards mentioned at the Chapter 3 should be taken into consideration, as default and bankruptcy risks and their negative effects are likely to be lower in Sukuk that take into account these findings and propositions.

**Recommendations for companies and banks seeking funds through Sukuk markets/sponsors/originators**

- Financial products should not be marketed using Islamic religion to attract interested parties.  

- The banks and Islamic institutions, whether they are sponsors or investors in the Sukuk, should continue to adhere to the principles of Shari'ah compliance to ensure acceleration of the pace of their growth. Adhering to the Shari'ah principles in the Sukuk, despite their rigidity in some aspects, may lead to better results in the medium and long term.

- The level of non-profit cooperation among Islamic financial entities should be increased.

- Financial institutions should take into account the rules of Taqlid and Fatwa when choosing the members of the Shari'ah committees that issue Fatwas and supervise the activities of the institution in order to ensure compliance with the Shari'ah provisions.

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1134 The good reputation of the Islamic financial industry should not be exploited by describing non-Islamic financial products as Islamic products to mislead investors who desire such products for religious or investment purposes. Governments must intervene to protect investors in this regard.

1135 Islamic institutions may generate good returns in the short term by neglecting and trying to elude Shari’ah provisions, making it even more crucial to suggest joint cooperation and responsibility in achieving compliance with Shari'ah provisions if these institutions wish to raise or maintain their level of integrity and credibility or seek to compete with experienced traditional markets that hold huge financial assets. This strategy will reduce the advantage of Islamic financial products with respect to Shari’ah compliance, therefore prompting investors who prefer Shari’ah transactions, not to so drastically differentiate between Islamic and conventional transactions.

1136 For example, Islamic institutions should provide guarantorship without request a consideration or fee, when a Sukuk sponsor requests it, because the preponderant view is that taking a consideration for a mere guarantorship contravenes the Shari'ah and because the absence of the guarantor from the Sukuk can contribute to reluctance on behalf of investors.

1137 In line with the rules of Ijtihad and Taqlid, it seems in the Shari’ah – in view of the present researcher – that financial institutions – which are in the position of imitators and inquirers of Shari’ah rulings – are prohibited to appoint members in their Shari’ah committees whom they know beforehand that their juristic views will most likely correspond to the wishes of the institutions without being bound by the rules of Taqlid and Istifta’ (seeking a Shari’ah opinion from Muslim jurists). When selecting their Shari’ah members, Islamic financial institutions may look through researches, publications and meetings with jurists and muftis and select those scholars whose juristic opinions or fatwas on financial transactions conform to their policies and attitudes. As such, the institutions will ensure their endorsement of their financial products in order to gain higher profits and relax Shari’ah restrictions. Such an act is not permissible in Islamic Shari’ah, since it represents a method of deliberate seeking of Fiqh concessions. It is obligatory for the financial institution to choose for its Shara’ih committee the Muftis whom it believes are qualified jurists for the Fatwa. It is prohibited for the institution to choose Muftis and Muslim scholars who are permissive and lenient in Shari’ah rulings and Fatwas in order to ensure these jurists’ approval of the financial products. Failure to comply with Islamic finance principles including Taqlid rules may expose the Sukuk to the risk of non-compliance with Shari'ah provisions and loss of investors’ confidence, especially if criticism is raised against the Sukuk by scholars. However, it is difficult to discern whether these rules have been observed and applied or not, because such a situation requires consideration of the beliefs and intentions of the institution, unless the institution reveal its methods of choosing the members of the Shari’ah committee and those methods prove to be contrary to these rules. It should be noted that some jurists may permit some cases and transactions not because they are lenient in giving fatwa, but because of their conviction -
• The ideal standards (or at least the plausible standards) mentioned at the Chapter 3 for originators should be taken into consideration.

**Recommendations for government bodies concerned with Sukuk, especially Saudi Arabia**

• A Sukuk law should be enacted in Saudi Arabia to exclude its provisions from certain provisions of existing laws that may restrict the development of Sukuk, restrict the circulation of types of Sukuk that may be traded in the Shari'ah in the case that the Sukuks do not represent debt, and that do not consider Sukuk's uniqueness.\(^{1138}\)

• As is the case in a few countries, Saudi Arabia should prevent conventional banks and conventional financial institutions from offering Islamic products.\(^{1139}\)

• Local credit rating agencies should be encouraged and supported as well as offer support for the expansion of rating to include the Shari'ah rating of structured finance.

• Attempt to raise the country's sovereign credit rating because credit rating agencies usually do not grant a credit rating to a company, or its securities, higher than the credit rating of the country where the company is located, regardless of its financial position.

• Due to the weak Shari'ah investment qualification and the minimal specialists in this field, the universities should, with government assistance, develop the curricula related to Islamic finance, which combines Islamic

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after conducting juristic research, reaching the degree of Ijtihad and adhering to the rules of ratiocination mentioned in books of Islamic jurisprudence - that those transactions are permissible. This arises from their embrace of various juristic principles and building on them, such as the principle that the origin in financial transactions is permissibility and soundness, unless a piece of Shari’ah evidence attests their prohibition. Their abstention from falling into the Shari’ah-prohibited leniency is evidenced by their banning of other financial transactions and many other matters outside the area of financial transactions. It is noted that each of the four Islamic schools expands the scope of permissible issues and actions in numerous matters, while the other schools narrow in the same matters, and vice versa. Thus, there is no juristic school that expands or makes restrictions on actions, acts and transactions in every area and application. Thus, there is no juristic school that expands or makes restrictions on actions or transactions in every area.\(^{1138}\) Some laws, such as the CML, the Companies Law, Arbitration Law, and the Credit Rating Agencies Regulations need to be amended as described in present research and for the reasons that are given.

\(^{1138}\) Failure to do so would weaken competition with Islamic banks and Islamic institutions and thus they might be lenient in offering or participating in financial and investment products that contravene Shari’ah. Furthermore, Islamic institutions would benefit from their reputation as Islamic entities. Unfair competition is evidenced by the fact that Islamic institutions and banks bear expenses for reasons that do not exist in many conventional institutions. The implementation of this proposal will lead to a balance in the market, ease the pressure on Islamic banks, and eliminate some of the justifications of Islamic banks and institutions to exceed the requirements of Shari’ah. This would likely have a positive impact on Islamic finance and debt markets, especially in terms of compliance with Shari’ah and the maturity of some proposed solutions for dealing with risks of default and bankruptcy. This proposal could turn some traditional institutions into Islamic ones, increasing activity of Islamic Sukuk markets and Islamic capital, which may help defaulted Islamic companies in Sukuk to access liquidity. On the other hand, this proposal opposes one element of the research proposal which includes the development of conventional debt markets to enhance liquidity.
jurisprudence, banking and finance, as well as the introduction of a specialization, Risk Management of Islamic Investments.

- Governments should finance their budget through Sukuk to develop Islamic debt markets, and as way of attracting investors.
- Allow non-bank financial institutions to expand in Saudi Arabia, offering another source of liquidity and collateral resources for the banking sector in financing private sector entities, particularly distressed companies in Sukuk. Non-bank financial institutions are more likely to engage in high risk investments than banks.
- Allow limited liability companies in Saudi Arabia to issue Islamic debt instruments for private placement.
- Acknowledge that the countries that govern and apply Islamic law and those who are authorized to issue laws are most likely subject to the rules of Ijtihad and Taqlid, and consider that some Shari’ah jurists prevent the codification of substantive laws that relate to substantive matters.
- Recognize that when a law that is related to Sukuk or any proposed solution is enacted, the judicial authorities must approve the judge’s request to transfer the disputed case to another judge if the former believes that the law or some provisions related to the case are in conflict of Shari'ah, especially if the conditions of Ijtihad in the Shari'ah apply to him. This is unless he is authorized to issue rulings according to what he views as in accordance with the Shari'ah and therefore he is not forced to apply that law.

Recommendations for the Fiqh councils and Shari’ah committees of the Islamic financial institutions

- With appreciation for their important contributions and recognition of their diligence, each of the Shari’ah councils must scrutinize its provisions and standards to ensure consistency of what is issued by each council and to avoid inconsistencies between decisions. If the Fiqh Council has two versions, one in Arabic and one in English, it should be ensured that the two versions are consistent in their provisions and decisions.
- Study and issue resolutions on some of the proposed solutions designed to combat default and bankruptcy risks.
- Focus on issues related to handling Shari'ah disputes among Shari'ah scholars and on some matters related to Ijtihad and Taqlid.
• It is highly recommended that the language of Members of Shari’ah committees of Islamic financial institutions or independent Shari’ah committees is the same language in which Sukuk would be issued and in which legal documents would be written. This would avoid potential translation errors that may lead to a violation of the Shari’ah.

• Every financial product marketed as an Islamic product must be accredited and approved by Shari’ah committees qualified for Fatwa according to Shari’ah.

• It is highly recommended that Shari’ah committees overseeing the products of Islamic banks and companies are independent and in no way affiliated to avoid conflict of interest and to strengthen the reputation of Islamic financial instruments.

• Pay attention to the Shari’ah supervisory committees on implementation of the decisions of the Shari’ah committees of the financial institutions.

**Recommendations for researchers on Sukuk and related issues**

• Do not attempt to unify the Shari’ah standards of transactions because it is impossible to unite the views of Shari’ah scholars and it is very difficult to oblige anyone to one view without obstacles for several reasons, including the rules of Ijtihad and Taqlid.

• Direct research efforts toward the Shari’ah ways of dealing with Shari’ah disputes over transactions among scholars.

• Verify these forms of analysis as well as the suggestions and conclusions and validate their accuracy.

• It is highly recommended that a survey of investors should be taken, especially aspects related to Shari’ah issues, such as the position and dealing with the Shari’ah dispute over financial transactions, and the size of the involvement of Muslim investors in non-Islamic financial products.

• Study the impact of religion in the direction and movement of debt and capital markets, especially in Saudi Arabia.

• Research the possibility of finding models for financial transactions that are not controversial among Shari’ah scholars or that the dispute is very weak.
General recommendations

- Study the opportunities and challenges of establishing a non-profit Islamic bank as a nucleus that can be followed by other banks whose objective is to provide goodly loans (al-qard al-hasan) or low-cost Islamic financing to defaulted or near-default companies whose activities are subject to Islamic Shari'ah compliance.1140

- Observing compliance of Shari'ah rules throughout the entire Sukuk process, including that Shari’ah is the law governing any Sukuk dispute, will likely reflect positively on the demand for Sukuk, attracting more investors, especially Saudi Arabians, as it would ensure accordance with Shari’ah if there should be a future dispute regarding the Sukuk.1141

- Classifications relating to applications that fall under asset-based Sukuk and that fall under asset-backed Sukuk should be reviewed.

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1140 The activities of this bank could include dealing with Islamic financial products to generate financial resources, accepting deposits that customers will most likely be willing to deposit for religious and moral purposes, mainly if the bank is in a Muslim country, and engaging in Sukuk while considering the suggestions proposed in this research.

1141 As an example, it is not sufficient to apply Shari’ah rules in legal documents of Sukuk while at the same time, the jurisdiction of such transactions are not governed by Shari’ah, or vice versa, when the jurisdiction of the transaction is governed by Shari’ah but Shari’ah rules are not applied in the legal documents. It is also important that the Sukuk industry in the country that has jurisdiction over the possible dispute of Sukuk is mature and experienced.
Conclusions

From both an investment and economic standpoint, the Islamic capital and debt markets, including Saudi Arabian debt markets, do not adequately protect Islamic Sukuk holders' interests as they do holders of conventional securities. Sukuk investors are not granted sufficient financial guarantees, preventive measures or appropriate tools to impede risks of default, bankruptcy and Shari’ah, nor assistance in debt restructuring negotiations when needed. The current efforts in Saudi Arabia to assess and rectify the guarantees and preventative measures designed to protect the interests of investors from risks in Sukuk are insufficient, and the current proposed solutions are inadequate. Islamic finance principles prevent certain transactions, clauses and items, and therefore Sukuk currently lacks many of the advantages and treatment options available in traditional debt instruments. For example, a contract underlying Sukuk that contains an item prohibited by the Shari’ah may annul the contract that the Sukuk is based on.\(^{1142}\) In addition, the current efforts to protect Sukuk investors are not commensurate with these risks, are flawed and in need of development. This evaluation is an expansion on these current efforts, using three defaulted Sukus, based on Ijarah, Murabahah and Musharakah contracts, as case studies. In this dissertation, we developed improvements, guidance, solutions and criticism, which we consider useful in reducing the risks and increasing the level of protection of Sukuk holders. We also discussed the potential challenges of these contributions and solutions.

In the first chapter, we considered the Islamic and Saudi Arabian legal systems in relation to the subject of dissertation and the research issue. We presented a general background on three types of Sukuk and discuss their evolution as well as the risks associated with them. We examined the most important sources of Shari’ah: Quran, Sunnah, Ijma (Consensus of Opinion) and Qiyas (Analogical Deduction). Also, we discussed the role of the four Islamic Fiqh schools and contemporary councils which play an important role in the cultural and social aspects

\(^{1142}\) Some companies may exploit non-compliance with Shari’ah in order to annul the contract underlying Sukuk or to change the characterization of the contract underlying Sukuk to exclude several features that protect investors from bankruptcy risks. With the annulment of the contract, each party would claim the investment yielded when entering into the contract, although these Sukuk investors would only recover their capital if the competent courts consider the case under the provisions of Islamic Shari’ah. In this case, the investor is harmed as the obligor in Sukuk may not be able to return the capital it had received from the Sukuk holders because that capital would have been liquidated for use. This specific example of exploitation and Shari’ah risks is explained in a case study.
of Islamic society. In addition, the contemporary Shari’ah councils - in term of the contemporary issues - and the Hanbali school have consideration in the judicial realm in Saudi Arabia. Although it is governed by Islamic law, we argue that there is ambiguity concerning the legal referentiality to be applied by the Saudi Arabian CRSD. We discussed many issues on the grounds that the jurisdiction of Sukuk is governed by Islamic law that Saudi Arabian general courts apply as well as and Islamic and Saudi Arabian arbitrations. We also explored the lack of understanding of contract provisions and their applications, as that may have a negative impact on efforts to protect Sukuk holders. Also, we explained how default reflects on an increase of chance of exposure of some risks of Sukuk. We argue that there is relationship between default risk and other risks of Sukuk. In this chapter, we discussed the research issue and the negative impact it incurs, as well as the distress investors experience when facing default and bankruptcy risks. We also explored, in regard to those risks, the discrepancy of protection compared to conventional debt instruments, as any interest-usury in Sukuk is prohibited by Shari’ah in the prospectus (or the legal documents), court judgments or voluntary debt rescheduling arrangements. Trading Sukuk that represents debts is prohibited, and therefore in a potential default situation, the investor cannot dispose of Sukuk holdings by selling them to an entity inclined to high-risk investments. In general, Shari’ah prohibits the requirement of an insolvent to pay his debt and obliges a respite. Shari'ah deprives most of the derivatives that conventional financial institutions and banks use to deal with credit risk. The choices of Islamic companies seeking funds to meet their obligations are limited as any interest-based financing is forbidden. The source of credit risk and bankruptcy in Sukuk falls on one side, usually a single obligor. Thus, the current protections offered to Sukuk investors against credit and bankruptcy risks are not commensurate with the negative effects of these risks.

In the second chapter, we reviewed and analyzed aspects of three distressed Sukuk as case studies without elaborating on the protections and guarantees provided. We select these cases to prove that Sukuk holders face default, bankruptcy and Shari’ah risks, to stress that Sukuk holders do not have sufficient protection from default and bankruptcy risks, to evaluate the current protections provided to Sukuk holders to help improve the current efforts to protect Sukuk holders from these risks and to examine their compliance with Islamic finance principles.
We found that in each of the three cases, the originators defaulted on payment and the legal title of the Sukuk/securitized assets remains in the name of the originator/seller. We concluded that the accurate characterization of each of these Sukuk is different from what is stated by the legal documents of these Sukuk. Also, we found that TID Sukuk is based on a contract known as a diminishing Musharakah, which is supplemental to the Mudarabah contract. These Sukuk include clauses and arrangements that are, or could be, controversial among the jurists of Shari'ah, received high credit ratings and extended the concept of infringement to include the default. The originator, in his capacity as a manager of the Musharakah assets, is bound to some procedures such as avoiding being a guarantor for anyone and not to increase debts for a specified amount, pursuant to the legal documents. There has been disagreement among the researchers regarding whether the binding undertaking or promise to repurchase Sukuk is at market or nominal value. If the undertaking/promise is at nominal value, the Sukuk are at risk of non-compliance with the Shari’ah, which could lead to the revocation of the entire transaction. The originating company in this case suffered debt and was required to, with government assistance, reschedule debt and reach a compromise with some creditors. The company delayed the implementation of its commitment to Sukuk holders who do not have the right of recourse to the Musharakah contract assets. As for the NFCB Sukuk, which were issued with a high credit rating (A+), the transaction documents stated that the transaction was based on the Murabahah contract which is accepted by the majority of Shari’ah scholars, whereas in the research it was found that it was actually based on a reverse ‘Inah sale contract, which is prohibited by the majority of scholars and Fiqh schools. While, a ‘Inah sale contract is permitted by the Shafi’is and the Shari’ah Advisory Council of Bank Negara Malaysia on conditions. If this council considers a ‘Inah sale contract like a reverse ‘Inah sale contract, that Sukuk does not fulfill these conditions. Thus, this may lead to Shari’ah risks which may lead to the revocation of the entire transaction, especially if Saudi Arabian courts maintain jurisdiction to consider this transaction if a dispute arises. The transaction documents extended the concept of default on payment to include, for example, the failure to comply with a legal ruling that, in view of the trustee, would have an adverse material effect on the ability of the issuer to meet its obligations to the Sukuk holders. For ISB Sukuk, the research suggests that the transaction is based on the sale of assets with the intention of leasing them back, ending with ownership.
These instruments were granted an A+ rating at the time of issue. The transaction included bilateral, unconditional and irrevocable undertakings that the issuer purchases assets when default occurs, upon liquidation or expiration of the Ijarah period. This transaction included items that are contrary to the opinion of the majority of jurists and Fiqh councils, for example, a binding bilateral undertaking. All of these Sukuk have Shari’ah advisers. In each of these three cases, we explained what Sukuk represent in every stage of the Sukuk’s existence.

In chapter three, we addressed the assessment of the protections provided to Sukuk holders to prevent risks of default and bankruptcy, providing rectified proposals and necessary improvements. We argue that despite their importance in investing in debt markets, the CRAs cannot be relied upon for many reasons. These agencies played a negative role in the occurrence of financial crises and are accused of conflict of interest and of lack of integrity, as well as being under the influence of the political sphere. Thus, it is considered that some of their procedures and methodology are flawed. Although all of the case studies received a credit rating that falls under "investment grade," the Sukuk defaulted. Among other discrepancies of rating, one shortcoming on behalf of these agencies regarding Sukuk is that decisions are limited only to credit rating, despite the importance of the relationship between Shari’ah risks and credit risk. The current credit ratings focus usually on the securities or issuers without the originator, who serves as a significant party in Sukuk and serves as the primary source of risk of default or bankruptcy. We also reviewed the credibility of credit rating agencies in Saudi Arabia, considered weak for several reasons, although they made positive advancements in this regard over the last four years. In this chapter, we discussed the securitization that includes the creation of SPV, or its equivalent, coupled with certain standards to immunize traditional securities holders from the bankruptcy of the originator or the SPV itself. We addressed the perspective of researchers who touched on conventional securitization in various jurisdictions and who emphasized the importance of some criteria for investors to be immune from the bankruptcy of seller of the assets which would be securitized. The first criterion is that the executed sale should be based on a "true sale" by transferring the legal ownership and beneficial ownership to the buyers/investors. The second criterion is that the SPV should be separated legally from the originator/seller. While in Sukuk, it is noted that previous research focus on the right of recourse to the Sukuk assets, which can only be achieved by the correct legal action, from
Shari'ah perspective, such as an enforceable sale (Bai’ Lazim). The researchers differed in opinion as to the criteria applied to ensure the right of recourse, such as registration, meaning the transfer of legal ownership. We analyzed and discussed various views on the Shari'ah characterization of beneficial ownership in the context of sales and purchase transactions. Shari'ah does not require registration or documentation of the sale or other contracts in order for it to be completed and effective. In general, when the offer and acceptance has been concluded, the buyer becomes the owner of the sold assets which should then be transferred to him. However, some researchers mentioned the importance of transferring legal ownership/registration of Sukuk assets when the selling takes place. The present research believes that this varies between jurisdictions. If the Sukuk assets would be issued from Saudi Arabia, the registration of Sukuk assets in the name of the buyers/investors is not required but recommended, stressing that foreign investors, whom Saudi Arabian laws prevent from owning particular assets to be securitized, should not be involved in these Sukuk for the probability of significant restrictions on recourse of the assets in the applicable Sukuk. Regarding the immunization of SPV from voluntary or involuntary bankruptcy, we discussed, argued and analyzed commentary from the researchers and provide suggestions. None of the case studies contained the transfer of legal ownership and that may be the reason why the Sukuk holders did not exercise the right to recourse to the Sukuk assets. In these case studies, from the perspective of many jurisdictions and at varying levels, there is a relationship between SPV, or its equivalent, and the originator, which may result in exposing the investor to originator bankruptcy risk. In this chapter, we proposed two levels of standards: *ideal standards* and *plausible standards* to protect investors from the risks of default, bankruptcy, non-compliance with Shari'ah and to aid the success of Sukuk markets. However, investors need additional protections for reasons that we mentioned in this dissertation. We also discussed in this chapter the possible Shari'ah characterization and judgment of one item that may make the obligor continue to pay, for fear of consequences. We also discussed the possible ruling by the Saudi Arabian courts on the item that obliges the originator to buy the assets - which originally would be rented to him on the basis of leasing ending with ownership transfer agreement - in the case of failure to pay the periodic rent, and the Sukuk holders being obliged to sell these assets only to that specific originator.
In chapter four, we proposed, with the avoidance of what is unanimously forbidden by Shari'ah scholars, various and reinforcing solutions to combat default and bankruptcy risks and solutions to help the success of debt restructuring negotiations in a way that does not harm the interests of investors and that reduces the discrepancies between Sukuk and conventional debt and investment instruments. We demonstrated the pros and cons and the adequacy and feasibility of each of these proposed solutions from a legal (Islamic and Saudi Arabian law) and economic perspective. The various proposals are not of a single pattern as some are direct and some are indirect, some are pre-issuance and some would be stipulated in the legal documents, and some could be implemented after default. This diversification of proposals, in addition to what we developed in the previous chapter, is due to Shari’ah, economic, and treatment considerations. Some are useful in dealing with credit risks, some are successful for bankruptcy risks and the protection of the capital of investors, some are effective only in terms of periodic returns and coupon not in maturity, some are useful in the success of debt rescheduling negotiations when default occurs or when approaching it, some are useful in prompting and motivating the obligor to pay if possessing liquidity or assets, some are useful in only some types of Sukuk, and some are useful in almost every circumstances. Other considerations include the Shari’ah dispute, or the possibility of it, on specific solutions. We also attempted to decipher what suits the willingness of investors who may reject some of the protective means of the risks of Sukuk because they may see or believe such means are prohibited in Shari’ah. This belief could be as a result of self-study if these investors are jurists (mujtahideen, plural of mujtahid) in Islamic Law and have the tools of Ijtihad or as a result of Istifta` (seeking Shari’ah opinion) if these investors are layman and perform Taqlid (imitation). If the jurists or muftis, who some investors follow and imitate, prohibit some of the protective means of the risks, these investors will most likely not consider such means. Another reason is that some companies seeking funding may not be able to work on one of proposals and it is therefore appropriate to provide several options in terms of proposed solutions as to what companies can provide to investors. In addition, some proposals may be criticized, some may have financial costs, and some may face the risk of non-compliance with Islamic law. Also, some are dependent on market development, changing market structure, investors culture,
jurisdiction, political will, and the modification of some relevant laws, in view of Muslim scholars who consider the codification of substantive law that does not conflict with Shari’ah permissible.

In the fifth chapter, we discussed the challenges these proposed solutions may face and offer solutions to addressing some those challenges. The challenges are related to Shari’ah, cultural, and legislative aspects. The Shari’ah challenges include the threats on the contract underlying Sukuk or threats concerning the item that has been controversial, or would be considered controversial by Islamic jurists, which may lead to the risk of non-compliance with Shari’ah and therefore present legal risks which may lead to the revocation of the entire contract or the clause that is set for the protection of investors. We proposed and discussed ways to deal with the Shari’ah dispute among Islamic scholars, which may be reflected on the judges of the Shari’ah courts - as in Saudi Arabia - or the Islamic arbitration. Regarding the cultural challenges, although some are related to Shari’ah challenges, they may prevent investors from engaging in financial products that have been disputed among scholars because of the result of the rules of Taqlid and Ijtihad in Shari’ah or because investors want to be out of the jurisprudential dispute by avoiding a financial application or act, which certain scholars permit and some prohibit, because being out of a Shari’ah dispute is recommended (mustahabb) in Shari’ah. Other proposed solutions face cultural challenges related to investment instruments. In the GCC countries, including Saudi Arabia, the investment culture of debt instruments including Sukuk is weak compared with stock, which is more attractive to Saudi Arabian investors. Some proposals depend on the modification of existing laws. One of the challenges in Saudi Arabia is that the amendment and enactment of the necessary laws may require a long period of time or may face objections such as that it is contrary to the general environment and tendency of the market. Also, in this chapter, the present research provides recommendations to several parties related to the protection of investor interest in Sukuk from the risks of default, bankruptcy, and non-compliance of Shari’ah. Finally, we concluded the dissertation by the conclusion.
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