Harvard-LSE Workshop on
Insolvency & Debt Restructuring in Islamic Finance

Venue: London School of Economics, February 28th, 2013, 8:30a.m--5:30p.m.

CONTENTS

Public Lecture on Islamic Finance

Islamic Finance and Shari‘a Compliance: Reality and Expectations

There is a perception of a widening gap between the reality of Islamic finance and the expectations of its stakeholders. The academic literature on Islamic finance frequently refers to ideals such as economic justice, equitable distribution of opportunity and wealth, and a deep concern for ethics. However, critics argue that the prevailing practices in the Islamic financial services sector comply with Islamic law in contractual form only, rather than in economic or ethical substance. How valid is this claim? If valid, what issues need be addressed in order to make the sector's prevailing practices more consistent with Islamic ideals?

Venue:

Hong Kong Theatre, Clement House

London School of Economics, London

Wednesday February 27th, 2013 Time: 6:30-8:00p.m.

Speakers:

Tan Sri Dato' Azman bin Hj. Mokhtar
Managing Director, **Khazanah Nasional, Kuala Lumpur, Malaysia**

Dr Frank E. Vogel
Founding Director, **Islamic Legal Studies Program, Harvard Law School**

Chair:

Mr. Justice Blair

WORKSHOP AGENDA

OVERVIEW

Last year participants chose "Islamic Financial Intermediation: Revisiting the Value Proposition" as the topic for the 7th annual Harvard-LSE workshop. This 'back to basics' exercise emerged from a sense that the industry should review the directions it had been taking since the global economic downturn.

This year, as the topic for our 8th annual workshop, participants overwhelmingly have chosen to focus on the Islamic finance sector's handling of insolvency and debt restructuring scenarios. The global economic and financial downturn has forced actors in this sector to face many challenging legal and regulatory issues, both Islamic and secular -- issues such as how to unwind, restructure or enforce particularly the *shari*'a-compliant structures and entities that had been innovated and developed over the last decade.

These challenges were compounded by the absence of sophisticated insolvency regimes and regulations, and by various rulings by non-Islamic courts on technical Islamic concepts, structures and principles. Also, events highlighted how, after all, the classical Islamic law addresses only the insolvency and defaults of individuals, and not those of sophisticated corporate enterprises and SPVs. Some of the more widely reported debt repayment failures in this sector include:

i. The Investment Dar default, a *sukuk* offering with heavy reliance on short term debt;
ii. East Cameron Gas – poor credit risk; court deciding the issue whether a 'true sale' of the assets occurred (issue of "asset-backed" versus "asset-based" *sukuk*);
iii. The Saad *Sukuk*, a *sukuk* collapse following allegations of financial fraud;
iv. The 'near default' of the Nakheel Sukuk, involving debt-restructuring following state intervention and issuance of hastily-drafted new insolvency laws.

Defaulting products and institutions have raised many valid queries, such as the extent to which one class of creditors may claim preference over another class, priority over others in recourse to assets (asset-backed versus asset-based *sukuk*), whether GCC regulatory regimes can adopt Chapter-11-style debt restructuring, *shari*'a issues pertaining to cross default and acceleration of future loans, and whether to uphold the limited liability of corporate entities versus 'piercing the corporate veil' and claiming against their individual shareholders.

INTRODUCTION

Islamic law lays down rules for *iflas*, the condition of being unable to pay one's debt (insolvency), and for *taflis*, the official act or procedure of declaring the person *muflis* or insolvent. Debt restructuring, defaults, triggers for events of default, cross default, debt acceleration and debt suspension mechanisms such as US Chapter 11 proceedings are all relatively new concepts to Islamic law.

This workshop aims to discuss how to achieve a morally sound balance between debtors' and creditors' rights in Islamic finance.

Questions to be addressed include, first, what we mean by the concepts of insolvency and debt restructuring within modern Islamic finance; second, what specific transaction-types, structures, mechanisms or institutions are needed to help the industry address new challenges in this sphere; and finally, what needs to be done, if anything, to readjust the current trajectory of the industry with respect to insolvency scenarios and defaults.

In September 2011, the Harvard Islamic Finance Project sponsored a panel discussion at Harvard Law School on the subject "Bankruptcy, Financial Distress and Debt Restructuring in Islamic Finance." To start discussion at this workshop, a brief report on that panel discussion has been circulated to all workshop participants. Also, as in previous years, each participant has been asked to provide comments prior to the workshop discussion, and these have been circulated. The purpose again being to allow us to launch our discussion at a more focused, further advanced level.

We hope that this preparation will enable us to spend more time discussing deeper level questions, such as what socio-economic and legal principles Islamic law can contribute for handling defaults, insolvency and debt restructuring scenarios in a modern financial system, in particular with respect to Islamic finance.

Also, in line with earlier workshops – which took up one or another case-study not only for its own importance but also to facilitate discussion of deeper issues confronting the industry generally – we hope that one of the outcomes of this workshop will be to elicit and articulate key new recommendations on how to move the industry forward generally, and not only in the contexts of insolvency or economic and financial crisis.

OBJECTIVES

In this workshop, we would like to examine the topic from five levels:

i. Defaulting *individuals*;
ii. Defaulting *corporate transactions* (insolvent corporate borrowers; *sukuk*);
iii. Distressed *financial institutions*;
iv. National and cross-border bankruptcy and insolvency *legislation, rules and regulation*; and
v. Islamic finance *industry bodies* (e.g., standards, model laws).

We intend to achieve following objectives during this workshop for each of the aforesaid five levels:

1. Reviewing the understanding of the Islamic insolvency and debt restructuring pendulum with respect to creditors' and debtors' rights.
2. Testing our understanding of how modern regulatory regimes have handled financial defaults and how they have applied Islamic legal concepts and principles.
3. Discussing and applying Islamic financial insolvency concepts.
4. Discussing potential immediate economic, legal and regulatory reforms required to better deal with the complexities involved in defaults of contemporary Islamic finance products and institutions.
5. Exploring any new guiding principles or processes for development emerging from our discussion that might help the Islamic finance industry in its quest for a more sustainable future.

AGENDA

8:30 a.m.	**Reception and Coffee**

9:00 a.m. Opening Remarks by Professor R. David Kershaw, London School of Economics

9:10 a.m. Introduction by Workshop Moderator, Frank E. Vogel

Part 1: Macro Overview of Insolvency

9:30 a.m. **Presentation of *Macro* Insolvency Concepts**

A brief discussion on the *macro*-level issues raised by Islamic finance in insolvency and debt restructuring scenarios.

9:50 a.m. **Participants' Views – Open Floor Discussion**

Opportunity for each participant to explain briefly their views on the following questions:

1. It is clear there are challenges in reconciling Islamic finance concepts with modern legal and regulatory regimes. These challenges lead to added costs, inefficiencies, inconsistent results, uncertainty, and reduced confidence. Some jurisdictions are better equipped than others to deal with the multitude of technical, legal, social, and religious considerations as an insolvency situation advances. So, should Islamic finance:

    a. Develop its own set of insolvency rules and regulations which can be universally applied in all jurisdictions? If yes, where do you start from? Which model should be used? What would be the unique aspects of this model distinguishing it from others? How would it be established and implemented?

    OR

    b. Continue to use the existing patchwork of legal structures and simply address each technical hurdle at each of the relevant levels on an ad hoc basis? If this option is chosen, how should we address each such hurdle? Given the issues of moral hazard and irreconcilable cross-jurisdictional issues, should/can we insist on special guidelines for Islamic finance industry? Can we really impose moral and ethical conduct on an inherently secular-based legal system? What about consumer and employee education?

2. How did the industry generate legally valid financial structures that could not be unwound in an orderly and proper way? Who is to blame? If no one, is this an acceptable risk the investors must simply assume and price in?

11:00 a.m.	**Tea/Coffee Break**

11:20 a.m. **Summary** – Moderator to provide a summary of all the points of view and frame questions.

Part 2: Macro Overview of Insolvency Issues - Testing the Scope

11:25 a.m. **Participants' Views – Open Floor Discussion**

Opportunity for each participant to explain briefly their views on the following questions:

1. If Islamic finance is meant to be fair, equitable and just, how are these concepts manifested in modern insolvency situations? Are the products delivering fair, equitable and just results in insolvency scenarios?
2. If modern Islamic financial intermediation is simply a *shari'a*- compliant version of conventional financial institutions and product offerings, is it not about time we give up once and for all any claims that Islamic finance mechanisms should differ in insolvency situations from regular conventional debts or bonds? If not, then how does or should Islamic finance differ in such situations?
3. How can modern insolvency regimes be enhanced to meet the current needs of Islamic finance and its application?
4. How can Islamic finance enhance insolvency regimes to reduce or prevent:
   - Consumer ignorance?
   - Moral hazards?
   - Lack of enforcement?

12:45 p.m.	**Lunch**

1:30 p.m. **Summary** - Moderator to provide a summary of all the main points of view.

Part 3: Discourse on Applied Islamic Finance – Micro Overview of Insolvency Issues

1:50 p.m. **Presentation of *Micro* Insolvency Concepts**
A brief discussion on the *micro*-level issues raised by Islamic finance in insolvency and debt restructuring scenarios.

2:00 p.m. **Participants' Views - Open floor Discussion**

1. For each of five levels [i.e., i) defaulting *individuals*; ii) defaulting *corporate transactions* (insolvent corporate borrowers; *sukuk*); and iii) distressed *financial institutions*]:

   a) What aspect of modern Islamic financial insolvency practices needs to *change* in order to achieve better outcomes?
   b) What aspect of modern Islamic financial insolvency practices needs to *remain* in order to achieve the best outcome?

2. For each level, what are the specific economic, legal and regulatory reforms that should be put in place?

3. How can individuals and lower-income consumers access proper insolvency and restructuring regimes, if there will always be high risks, high costs and enforcement problems preventing their effective implementation?

3:00 p.m.	**Tea/Coffee Break**

3:15 p.m. **Summary** - Moderator to provide a summary of all the points of view

Part 4: Way Forward

3:25 p.m. **Open Floor Discussion**

If you had the authority to do so, and knowing what you know now, how would you improve the current framework of insolvency regimes? With respect to Islamic finance transactions, how would you enhance insolvency and debt restructuring outcomes?

Participants to discuss—and, where possible, reach consensus on—points or issues within areas to be raised by the Moderator.

Part 5: Future Workshops

4:15 p.m. **Action Plan** – Participants to assist the Moderator in drafting a workshop summary including suggested solutions.

PAPERS, NOTES and COMMENTS

Habib AHMED, *Professor and Sharjah Chair in Islamic Law and Finance*, Durham University, UK

INSOLVENCY AND DEBT RESTRUCTURING: PREVENTION IS BETTER THAN CURE

"And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease; and that ye remit the debt as almsgiving would be better for you if ye did but know." (Quran 2:280)

Insolvency results when debtor is unable to pay the liabilities. The probability of insolvency increases with the increase in debt in the capital structure of firms. Everything else equal, a negative shock makes the firms with more debt insolvent that those with relatively less debt. When an entity becomes insolvent, the options available are to either declare bankruptcy or re-structure the debt. Debt restructuring usually takes place either by reducing the debt or rescheduling the debt payments to give more time to the debtor to repay liabilities. One option of reducing debt is to do a debt-equity swap, whereby part of the debt is transformed into equity.

Islamic Perspectives

Insolvency and debt-structuring from an Islamic perspective can be viewed at two phases. First is the ex-ante phase in which entities decide on the levels of debt that they should have. Islamic laws and principles provide general guidelines that have implications on debt and the likelihood of insolvencies. The second is the ex-post phase which deals with issues relate to the specific technicalities of what should be done when insolvencies occur and a need to restructure debt arises. Before discussing the issues in these two phases, it is important to note that while there are Islamic principles/rules related to insolvency and bankruptcy for individuals, discussions on debt-restructuring are limited as creditors are asked to give respite to debtors if the latter are in difficulties. Furthermore, given that corporate entities are only recognized in Islamic commercial law during recent times, the implications of these concepts for corporations are scant, if not nonexistent.

Ex-ante Perspectives

As the probability of insolvencies and bankruptcies increases with the increase in the proportion of debt in capital structures, the ex-ante solution to have a lower frequency of insolvencies is to keep the levels of debt low. In this regard there are guidelines that can be deduced from moral teachings of Islam.

While Islam does not prohibit debt, several sayings of the Prophet (PBUH) discourage Muslims to engage in excessive indebtedness.1 In one hadith, the Prophet seeks refuge from sins and debt, thereby implying the negative attributes of both. In another hadith, the Prophet refused to lead the funeral prayer of someone who died indebted and did not have the means to repay it. The incident shows even though the deceased was a Muslim, the consequence of not repaying the debt was a serious enough factor that led him not to lead his funeral prayer. The implications that one can draw from these Prophetic sayings are the following: people should take on debt only if it necessary, the debt should of amounts that is within a person's capacity to repay, and once indebted people should strive to repay it back.

Excessive debt needs to be discouraged also on the basis of maslahah/mafsadah considerations. The recent financial crisis exposed the damaging features of excessive debt in the economy. It revealed that too much debt was one of the key causes of the predicament and harmed many indebted individuals and economies at large. The aftermath of the crisis led to a renewed scrutiny on the harmful consequences of debt. The weekly Economist published a special report on debt in its 24 June 2010 issue in which it examined various aspects of indebtedness. The morals related to debt changed from being something negative in the past to acceptable in the present. Over the past century taking on debt became fashionable and was promoted in the society, both at the individual and national levels.

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[1] Narrated 'Aisha: Allah's Apostle used to invoke Allah in the prayer saying, "O Allah, I seek refuge with you from all sins, and from being in debt." Someone said, O Allah's Apostle! (I see you) very often you seek refuge with Allah from being in debt. He replied, "If a person is in debt, he tells lies when he speaks, and breaks his promises when he promises." (Bukhari, Volume 3, Book 41, Number 582).
Narrated Salama bin Al-Akwa: Once, while we were sitting in the company of Prophet, a dead man was brought. The Prophet was requested to lead the funeral prayer for the deceased. He said, "Is he in debt?" The people replied in the negative. He said, "Has he left any wealth?" They said, "No." So, he led his funeral prayer. Another dead man was brought and the people said, "O Allah's Apostle! Lead his funeral prayer." The Prophet said, "Is he in debt?" They said, "Yes." He said, "Has he left any wealth?" They said, "Three Dinars." So, he led the prayer. Then a third dead man was brought and the people said (to the Prophet), Please lead his funeral prayer." He said, "Has he left any wealth?" They said, "No." He asked, "Is he in debt?" They said, ("Yes! He has to pay) three Dinars', He (refused to pray and) said, "Then pray for your (dead) companion." Abu Qatada said, "O Allah's Apostle! Lead his funeral prayer, and I will pay his debt." So, he led the prayer. (Bukahri, Book 37, Hadith 488)

The result of the change in attitude results in the increase in levels of debt for individuals, corporations and nations. This is reflected in rise in the amount of household debt from about GBP 14,000 per head to GBP 24,000 per head between 2001 and 2010 in UK and from USD 27,000 to USD 44,000 in the US during the same period (Economist 2010b). For ten industrialized countries, the average total debt (private and public) increased from 200% of GDP to 300% between 1995 and 2008, with Iceland having a debt 1200% of its GDP (Economist 2010a).

High levels of debt have various detrimental effects on both individuals and national economies. A study revealed that higher debt levels were associated with lower levels of growth (Economist 2010a). In a study, Campbell and Hercowitz (2009) find the higher growth in the level of debt reduces the welfare of households. Economist likened debt to alcohol and nicotine stating 'a debt boom tends to induce euphoria' (Economist 2010a). Analyzing the problems related to the crisis, Taleb and Spitzagel (2009) identifies too much debt as the 'real evil'.

As indicated, an obvious ex-ante solution to avoid insolvencies is to reduce the proportion of debt in capital structures. This is not only supported by the moral teachings of Islam, but also goes back to the foundational discussions on Islamic economics that showed preference for equity modes of financing. A higher proportion of equity relative to debt based modes ex-ante would reduce the likelihood of insolvencies and bankruptcies are expected to decrease to great extents.

Ex-post Perspectives

As the Islamic financial industry is modeled similar to the conventional financial sector, they predominantly finance using debt based modes. High levels of debt increases the probability of insolvencies when a negative shock affects the economy. This would require debt-restructuring As Islamic debt arises from sale-based contracts there are certain restrictions in how debt can be restructured. Whereas the level of debt can be reduced by creditors and time of repayment extended, the amount owed cannot be increased. As mentioned, one Shari'ah compliant way to deal with insolvencies is to transform debt into equity.

Alternatively, Islamic financier may act like their conventional counterparts and try to increase the amount beyond that is owed to compensate for the longer time of repayment. While some (controversial) Shari'ah compliant methods can be used to do restructure the debt, in substance this would be similar to riba jahiliyyah whereby the amount owed is increased when the debtor fails to repay the debt on time. Interesting, if non-debt modes are used for financing, the issue of restructuring payments becomes much easier. For example, if an asset is financed by ijarah mode and the client is unable to pay the rent on the assets due to distress, then the length of the lease contract can be extended. In this way, the financier will still be able to earn income for a period longer than that stipulated in the original contract.

Conclusion

One of the key reasons of insolvencies is high levels of debt. The proponents of Islamic economics envisioned a system that would be stable as it would be dominated by equity-based financing. Whereas there are reasons to belief that the non-debt instruments have built in features that can deal with problems of insolvencies and restructuring, too much dependence on debt–based financing dissipates this advantage. Using debt-based modes not only makes insolvencies more likely but also creates problems of debt-restructuring as the amount owed cannot be increased. Ironically, one of the ex-post solutions of insolvencies is debt-equity swap. Following Islamic moral principles ex-ante and keeping debt levels low would reduce the likelihood of insolvencies and provide the safeguards to avoid debt-restructuring or bankruptcies.

References

Campbell, Jeffrey R. and Zvi Hercowitz (2009), "Welfare implications of the transition to high household debt", Journal of Monetary Economics, 56 (1), 1-16.

Economist (2010a), "Debt: Repent at Leisure", The Economist, June 24th 2010.

Economist (2010b), "In a Hole: Stagnation, Default or Inflation Await. The Only way out is growth", The Economist, June 24th 2010.

Taleb, Nassim Nicholas and Mark Spitzagel (2009), "Time to tackle the real evil: too much debt", Financial Times, July 13, 2009.

Salman Syed ALI, *Chief, Research Division*, IRTI, Islamic Development Bank, Jeddah, Saudi Arabia

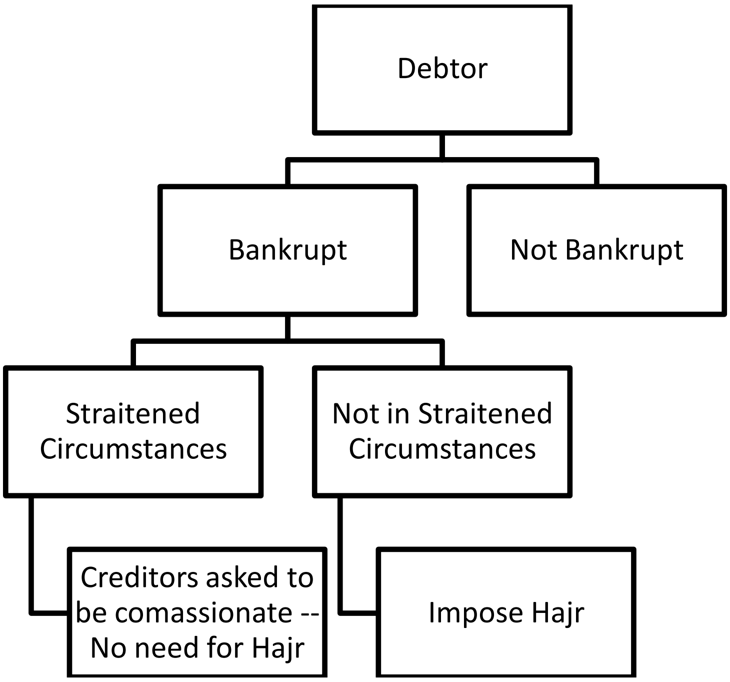
INSOLVENCY AND DEBT RESTRUCTURING IN ISLAMIC FINANCE

To understand the theory of bankruptcy and to develop models for bankruptcy resolution in Islamic finance clarity on the following aspects is essential:

- Islam prohibits interest.
- Money is recognized as medium of exchange and a facilitator with no intrinsic potential to grow or increase in value by time.
- Debt is not prohibited but not encouraged. It does not mean a neutral stance towards debt. Debt is rather discouraged.
- Debt cannot be extinguished except by payment in full (*ada*) or by its forgiveness (*ibra*) from the creditors. There is no other way to discharge debt. (Note: Hawala, Sale of debt to the creditor or to a third party, Negotiated Settlement, Acceleration cum Curtailment, Swap with equity all are various forms of payment with forgiveness that can be the options ex-post to stress or default but not part of the original debt contract).
- Justice (*adal*) and Benevolence (*ihsan*) are fundamental in all dealings. In debt contracts, it translates into insisting the debtor to keep his promise of timely repayment and encouraging the creditors to show leniency is case debtor is in financial difficulty to extend time and/or forgive full or part of the debt.

The words insolvency and bankruptcy are sometimes used alternatively, however there is a difference. Insolvency is a state of 'private information' (known to the individual agent himself) or at most 'common knowledge' (known to some others around) that total assets have fallen short of total liabilities. Bankruptcy is 'public information' of this fact when everyone knows that everyone knows about an economic agent that its liabilities have exceeded the assets. That is why bankruptcy is a declared state of insolvency pronounced by a court. On face, this appears to be only a philosophical difference or splitting the hair, however this informational difference has economic consequences. A state of less than public information can result in rumors, expectations and a different kind of behavior from the counterparties of the distressed individual or institution than that in a state of public information. In the former case creditors try to take advantage of their own information unsure if others have same or different information. While in later case everyone is approaching the issue with same knowledge without any asymmetry of information.

Insolvency that we are concerned in the context of bankruptcy pertains to negative net worth. A shortfall in cash-inflows compared to the planned cash-outflows required to meet the present obligations can create an event of default but it does not necessarily create an insolvent state i.e., negative net worth or bankruptcy. However, a default whether willful or consequential to circumstances (such as cash-flow problem) can lead to creditor claims, heightened concern of the other creditors and liquidation of some assets to pay. This may or may not lead to discontinuity from business-as-usual (whether it is an individual person or a business firm) depending on its available sellable assets relative to the liabilities. In case of a financial firm this threshold of concerned creditors reaches much earlier than that in the case of a person or a non-financial firm. This difference is due to the capital structure and the nature of business of a financial firm. Thus a hint of a possible insolvency of a financial firm can lead to its bankruptcy.



THE ISSUES FOR DISCUSSION:

1. Real Person vs Legal Person -- Higher Debt Propensity Higher Bankruptcy Cost:

A person can be risk averse thus cautious in loading himself with debt (or become addicted to debt hence take more debt). But a limited liability corporate may not be that cautious because:

(i) It is not a real person; therefore internal corporate governance will matter most.

(ii) Given the limited liability it can keep on taking more and more debt (say to increase shareholders' returns or to bet on future prospects). The restraint would be only the suppliers of credit.

The arrangement of limited liability corporate sows the seed of bias towards debt.
Bankruptcy of an individual real person creates problems at smaller and local level. But bankruptcy of a corporate entity (legal but non-real personality) creates larger problems due to extensiveness in networked connections and interdependencies. For the same reasons the problem is more severe in case of bankruptcy of financial firm.

2. Incentivizing and Balancing of Rights and Obligations:

Every system has its methods of checks and balances which work collectively together to create the desired outcome that confirms to an underlying philosophy. Bits and pieces on their own cannot achieve the overall goals nor individually can they create a balance. The balancing between creditors' and debtors' rights in Islam is created through obligations and incentives that account for this world and transcend also into the hereafter. That is, punishments and incentives in this world as well as in al-akhirah. Commandment to the debtor to fulfill his obligations without delay (a religious duty) and encouragement to the creditors to give leniency to the debtors by giving more time for payment or by forgiving the whole or part of the debt. These incentives can work in case of individuals, as the final judgment in al-akhira will be of individuals. But how can a corporate entity (which is only a legal personality) can be tried and incentivized based on al-akhira considerations? Thus for a limited liability corporate firm operating in Islamic economy there will be only one side of the incentives mechanism to provide control. This implies a need to rethink the organizational form of business or the bankruptcy incentive system and procedure.

This issue is of concern in defaults involving any legal personality whether it is a corporate non-financial firm or a financial institution or a government. A corporate structure which addresses this problem is given below.

A Proposed Model for Corporate Structure:

Categories of Stakeholders	Liabilities	Gains/Profits	Other Rights	Tradability of Shares
Tier-1: Controlling Shareholder and Executive Board of Directors	Liability proportionate to their investment not limited by amount invested (i.e., can go to their other personal wealth)	Predetermined proportion of share in distributable profit	• Can set strategic direction and policy • Involved in management decision making • Voting rights	Yes (trade with approval or without approval clause can be added)
Tier-2: Ordinary Shareholders	Liability proportionate to their investment but limited by amount of investment	Predetermined proportion of share in distributable profit	• Voting Rights • Not involved in policy or management decision making	Yes
Tier-3: Employees	No partnership liability related to the company Usual liabilities as person (e.g. arising from negligence, fraud, civil and criminal law violation etc.).	Wages		Not applicable

This structure has the advantage that it balances between legal personality and real personality thus retains the advantage of corporate vile and full exposure. The ordinary shareholders who are a big potential source of funding but are not involved in active decision making are shielded from incurring extreme risks by enacting limited liability. This protection will encourage investment in a corporate owned by large number of individuals where the outcome is affected by entry, exit, and actions of other shareholders. However, the same shield is not available to the active decision maker partners who also participate by their capital. Another way to understand this structure is in terms of classical *fiqh* contracts. In this business, the Tier-1 shareholders are joining as partners (contributing both money and effort) whereas the Tier-2 shareholders are joining the venture through a *mudharabah* contract as *rab al-mal* to the extent of their capital.

Turkey has made a move recently to make board members more liable such that third parties (e.g. creditors) can also sue them. More study on this Turkish law is needed. (Turkish Commercial Code published in the Trade Registry Gazette dated 14 February 2011 and numbered 27846)

3. Methods of Debt Extinguishment and their implications:

In conventional finance debt can be extinguished by (i) payment, (ii) forgiveness or write-off by the creditors, (iii) declaration of bankruptcy. This last method normally operates through courts or a set bankruptcy procedures which can be initiated by the debtor with or without pressure from the creditors. Thus there are instances of strategic default. A debtor calculating the cost and benefits to him of bankruptcy declaration verses continuity of business choses default and files for bankruptcy protection. Or perpetrate fraudulent transfer of assets before declaring default.

In Islamic finance by contrast debt cannot be extinguished accept by its payment or forgiveness by the creditors. Thus, declaration of bankruptcy cannot be used by the debtor to get his debts written off. The debt obligation carries over even on the Day of Judgment unless someone pays on his behalf or creditors forgive. Strategic default is therefore not an option.

4. Bankruptcy protection filing is for whose benefit: debtor or creditors?

Knowing that it is the debtor who generally files for bankruptcy protection under Chapter-11 it appears that he is the benefitted party from this protection. Indeed debtor is protected that his assets get shielded from immediate grabbing and fragmentation by the creditors, until proper value of assets can be determined and orderly arrangements can be made to settle the debts by sale of these assets or restructuring of debt or through debt to equity swap etc. However, Chapter-11 bankruptcy filing protects the creditors more than the debtor in several ways. First, by preventing grab and fire sale it preserves the value of assets and helps generate better amount for payment of claims. Second, and more importantly, it does not allow some creditors to get the assets to the satisfaction of their claims at the expense of the others. By the same token it precludes the possibility for the debtor negotiating separately with each creditor and using these separate deals to his own advantage by pitting one creditor against the other or by cross benefiting some creditors at the loss to other creditors. In other words, it makes creditors a single group to negotiate from a powerful position and extract maximum possible debt claim.[2] The downside of this arrangement is that it impedes the chances of continuity of the business or the possibility of even one creditor taking a compassionate stance to allow more time or leniency to the debtor. Because either a creditor cannot individually negotiate or any benefit that he intends to provide to the debtor by rescinding part of his own claim will pass to the other creditors not to the debtor. In short, bankruptcy procedure in the conventional finance provides a coordination mechanism for maximum extraction from the debtor instead of coordination for optimal help to the debtor.

In contrast, the bankruptcy procedures in Islamic finance would be to create coordination for cooperation to provide optimal help. The interceder (managing the negotiation) can suggest to the creditors to forgive a portion of the loan and even seek outside parties to help pay the claims of non-consenting creditors.

The examples from the ahadith reveal that the Prophet (s.a.w) started with negotiated solution; if it failed he helped raise the production or encouraged contribution from others, and finally distributed the assets of the debtor to the creditors.

5. How the bankruptcy process can be initiated?

The bankruptcy declaration process is normally initiated by the creditors whose debt has matured and they have been defaulted. However, the settlement process can also be initiated by somoto action of the court itself. The incident of Ka’b bin Malik testifies this that Prophet came out of the house after hearing loud voices of men arguing each other and intervened in settlement of a dispute over debt.

6. Assets not included in the bankruptcy procedure:

Assets that do not belong to the debtor (legal personality of the debtor) are not included in the asset accounting. For example, assets belonging to an independent entity separate from the debtor, assets transferred to SPV for issuance of sukuk (provided there is true sale), assets held by debtor as *wakil* (agnet) whether against a fee for a commission ratio are not part of the bankruptcy proceedings.

7. What will be the hierarchy of asset liquidation and distribution among the creditors?

Detailed rules do exist. For example the distribution of the assets can follow fiqh established hierarchy which may differ somewhat between different *madahib* (schools of jurisprudence). The judge will start the distribution of assets from the same category or kind in which the debt was incurred. For example, loans incurred in one currency will be paid in the same currency. In doing so liquid assets will be used first before selling other assets.

AAOIFI in its Shariah standard no. 43 on Bankruptcy has established following hierarchy in priority of claims:

First the cost or wages of the liquidator himself will be set aside, second the claims of secured debts that were secured by mortgage (*rahn*) according to laws of *rahn*, third the wages and rent payments to the hired labor, assets which are identifiable as belonging to particular creditors and still intact can be possessed by these creditors, and lastly the claims of all unsecured creditors without any seniority in their treatment.

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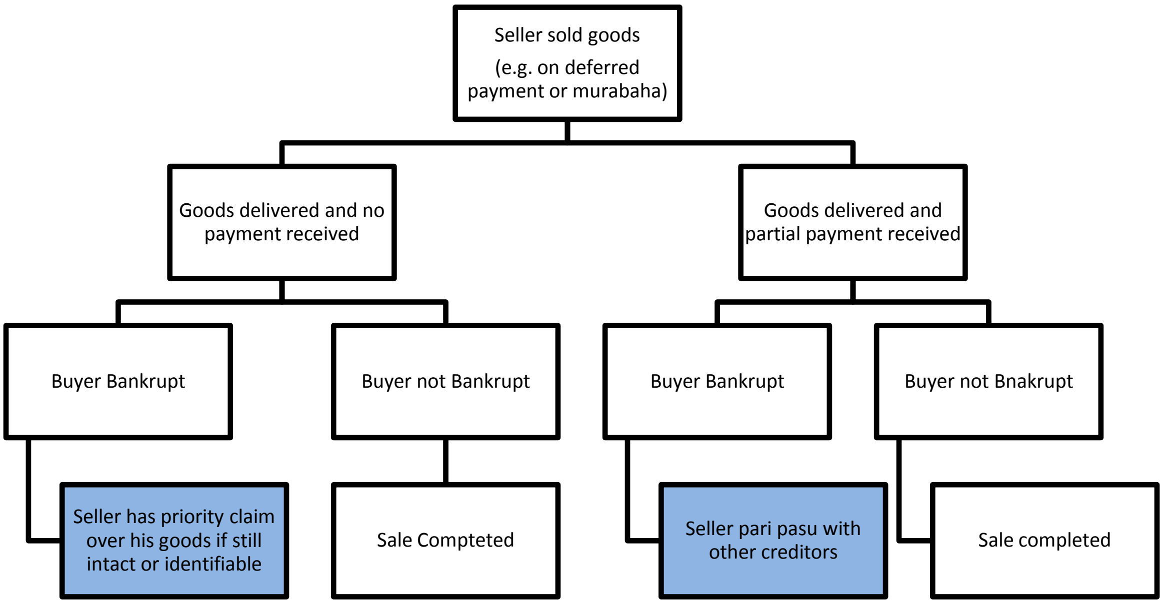
[2] This is not only true for corporate defaults but also for sovereign defaults. For example, when the countries in South America defaulted and the problem lingered on then the Brady plan for debt negotiation was created in early 1990s to swap the old debt with new but tradable debt (Brady bonds). It implemented it by creation of a consortium of creditors and the condition that countries in default will negotiate debts only with this consortium rather than with individual creditors.

Example of hierarchy of debt claims



(Sahih al-Bukhari, no. 2272). It is related that Abu Hurayra was heard to say that the Messenger of Allah, may Allah bless him and grant him peace, said - or he said, "I heard the Messenger of Allah, may Allah bless him and grant him peace, say, 'If anyone finds any of his property with another man, or person, who has become bankrupt, he has more right to it than other people." (Muwatta, Book 31, 88)
The prophet is reported to have stated that:
"Whenever a man sells wares and then the buyer becomes bankrupt and the seller has not taken any of the price and he finds some of his property intact with the buyer, he is more entitled to it than anyone else. If the buyer dies, then the seller is the same as other creditors with respect to it."
Quoted in Hassan, Abdullah Alwi (1994), p.132 citing:
Muwatta of Anas bin Malik version of Shaybani, p.278.
Muwatta of Anas bin Malik version of Yahaya al-Laythi, p.565.
Mussanaf of Al-Sanai, p.264.

8. Creating a schedule or pre-agreed arrangements to follow in case of default and bankruptcy (i.e., insolvency regimes) – advantages and disadvantages?

In order to expedite the decision making and steps to be followed in case of a default and in case of bankruptcy economists would like to suggest pre-agreed schedule of payments, discounts, and assets to be liquidated to make the settlement. However this approach has its own problems. First, there is the problem of 'time inconsistency' of decision and consent. Something that was agreeable between the two parties (or more than two parties) ex-ante to the event may not remain consented ex-post and create dispute. Therefore Islam emphasizes consent of both parties in all transactions and within the same session *(majlis)* and its confirmation is by completing at least one leg of the contract within the session. Second, a pre-agreed re-pricing can open a back door to interest through strategic defaults. That is, a party deliberately defaulting to buy time for consenting to pay a higher price which has been pre-agreed in the schedule.

A balance between these benefits and costs can be achieved by:

- Pre-agreeing on outlines of actions to be followed (rather than prices or percentage of discounts or markups) in case of default on debt. These actions can include description of hierarchy of the types of assets to be liquidated or alternative forms of payments, the governing law used etc.
- Creating a fall-back (automatic) insolvency regime within the Shariah parameters at the level of national (or sector) specific law which the courts can use. Common knowledge of these parameters will help in convergence of expectations and quicker agreement during the bankruptcy.

Appendix

QURAN:

“*If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew*.” (2:280)

Allah Almighty says, *"Allah commands you to return to their owners the things you hold on trust and, when you judge between people, to judge with justice. How excellent is what Allah exhorts you to do! Allah is All-Hearing, All-Seeing."* (4:58)

AHADITH:

The prophet (s.a.w) said “ … every loan must be paid. …”

The Holy Prophet (S) asked his followers,
“Do you know who is the actual destitute?”
“One who has no money, property or treasure,” they replied. The Holy Prophet (S) said,
“There is no destitute in my Umma except the one who has performed the prayers, kept fasts, paid the Zakat, performed Hajj but on the Day of Judgement a person will come whose property he has usurped, and a person whose blood he had shed and another one whom he had beaten. Then the good deeds of this man will be transferred to those who have rights upon him. If his good deeds are exhausted before all the rights are fulfilled then the sins of those who have rights upon him will be added to his sins. Then he shall be thrown into Hell.”

1. Sayyiduna Abu Hurayra (Allah be pleased with him) narrates that the Messenger of Allah (Allah bless him & give him peace) said: “Delay in repaying debts by a wealthy person is oppression.” (Sahih al-Bukhari, no. 2270)
2. The Messenger of Allah (Allah bless him & give him peace) said: “The delay of a well-off person (in paying off his debt) subjects him to punishment and disgrace.” (Sahih al-Bukhari, no. 2271)

3. It is related from Abu Hurayra that the Prophet, may Allah bless him and grant him peace, said, "If someone takes people's property intending to repay it, Allah will repay it for him, and if someone takes it intending to destroy it, Allah will destroy him." (Sahih al-Bukhari, no. 2257)
4. It is related that Jabir ibn 'Abdullah said that his father was killed in the Battle of Uhud as a martyr while he had debts. (He said,) "The creditors were insistent about their rights and I went to the Prophet, may Allah bless him and grant him peace, and he asked them to accept the dates of my garden and discharge my father, but they refused. The Prophet, may Allah bless him and grant him peace, did not give them my garden. He said, 'We will come to you in the morning.' He came to us early in the morning and walked about amid the palm-trees and prayed for blessing in their fruit. I cut them paid them off and we still had some of its dates left." (Sahih al-Bukhari, no. 2265)
5. It is related from Wahb ibn Kaysan that Jabir ibn 'Abdullah informed him that his father died and left a debt of thirty *wasqs* to a man of the Jews. Jabir asked for time to pay and the man refused to give him it, so Jabir spoke to the Messenger of Allah, may Allah bless him and grant him peace, to intercede with him on his behalf. The Messenger of Allah, may Allah bless him and grant him peace, went and spoke to the Jew about taking the fruit of his palm-trees in return for what he was owed, but he refused to do so. The Messenger of Allah, may Allah bless him and grant him peace, then went in among the date-palms and walked about among them and then said to Jabir, 'Cut them and give him what is due him.' So he cut them after the Messenger of Allah, may Allah bless him and grant him peace, had left and he gave him a full thirty *wasqs* and had seventeen *wasqs* over. Jabir came to the Messenger of Allah, may Allah bless him and grant him peace, to tell him what had happened and found him praying 'Asr. When he finished, he told him about the surplus and he said, 'Tell that to Ibn al-Khattab.' Jabir went to 'Umar and told him and 'Umar said to him, 'I knew when the Messenger of Allah, may Allah bless him and grant him peace, walked in it, that it would be blessed." (Sahih al-Bukhari, no. 2266)

Debt is not desirable:

6. 2267. It is related that 'A'isha reported that the Messenger of Allah, may Allah bless him and grant him peace,used to make supplication in the prayer: "O Allah, I seek refuge with You from wrong action and debt."

Someone remarked to him, "How often you seek refuge from debt, Messenger of Allah!" He said, "When a man is in debt, when he speaks, he lies and when he makes a promise, he breaks it."

7.

Discouragement of dying with debt.

2168. It is related that Salama ibn al-Akwa' said, "One day we were sitting with the Prophet, may Allah bless him and grant him peace, when a dead man was brought for burial. They said, 'Pray over him.' He said, 'Has he any debts?' They answered, 'No.' He asked, 'Has he left anything?' They said, 'No,' so he prayed over him. Then another dead man was brought for burial and they said, 'Messenger of Allah, pray over him.' He asked, 'Has he any debts?' It was said, 'Yes.' He said, 'Has he left anything?' They replied, 'Three dinars.' He prayed over him. Then a third was brought and they said, 'Pray over him.' He asked, 'Has he left anything?' They answered, 'No.' He asked, 'Has he any debts?' They said, 'Three dinars.' He said, 'Pray over your companion.' Abu Qatada said, 'Messenger of Allah, pray over him and I will pay his debt.' So he prayed over him."

Thawban reported: The Messenger of Allah, peace be upon him, said, "**Whoever dies free of three things – arrogance, theft, and debt – then he will enter Paradise.**"

[Sunan At-Tirmidhi, Book of Expedition, Number 1572, ***Sahih***]

عَنْ ثَوْبَانَ قَالَ قَالَ رَسُولُ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ **مَنْ مَاتَ وَهُوَ بَرِيءٌ مِنْ ثَلَاثٍ الْكِبْرِ وَالْغُلُولِ وَالدَّيْنِ دَخَلَ الْجَنَّةَ**

سنن الترمذي كتاب السير عن رسول الله صلى الله عليه وسلم باب ما جاء في الغلول

المحدث الألباني خلاصة حكم المحدث صحيح

Responsibility to pay off the debt of a deceased rests on government if his wealth is insufficient for it.

8. 2268. It is related from Abu Hurayra that the Prophet, may Allah bless him and grant him peace, said, "If anyone leaves money, it is for his heirs, but if anyone dies leaving weak dependants (or debts) it is our duty (to take care of them)."
9. 2269. It is related from Abu Hurayra that the Prophet, may Allah bless him and grant him peace, said, "There is no believer but that I am closer to him than anyone both in this world and the next. If you wish, recite, *'The Prophet is closer to the believers than their own selves.'* (33:6) If any believer dies and leaves money, it goes to whatever legal heirs he has. But if anyone leaves a debt or a needy family, I am the one to come to. I am his guardian."

495. Narrated Abu Huraira

Whenever a dead man in debt was brought to Allah's Apostle he would ask, "Has he left anything to repay his debt?" If he was informed that he had left something to repay his debts, he would offer his funeral prayer, otherwise he would tell the Muslims to offer their friend's funeral prayer. When Allah made the Prophet wealthy through conquests, he said, "I am more rightful than other believers to be the guardian of the believers, so if a Muslim dies while in debt, I am responsible for the repayment of his debt, and whoever leaves wealth (after his death) it will belong to his heirs."

Source: Sahih BukhariShare by Imam Bukhari, translation by M. Muhsin Khan
Chapter: Transferance of a Debt from One Person to Another (Al-Hawaala)

Hierarchy of claims:

XIV: When someone finds his property with a bankrupt person to whom he has sold it, lent it, or entrusted it, he has the greatest right to it.
Al-Hasan said, "When someone is bankrupt and that is ascertained [by the judge], he is not permitted to set slaves free nor to buy or sell."
Sa'id ibn al-Musayyab said that 'Uthman judged that if someone took part of what he was due before the person became bankrupt, that was his. If someone recognises his goods, he has most right to them.

Who has the right to initiate insolvency and bankruptcy proceedings?

2260. It is related from Abu Hurayra that a man came to ask the Messenger of Allah, may Allah bless him and grant him peace, to settle his debt and spoke coarsely to him. His Companions went for him and the Messenger of Allah, may Allah bless him and grant him peace, said, 'Leave him alone. The one with a right is allowed to speak. Buy him a camel and give it to him.' They said, "Messenger of Allah, we can only find one which is better than the age that this one warrants.' He said, 'Buy it and give it to him. 'The best of you is he who is most generous in settlement.'"

(Sahih Bukhari Book 49. Hadith no. 873.) Narated By Abdullah bin Kab : That Ka'b bin Malik told him that in the lifetime of Allah's Apostle he demanded his debt from Ibn Abu Hadrad in the Mosque. Their voices grew louder till Allah's Apostle heard them while he was in his house. So he lifted the curtain of his room and called Ka'b bin Malik saying, "O Ka'b!" He replied, "Labbaik! O Allah's Apostle!" He beckoned to him with his hand suggesting that he deduct half the debt. Ka'b said, "I agree, O Allah's Apostle!" Allah's Apostle then said (to Ibn Abu Hadrad), "Get up and pay him the rest."

FATAWA:

If the debtor wants to pay earlier than the specified date, in return of discount on the agreed amount, then this is impermissible according to the majority of the classical scholars, which includes the four schools of Islamic law. (See: Ibn Qudamah, al-Mugni, 4/174)

Al-Hasan and Qatada said, "If someone possessed wealth on the day it [a debt] was transferred to him, the transfer is permitted." Ibn 'Abbas said, "When two partners or heirs break up, and one of them takes assets and the other takes debts which prove to be uncollectable for him, the latter has no claim against the former."

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Ijlal Ahmed ALVI, *Chief Executive Officer*, International Islamic Market, Manama, Bahrain

INSOLVENCY & DEBT RESTRUCTURING IN ISLAMIC

Sukuk Default & Restructuring Background

My comments and analysis will be covering Sukuk, a major Islamic Capital Market instrument. The global financial crisis which started in mid 2008 had impacted the Sukuk market the most and number of high profile Sukuk such as East Cameron, Investment Dar, Golden Belt, Nakheel, Dana Gas etc., ran in to difficulties which resulted into steep drop in Sukuk market for instance Sukuk issuances in 2008 dropped to USD24 bio as compared to 2007 record Sukuk issuance figure of USD50 bio. Initially doubt emerged whether the Sukuk can be restructured or how the default will legally handled etc., some experts went on to predict that this could be end of Sukuk market; however, thankfully this was not the case and once the dust settled down and defaulting Sukuk were either restructured or in some cases repaid hence market confidence was restore. The Islamic Industry has witnessed a record Sukuk issuances of USD 92bio and USD 137bio in 2011 & 2012 respectively and various Islamic jurisdictions as well as corporate has led the way in this recovery.

The Sukuk defaults have also highlighted a number of issues which were earlier ignored such as explicit guarantee versus implicit guarantee for quasi sovereign Sukuk, asset backed Sukuk versus asset based Sukuk.

The point remains that whether Sukuk is debt type like Ijarah or equity type like Musharakah that restructuring has followed the same methodology as in case of conventional Bonds perhaps the way purchase undertaking and guarantees have drafted in the agreements led to this practice. For instance the Dana Gas $1bio Mudarabah Sukuk defaulted in October 2012 and started restructuring negotiation with creditors and after several months of negotiations the issuer was able to restructure the Sukuk and creditors agree to the proposal of $70mio in cash (Dana Gas had earlier repurchased USD80mio Sukuk) and split the remaining into $425mio Convertible Sukuk will pay profit of 7% and $425mio Ordinary Sukuk will pay 9% as compares to 7.5% profit on the existing Sukuk.

IIFM SUKUK REPORT 2ND EDITION ARTICLE BY HUSAM EL-KHATIB & EDITED BY IIFM REVIEW COMMITTEE

Sukuk reflect an ownership interest in an underlying asset, transaction, or project. It refers to the process of pooling tangible assets, their usufruct, or beneficial ownership into an entity which issues *Sukuk* certificates reflecting undivided, proportionate ownership.

They are similar to any other financing and investment product, Islamic or conventional, in terms of their exposure to default scenarios. Whilst the business causes leading to *Sukuk* default are varied, the ultimate reason for a default is the Issuer's failure to pay the *Sukuk* investors their dues in accordance with the terms governing the *Sukuk* issuance which may lead to the restructuring of the debt or indebtedness restructuring[3].

However, restructuring of *Sukuk* is not the same as with conventional bonds as they pose a number of additional challenges. For example, the nature of *Sukuk* structures are crucial to how they are to be restructured or unwound. Some *Sukuk* are securities that resemble debt obligations with determinable fixed returns, while other *Sukuk* resemble equity-like investments, containing a variable return (largely *Mudarabah* or *Musharakah* based *Sukuk*). Yet, all have different methods and forms of transferring, applying and dealing with the underlying asset, usufruct, venture or project in order to comply with the precepts under *Shari'ah*. These requirements need to be protected in a default scenario.

Restructuring Objective

The objective of any restructuring is twofold; firstly, to ensure the fair treatment of its creditors; and secondly, to ensure that the obligor can continue to operate as a going concern. Decisions as to whether to pursue a course of restructuring versus enforcing bankruptcy largely depend on how best to extract the highest value for the owed creditors.

Restructuring *Sukuk* from the perspective of the obligors is also preferable. It provides the obligors with the additional time to meet their obligations as well as to save the enterprise. Restructuring involves either extending the payment terms, conducting a debt for equity swap, agreeing to a profit haircut, or replacing the original *Sukuk* certificates with new certificates (usually involving a new asset sale transaction but at higher profit rates).[4]

One of the first key steps in any restructuring process is for the obligors to negotiate with the trustee and the *Sukuk* holders to determine: whether there is any potential event of a default; whether a default has in fact occurred; and/or whether the situation can be resolved before making any official announcements. Given the lack of sophisticated

[3] Debt restructuring or indebtedness restructuring is a process that allows a private or public company or a sovereign entity facing cash flow problems and financial distress, to reduce and renegotiate its delinquent debts in order to improve or restore liquidity and rehabilitate so that it can continue its operations.

[4] See Dr. Mohd Daud Bakar. '*Sukuk Restructuring: Issues and Challenges'*. Amanie Islamic Finance Consultancy and Education, LLC, DIFC.

insolvency laws and procedures in the GCC, agreeing upon a restructuring course of action with *Sukuk* holders is even more important.

Balancing the interests of all the parties, be it the creditors' expectations, the trustee's role, *Shari'ah* board requirements, and the obligors' obligations and constraints, is a major challenge in of itself.[5] Also, the location of all the parties and gathering them together to convene a meeting can be equally challenging.

The Sukuk Trustee

The trustee is essential to any *Sukuk* restructuring. But their powers and authority to represent the *Sukuk* holders' interests has been a matter of intense debate. The trustee is limited both by the authority as set out in the *Sukuk* documentation [6] and by the constraints placed on it due to the particular *Sukuk* structure itself. Some have suggested using a third party delegate, in particular for enforcing any purchase undertaking or guarantees in the *Sukuk* structure.[7] If the situation warrants, a meeting of the *Sukuk* holders and the trustee may have to be convened.[8] The objective of this meeting is to pass a resolution to allow the *Sukuk* to be amended. Amendments can include changes to the *Sukuk* payment terms, dates and processes. If a resolution is not agreed upon and passed, further negotiations are conducted until a revised resolution is agreed upon. Continued deadlock could lead to a formal default announcement and/or insolvency procedures.

A restructuring is devised through creditors' consent rather than through a court process. Therefore, the obligor engages with the *Sukuk* holders and other creditors through some form of coordinating committee. For conventional bonds, this is through a bond holders committee represented by the trustee. For *Sukuk*, this is through a *Sukuk* holders committee represented by the trustee, or an appointed delegate acting on behalf of the trust.[9]

The Claims

Any restructuring, by way of a scheme of arrangement[10] or other, would begin with an assessment of the claims against the obligors' financial status. For *Sukuk* holders, determining their exact status and interests vis-a-vis other creditors is vital. Are the *Sukuk* holders deemed secured creditors, unsecured creditors, preferential creditors or other?

Whether and how much a *Sukuk* creditor gets back of his investment and distributions depends on his ranking in the payment claims list. The obligors and the creditors will need to agree on the quantum, classification and ranking of the claims.[11] Claims secured against particular assets would have preferential priority over those asset values. To make matters more challenging, the values of all the obligor's assets may have significantly changed since the start of the *Sukuk*.

Even in the event of bankruptcy, the priority of claims, along with the residual valuations of an obligor's assets, are highly contentious.

Unlike conventional bond holders however, the rights and remedies of *Sukuk* holders can vary. Therefore, practitioners have to determine these with respect to the *Sukuk* by reviewing the terms and conditions of the *Sukuk* certificates, the trust deed and consider whether there is any purchase undertaking present by the obligor in favor of the trustee and its enforceability.

Under a *Wakalah Sukuk* for example, *Sukuk* holders do not have recourse to the assets of the *Wakeel*.[12] But they may enjoy some degree of protection if the *Wakalah* contains a specific purchase undertaking or guarantee.

Hence, the importance of understanding whether the *Sukuk* is either asset backed or asset based.

Restructuring of Asset-backed and Asset-based Sukuk

In asset-backed *Sukuk*, legal title of the underlying asset will, in most cases, have been transferred by the obligor into a bankruptcy remote special purpose vehicle (SPV) or ring-fenced from the obligor. In securitization parlance, this is known as a true sale. In the use of an SPV, the trustee appointed over the SPV will hold the assets in trust for the *Sukuk* holders. In a default situation, pursuant to the trust deed in place, the *Sukuk* holders can make a claim on the issuer's legal ownership interest just to that asset. If the cash flow of that asset is insufficient to meet the claims of the *Sukuk* holders, they can dispose of the asset. However, they cannot claim against the obligors themselves.

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[5] Hessam Kalantar and Owen Delaney. *'Restructuring of Islamic Finance Transactions in the Middle East: A New Frontier for Practitioners,'* Zawya Select 2010. Nov 30, 2010. See http://www.zawya.com/story.cfm/sidZAWYA20101130072143?q=*Sukuk* ownership

[6] The trustee may pursue the remedies available to it under document to enforce and accelerate the rights of the *Sukuk* holders.

[7] For instance, see *Supra* no. 12.

[8] The trustee can convene a meeting for the *Sukuk* holders. In many *Sukuk*, no less than one-tenth of the *Sukuk* holders are required for a resolution's approval.

[9] For an interesting solution to restructuring of *Sukuk* via the use of appointed delegates, please see the presentation provided by Debashis Dey, '*Capital Market Solutions to Restructuring Sukuk,*' 9th Annual Islamic Finance Summit, Euromoney Seminar, London. 23-24 February, 2010.

[10] A Scheme of Arrangement (or a "scheme of reconstruction") is a UK court-approved agreement between a company and its shareholders or creditors (e.g. lenders or debenture holders). See the UK Companies Act 2006, Part 26 (ss. 895-901) and Part 27.

[11] *Supra* 12

[12] This is true unless the *Wakeel* breaches its standard duty of care or the investment guidelines under which it operates.

In asset-based *Sukuk*, however, there was most likely only a beneficial ownership transfer or possibly no real transfer of the underlying asset(s). Here, *Sukuk* holders have at best a beneficial interest in the assets. However they do not have ownership of the asset, especially if there is a purchase guarantee in place. They will only have recourse to the obligor as an unsecured creditor with all other similar creditors. More details on the distinction between the two can be found in the chapter in this book on *Sukuk* Ownership Rights.
Sukuk holders can determine whether their *Sukuk* investment is asset-based or asset backed from the *Sukuk* prospectus, especially as highlighted in the risk factors section. Despite the availability of this information, many perceived their investment to be linked to the underlying asset performance, rather than simply being de facto debt instruments.[13]

Security Interest

Relevant to arriving at a classification of secured versus unsecured claims is determining whether procedures relating to perfection of security have been duly undertaken.

Perfection of a security interest on the assets is another important determinant in restructurings. Many *Sukuk* creditors mistakenly believed they had, in addition to a claim against the obligor, a security interest over the underlying *Sukuk* assets themselves. In other words, they deemed themselves to be a secured creditor.

If the security interest over the assets was not perfected in the name of the *Sukuk* holders, then the *Sukuk* holders may not have any security rights over them.[14] In a number of *Sukuk*, perfection of the security interest was not made over the underlying assets. Jurisdictional impediments, such as the prohibition of foreign ownership of real estate assets in certain GCC states, played a significant part in this failure to register the ownership.[15] Also, many investors were concerned that they were taking on additional risk (asset risk) along with credit risk. However, *Sukuk* holders will ultimately need to balance the objectives of what the *Shari'ah* is trying to achieve with that of their own investment risk criteria.

Cross Default

Once a *Sukuk* defaults, cross-default provisions in the obligor's financial agreements may kick in. In other words, a payment obligation that is not met under a financial agreement may give rise to claims under other financial agreements. Such cross default scenarios may require renegotiating repayments with all creditors together to avoid unfair preferential treatments.

Restructuring Options

Though a common tactic under conventional restructurings, extending the payment terms is not always possible under *Sukuk*. It largely depends on the *Sukuk* structure used.

Restructuring of asset-backed *Sukuk*, especially when the underlying assets have been transferred on a true sale transaction, is not possible. Under *Shari'ah*, in the absence of any fraud or gross negligence, the terms of an asset sale cannot be renegotiated after the sale has already been concluded. Thus, the payment terms cannot simply be extended. Doing so could also mean that the issuance is no different from a conventional financial debt transaction. The easiest to restructure however is the *Ijarah Sukuk*. The *Ijarah Sukuk*, given its relative flexibility in terms of adjusting profit levels and repayment terms, as compared with other *Sukuk* forms.[16] *Shari'ah* permits with mutual consent of the parties, the extension of a lease period and the readjustment of the periodic rental payments. Furthermore, the parties can agree to replace the leased assets if required. Investors can exercise their rights on the leased assets. It is no wonder that this has been the favorite structure for most *Sukuk* issuances. However, the *Ijarah Sukuk* does highlight some concerns of its own.[17]

Another restructuring device available in *Sukuk* restructurings is that of a 'haircut'. The concept of the investors taking a reduction on their investment in order to induce early repayment has been approved by AAIOFI.[18] But would a discount be acceptable in all types of *Sukuk*? In *Musharakah* and *Mudarabah Sukuk*, haircuts may not be made if the structure allows for any profit or capital guarantees. However, the AAOIFI pronouncements in February 2008, purchase undertaking of the *Mudarib's* capital could be deemed as an impermissible form of capital and project guarantee. In these cases, new revised securities would have to be agreed to replace the existing *Sukuk*.

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[13] *Supra* 9.
[14] Security rights include as, such as having possessory control over the asset, the ability to issue notices to the relevant parties, or to make court filings over the respective assets.
[15] *Supra* 12.
[16] Mohammed Khnifer, '*Stand and Default*,' Islamic Business & Finance: CPI Financial. Oct 2010.
[17] The unsecured Nakheel *Sukuk* restructuring showed that the valuation of the physical assets upon which the *Sukuk* was priced did not match the realization price had it actually defaulted, thus leaving the *Sukuk* holders well out of pocket. See also Blake Goud. *'Should Islamic Finance move Away from Unsecured Debt?'* Zawya. Dec 9, 2009.
[18] *Supra* 23.

Finally, debt for equity swaps is permitted under *Shari'ah* law. In a debt to equity swap, the creditors generally agree to cancel some or all of the debt in the exchange for equity in the borrowing entity. For *Sukuk* holders, this may also involve agreeing on a haircut of their expected profits.[19]

Approvals

Shari'ah board approval of any restructuring plan is critical, the fear being that what was once certified as *Shari'ah* compliant has become non-compliant post-restructuring. In particular, compliance of any new amendments to the financial documentation and the refinancing structure.

Reliance on the issuer's appointed *Shari'ah* board is another issue. Some creditors may choose to rely on the issuer's board, while others may require independent *Shari'ah* verification.

GCC Insolvency Regime Obstacles

Bankruptcy and insolvency laws in some countries, like the GCC, have yet to be properly developed and tested. At the time of writing, a UAE developer has filed for liquidation, one of the first UAE court mandated bankruptcies of a distressed property developer.[20] The *Sukuk* defaults that have occurred prompted action on improving insolvency regimes and rules.[21] However, they still suffer from the following key hurdles:

- The lack of proper laws, guidelines and institutions to deal with insolvency;
- Insufficient qualified insolvency practitioners, trustees and advisors in insolvency procedures;
- Insufficient non-court alternatives to deal with insolvency matters;
- Balancing creditor and debtor interests;
- Enforcement of restructuring plans and binding them on all claimants; and
- The staying of litigation in connection with a default during restructuring negotiations.[22]

Enforcement of Decisions

If a *Sukuk* default is litigated in the courts, especially in the GCC states, most cases would be affected by legal risk. For instance, decisions taken by foreign courts, such as in the UK, may not be enforced or respected in the GCC. In the UAE, courts under its federal law are permitted to re-open and examine the merits of a claim, set aside the parties' preference on choice of law (if other than UAE), and may challenge foreign judgments that are perceived to run counter to UAE public policies.[23]

Muhammad Al-Bashir Muhammad AL-AMINE, *Group Head* - Shari'ah Assurance Dept**.,**
Bank Al Khair, Bahrain

INSOLVENCY AND RESTRUCTURING IN ISLAMIC FINANCE:

Importance

Well established insolvency and restructuring regimes and debtor- creditor rights systems are a critical part of market infrastructure in any financial market. They are vital for numerous raisons. According the World Bank these reasons include (i) maximizing the value of a firm's assets and recoveries by creditors; (ii) providing efficient liquidation of nonviable businesses and reorganization of viable businesses; (iii) striking a careful balance between liquidation and reorganization (iv) providing for equitable treatment of creditors of similar situations; (v) providing for timely, efficient and impartial resolution of insolvencies; (vi) preventing the improper use of the insolvency system; (vii) avoiding the premature distribution of a debtor's assets by individual creditors seeking quick resolutions and settlements; (viii) providing a transparent procedure that contains and applies clear risk allocation rules and incentives for gathering and dispensing information; (ix) recognizing existing creditor rights and respecting the priority of claims with a predictable

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[19] *Ibid.*
[20] See http://www.arabianbusiness.com/first-uae-developer-files-for-bankruptcy-363578.html
[21] Ibid. Kalantar and Delaney. Ibid. According to them, Kuwait and the UAE are considering creating new restructuring. In December of 2009, Dubai enacted Decree No. 57 of 2009 following the Dubai World restructuring.
[22] Summarized from issues the highlighted by Hessam Kalantar and Owen Delaney. *'Restructuring of Islamic Finance Transactions in the Middle East: A New Frontier for Practitioners,*' Zawya Select 2010. Nov 30, 2010. See http://www.zawya.com/story.cfm/sidZAWYA20101130072143?q=*Sukuk* ownership
[23] Neil Domonic. *'Islamic Finance: Sukuk Market on Trial as Islamic Bonds Default,*' Euromoney Magazine. July 2009. See http://www.euromoney.com/Article/2245562/CurrentIssue/72526/Islamic-finance-*Sukuk*-market-on-trial-as-Islamic-bonds-default.html

and established process; and (x) establishing a framework for cross-border insolvencies, with recognition of foreign proceedings.[24]

The above objectives and purposes are not only relevant with regard to insolvency and restructuring regimes in Islamic finance, but they are backed by some other genuine and compelling grounds that make the issue an urgent undertaking. These justifications include among others the fact that Islamic law is one of the sources of law in some Muslim countries where the Islamic finance industry is flourishing and therefore, it will not be sufficient to just borrow from Western legal systems in order to address issues of insolvency and restructuring cases or to introduce needed reforms in this important area. Moreover, there is a need to establish a workable relationship between local legislations and Islamic law to avoid any conflict. At the same time, although compliance with Shari'ah principles is the primary requirement for Islamic financial products and services, Shari'ah is not yet recognized as a national system of laws in almost all Muslim countries and therefore, subjected to various interpretations and levels of acceptability. More importantly we have the contentious issue of enforceability of Islamic financial transactions at times of default, insolvency and restructuring especially international Islamic financial transactions generally governed by English law or New York law.

Causes

Looking at the different causes behind the cases of insolvency and restructuring particularly following the recent economic and financial crisis, reasons such as the divorce between real economy and financial economy, dependence on some highly speculative modes of finance or the use of interest based financial instruments and imprudent lending by financial institutions can be enumerated with regard to the conventional financial system. With regard to Islamic financial institutions one may mention the effects of the 2008 global financial crisis and more recently, the negative effects of the so-called “Arab Awakening” and its disruption of economic activities in many countries with strong presence of Islamic finance. However, it seems that over reliance on debt financing is a common denominator for most cases of default and restructuring in Islamic finance. Sharīʻah compliant financial institutions and companies entered into numerous debt-based Sharīʻah compliant financing arrangements, often accompanied by complex security packages.[25] In all of these types of products liabilities and indebtedness can be created and as a consequence of that there is an increased probability of default and eventually insolvency and restructuring.

To address issues of insolvency and restructuring in Islamic finance transactions and towards having a coherent and practical system in this area, we need to (i) outline the broader Shariah principles that form the core basis of such a system, (ii) the present status of Islamic law rules in this area,(iii) the major Islamic instruments that can be used to develop the system and (iv) how to benefit from the best international best practices without contravening Shariah principles and (v) what are the limitations.

Broad Sharīʻah Principles

1. One of the important recommendations by Islamic law is to be lenient with a debtor facing problem. This principle is established by verse 2:280 of the Qur’an which is commonly translated as: “If a person is in difficulty, let there be respite until a time of ease. And if you forgive the debt voluntarily it would be better for you, if only you knew.”
2. The above recommendation is balanced by the fact that Islamic law compels a debtor to repay his debt obligations on time and it is considered to be a sin and not just a legal obligation not to pay off all of your debts if you have the capacity to repay: “Oh, ye who believe! Fulfill your obligations/contracts” (*’awfu bil-‘uqud*).[26]
3. Islamic law also directs us to address the main causes of the problem. Insolvency has its roots in excessive debt and therefore, Islamic law exhorts its followers not to take on excessive debt and leverage. This is by no mean an exclusion of Shariah compliant debt transactions which are an integral and vital part of any Islamic financial system.
4. Based on Islamic law prohibition of riba, the amount of debt must not be increase for the benefit of the creditor due to delay in payment. Any increase in the debt over time is a kind of ribā. Thus, issues such as

[24] The World Bank, *Principles for Effective Creditor Rights and Insolvency Systems*, Revised Draft –21 December 2005 http://www-wds.worldbank.org.

[25] Hessam Kalantar and Owen Delaney, Restructuring Islamic Finance Transactions in the Middle East: A New Frontier for Practitioners, *Islamic Finance News*, July 28,2010, pp. 16-17, www.islamicfinancenews.com

[26] Al Ma’idah (5) verse no1

interest on interest, packaging interest based instruments in the form of Collateralized Debt Obligations (CDOs), and Credit Default Swaps (CDSs) etc are not allowed in Islamic law and therefore, the bubble created through this chain of transactions is eliminated.

5. The principles of justice and equity enshrined in the objectives of the Sharīʻah (maqasid) should guide any attempt to develop a viable Islamic insolvency and restructuring regime.
6. The right of *gharimun (debtors unable to pay their debt)* is part of the eight categories of beneficiaries of zakah and therefore, should be part of Islamic law of insolvency regardless of inefficient implementation of zakah throughout the Muslim world today.

The assessment and relevance of classical Islamic law principles pertaining to insolvency and restructuring differ from one researcher to another. Some hold the opinion that "the rules of insolvency in the Shari'ah are ill-suited to create a modern bankruptcy regime"[27] or the statement that "There was no concept of bankruptcy in fiqh/classical Islamic law, merely insolvency (iflas)[28]. However, the above statements and similar positions stand in sharp contrast with some other views that maintain that

> "The classical Islamic law of bankruptcy was quite developed. The legislators in many participating countries of the Organization of the Islamic Conference will undoubtedly want to rely on this rich body of Islamic jurisprudence to inform and inspire the reevaluation of their current bankruptcy laws in light of the recent economic meltdown and the deficiencies in their existing national bankruptcy laws." [29]

It has been also stressed that

> The core of the Islamic tradition offers reformers a solid foundation on which to build a modern insolvency relief structure. This region holds tremendous promise for reconciliation between local values and ancient legal norms on the one hand, and on the other, time-tested ideas borrowed from abroad for implementing effective modern techniques for addressing financial distress. In few other areas of governance do modern Western and Islamic norms seem to dovetail so smoothly. The essential elements and policies of modern bankruptcy law resonate quite harmoniously with the long Islamic tradition of peace, compassion, reconciliation, and forgiveness. [30]

Despite these contradictory positions it is acknowledged that economic, social and political circumstances of the twenty-first century are different from those of the early days of Islam where Islamic law was developed or its later expansion through the writing of scholars throughout the past centuries. However, what is needed here is a balanced approach that is based on the principles enshrined in the primary sources of Islamic law (Quran and Sunnah) and at the same time benefits from the work of early Muslim scholars (classical fiqh) as well as from the best international best practices and experiences. It is very important to note here that although the fundamental rules of Islamic law are not subject to change, we also have rules based on ijtihād and which could be influenced by the changes of time, place and circumstances. These rules could easily change, if the bases have changed. For instance the concept of *mulāzama*, or the harassment of the debtor through the constant pursuit of him or the implementation of imprisonment of the debtor that failed to pay his debt obligations in modern times and its application to companies are examples of some of the issues that need fresh review and interpretation.

The need for reform and continued development of Islamic law principles and their application in this area is clearly manifested by the position of some of the influential institutions shaping the modern direction of Islamic law such as the Islamic Fiqh Academies based in Jeddah and Makkah and the Accounting and Auditing Organization for Islamic financial Institutions (AAOIFI). Although of some these institutions have recently addressed the issue, it is clear that further research and reforms is needed.

The Makkah-based Fiqh Academy has yet to address the issue while the Jeddah based Academy issued its first resolution (resolution no.186 -20-1) on the issue following its meeting in September 2012. However, the resolution issued by the Academy was below market expectations and failed to address some important aspects of insolvency and restructuring. After defining the related terminology which are Iflās and I'sār and the difference between the two, the

[27] Haidar Ala Hamoudi, "The Surprising Irrelevance of Islamic Bankruptcy" American Bankruptcy Institute ABI LAW REVIEW Vol. 19: 505 522

[28] Islamic Finance -Bankruptcy, Financial Distress and Debt Restructuring: A Short Report, Harvard Law School Islamic Finance Panel, September 11, 2011, p.4.

[29] Abed Awad and Robert E. Michael, " Iflas and Chapter 11: Classical Islamic law and Modern Bankruptcy", *The International Lawyer* , Fall 2010

[30] Jason Kilborn "Bankruptcy and Islam: An explicit tradition of compassion and forgiveness", *Cayman Financial Review*, April 12, 2011.

resolution outlined the restrictions that could be imposed on a bankrupt person such as preventing him through a court's decision from any transaction or traveling if that could affect the rights of the creditors. Selling his assets and distributing the proceed to creditors will be undertaken by the court and the creditors have the right to return to him for payment if he obtained new assets. The Fiqh Academy's resolution is explicit in postponing issues related to bankruptcy and insolvency of companies, or the possible Sharīʻah compliant mechanisms for debt security that could minimize the effect of any default or bankruptcy.

On the other hand, AAOIFI issued a standard on default payment by a debtor (standard no.3) in May 2000 and another standard on *Iflās* or Insolvency (standard no.43) in May 2010.The standard on default payment by a debtor outlined the major Sharīʻah principles on the issue such as the prohibition to delay in payment by a debtor who is capable or the prohibition not to stipulate any compensation for delay payment and the creditor right and entitlement to apply for the sale of any asset pledged as collateral for the debt. The standard also points out the right of the creditor or seller in a murābaḥ ah contract to repossess the asset following the buyer's default or bankruptcy and inability to pay the price. It is also permissible that the defaulting debtor makes a commitment to give a specific amount as penalty to be given as charity with the main objective of pressing customers to pay on time if they want to avoid a penalty. Furthermore, the standard refers to the right of Islamic financial institutions to blacklist a defaulting customer and inform other institutions about him.

It is clear that the standard is dealing with cases of an individual client in default and not cases whereby an institution or a corporation is facing default and insolvency issue. It also did not address the possible mechanisms of restructuring and reorganization.

On the other hand, the standard on insolvency (*iflās*) has been long overdue and eventually issued in 2010. Despite this delay it represents a step in the right direction. However, it has been observed that despite the numerous cases of restructuring and reorganization at the time the standard was drafted and promulgated, it did not address these issues. It was limited to issues pertaining to liquidation. Furthermore, the standard did not attempt to compare the classical Islamic law position on insolvency with the prevailing modern legal provisions and international best practices. Moreover, the standard is more concerned with personal bankruptcy rather than corporate insolvency particularly companies facing financial distress and liquidity shortage as it is the case of many companies in the region following the global financial crisis of 2008. Yet, corporate insolvency seems to be much closer to the organization's mandate as a standard setter for Islamic financial institutions and not the insolvency cases for individuals despite their importance.

On the other hand, government intervention in bankruptcy issues is common, especially if the liquidation involve government related entities or large conglomerate that employs large number of workers and could affect the national economy. The standard is also silent on the issue of *qharimin* (debtors) as one category of the beneficiaries of zakat and whether they can be part of those who should be supported to pay their debts and what are the conditions. However, the above observations do not deny the fact that the standard constitutes a positive step that can enrich future discussions on the subject. One example is the standard backing of the opinion that in case the debtor was declared bankrupt but his distributed asset falls short in paying back the whole debt, the creditors have no right to ask him anything more in future *qada'an* (as a matter of rule of law) but they could do so *diyanatan (*as a matter of moral obligation). The standard takes the position that insolvency can be voluntary but should not be used as a trick for other purposes .The standard elaborates on the bankrupt's obligations to refrain from being indulged in any business transaction that could harm the creditors, the responsibilities of the relevant authorities to declare him bankrupt upon the creditors' demand and restrict his managerial business actions or the fact that the declaration of bankruptcy is the prerogative of the judiciary. It also refers to principle that the dwelling house, wearing apparels and those instruments/materials used for earning livelihood by the insolvent cannot be touched by the creditors under any circumstances.

Restructuring

The Sharīʻah parameters on restructuring are generally governed by the rules of Islamic law pertaining to dealing with debt obligations whether through the selling of the debts obligations, using it as a capital of muḍ ārabah, using it as consideration and exchanging it against a commodity, swapping it with shares or even forgiving it partially or entirely. Although the development of viable instruments for debt restructuring in Islamic finance is still in its early stages, a number of alternatives from the classical Islamic law products can provide valuable guidance and direction towards developing viable debt restructuring mechanisms for modern Islamic finance. Yet, it should be acknowledged that all these alternatives were the points of strong difference of opinion among early Muslim jurists and still remain debatable among contemporary scholars. The following are some of these instruments that can be used in the restructuring process.

- Ibrā' (cancellation of debt),
- hawālā (transferring a debt liability to a third party),
- Voluntary deferment of debt obligation maturity without extracting benefit to the creditor
- Creditor acceptance to forfeit some of the debt in exchange of an immediate payment or haircut.

- Conversion of debt liabilities into shares
- Using debt obligations as a capital for a new muḍ ārabah venture
- Providing a new *tawarruq* financing to the defaulting party so that he can repay the old liabilities while incurring new liabilities under the concept of *qalb al-dayn*.
- Using *salam* debt as a price for a new commodity to be purchased
- Selling an asset portfolio with a unilateral promise to repurchase it back

Issues

1. As alluded to earlier Islamic finance can benefit from some of the existing international best practices and experiences as long as they do not contradict Sharī'ah principles. The USA Chapter 11 on restructuring and reorganization for instance, is considered as an example of modern insolvency legislation[31] and there is an attempt to adopt some of its provisions by some of modern legislative reforms in some countries where Islamic finance is flourishing. Moreover, at least two cases of insolvency and restructuring involving Islamic finance, namely Cameron Sukūk and Arcapita restructuring case are filled recently under the provisions of Chapter 11 of the USA. However, a balance needs to be maintained while dealing with such legislations so that the Sharī'ah principles of justice and equity are maintained and at the same time the shortcomings of such legislations are avoided as much possible. In fact, Chapter 11 has not been homogenous over time and some have criticized it for being too lenient on debtors. The practical application of Chapter 11has changed over time.[32] Moreover, misuse of such legislations is well recorded as it is case with the concept of "strategic bankruptcy" whereby organizations may file bankruptcy petitions to shift potential or pending financial risks to other parties. Companies may also use bankruptcy as a strategy in litigation, merger negotiations[33]. This is unacceptable in Islamic finance as it is against the principles of justice, equity and transparency.
2. Although the notion of a separate corporate personality and limited liability is now part and parcel of Islamic law parctice, however, the particular details of the concept with reference to insolvency and restructuring need a fresh review and study based on the Shariah principles of justice and fairness.
3. Law reform by itself is not sufficient for an efficient insolvency and restructuring regime. True reform also requires a holistic approach, addressing the capacity and efficiency of local courts, and therefore, the training of judiciary and the development of a body of experienced insolvency professionals having Islamic law background is a precondition for better implementation.
4. Developing out-of-court alternatives for resolution of insolvency issues, including rescue and restructuring. This is also prompted by the fact there are many Islamic finance restructurings cases that are taking place consensually, out of court.
5. Investor rights in asset-based ṣ ukūk following insolvency and restructuring need particular attention. The confusion that followed some of the cases of sukuk default and the right of sukukholders following the recent financial crisis needs to be addressed. Although investors own the underlying assets of the sukuk, they have no right of direct resort to these assets at the time of default and insolvency.

M Iqbal ASARIA, *Secretary General, Muslim Council of Britain*, London, U.K.

INSOLVENCY AND DEBT RESTRUCTURING

The subject lends itself to a very timely discussion.
The lessons from the default and near default of Sukuks and other financing are worrying. We can divide the issues into a number of categories:

Governing Law and its implications

Many of the contracts state English Law as the relevant law governing them. It thus becomes important to see what implications this will have. Under English Law, the proper law of contract must be the law of a country, so English

[31] Michael J.T. McMillen *An Introduction To Shariah Consideration in Bankruptcy and Insolvency Contexts and Islamic Finance First Bankruptcy (East Cameron)*
[32] Isthumus *Restructuring in the MENA Region A Practical Approach*, February 2011 p.18. www.isthumuspartners.ae.
[33] Ena Rose-Green and Mark Dawkins, "Strategic Bankruptcies and Price Reactions to Bankruptcy Filings", *Journal of Business Finance & Accounting*, 29(9) & (10), Nov./Dec. 2002, pp.1319-1335.

courts would disregard a choice of law clauses which stipulate Shariah law or non-national law as proper law of contract and apply English law rules unless the provisions of non-national law were incorporated into the contract as contractual terms for the purposes of siding the interpretation of specific aspects of the contract. So there must be sufficient certainty and clarity as to the provisions which are to be incorporated. The doctrine of incorporation can sensibly operate where parties have by the terms of the contract specifically identified specific "black letter" provisions of foreign law or an international code or set of rules apt to be incorporated as terms of relevant contracts, such as particular Articles of French Code or the Hague Rules. The general reference to principles of Shariah in this case afford no reference to, or identification of, those aspects of the Shariah law which are intended to be incorporated into the contract. The alleged basic rules are neither referred to nor identified (these were the observations in Shamil Bank's case). It was further observed in the Shamil Bank's case that the general reference in the Financing Agreements to Shariah law was, therefore incapable of incorporating Shariah law into the contracts. It appears that incorporation may have been successful if the parties had stipulated specific "black letter" provisions of Shariah law.

The other aspect is the approach of the English courts towards the principles of Shariah. Para. 55 of the judgement in the Shamil Bank case is important, in this respect. "So far as the principles of Shariah are concerned, it was the evidence of both the experts that there are indeed areas of considerable controversy and difficulty arising not only from the need to translate to proposition of modern law texts which centuries ago were set out as religious and moral codes, but because of the existence of a variety of schools of thought with which the court may have to concern itself in any given case before reaching a conclusion on the principle or rule in dispute."

The use of English Law as governing law is thus fraught with serious implications. However, if this has to be done for a number of reasons then recourse to any Alternative Dispute Resolution mechanism must be available. Only when such ADR fails then litigation should in courts be contemplated.

Alternative Dispute Resolution

So far very little use has been made of a genuine dispute resolution mechanism. Some work has started on a distinct Islamic Dispute Resolution (IDR) mechanism as opposed to the conventional Alternative Dispute Resolution mechanism. This could infuse the spirit of Shariah into the mechanism and also avoid defaults etc unless absolutely necessary.

ADR in commercial disputes has been an established process in English law. However, whether this principle can be stretched to aspects of religious law is debateable. Developments in Rabbinical Law and other faith law in the UK provide promising avenues.

There is now an established tradition of binding arbitration by the parties to a dispute in Rabbinical Courts and talk of similar extension with regards to civil disputes in Shariah arbitration councils. Any such agreed arbitration would become binding and would be backed by higher courts in the UK.

There have been ideas mooted to devise a similar regime of arbitration for disputes on Islamic finance. The modalities of what needs to be done are still to be worked out but many well informed lawyers think that this is doable. In this case it would be appropriate to have relevant arbitration clauses inserted into the contracts to enable the process to be made transparent.

Currency of Issuance and Extra territoriality

Whilst English Law continues to be the favourite for governing law, the US dollar seems to be the currency of choice. However, this poses the question of extra territorial reach of US courts over any disputes involving US dollar transactions. Class actions brought in US courts by qualified persons can allow these courts to exercise jurisdiction or issue orders for freezing of assets and such like. This has been the favourite technique of "vulture" funds in the case of sovereign debt restructurings.

Since subscribers to Islamic Finance offerings can be US institutions, subsidiaries of US institutions or can become resident in the US, this possibility needs to be factored in. English jurisdiction will not afford protection in such cases as US dollar clearance via New York offers US based litigants' ample opportunity to frustrate any unfavourable outcome.

Abdul Kadir BARKATULLA, *Mufti and Islamic Finance Sharia Scholar*, London, United Kingdom

INSOLVENCY AND DEBT RESTRUCTURING: SHARIA DELIBERATIONS

General Observation

Commitment leading to indebtedness is a natural consequence of exchange through trade and investment activities. Even in a barter economy debt obligation would have been created. Need for quantification of obligations in post barter era, led to utilisation of standard objects as money. Essentially usage of monetary representation in itself is a quest for acceptable means of settling indebtedness. Insolvency and debt problems remained local and personal in most rural economies. Apart from occasional inflation, stable monetary representation can be seen as fair and just attempt to settle relative values of goods and services. Insolvency of individuals or entities indicates failure of business expectations, apart from events of force major or fraudulent wilful misrepresentation.

In post industrial society, as pace of change and business exchanges accelerated to unprecedented level, insolvency and debt issues also acquired an epidemic magnitude. 19th and 20th centuries witnessed their fair number and scale of debt related issues to be dealt with. Legislations to deal with problems of debt were promptly developed to introduce an orderly resolution and bring about a level of certainty in post debt settlement deals. There remains a level of lean towards investor protections rather than business salvage. This is evident in statistics of liquation in Europe, after bankruptcy filings. In 21st century globalised world, debt and insolvency not only affected individuals or entities, but crossed boarders into countries and continents.

Problem of individual insolvency and indebtedness can be viewed as financial viral infections before it converts to an epidemic if not dealt effectively with fairness and balance.

The purpose of insolvency and bankruptcy procedures and legislations should be to serve as a financial hospital for people sick with indebtedness and those affected with them. Only in cases of chronically infectious disease we need to confine the sick to isolation units (debarring and imprisonment of debtors).

Islamic belief and value system is full of financial lifestyle guidelines and pre-emptive and deterrent measures. Accountability, including financial, is fundamentally incorporated in the articles of belief (day of reckoning and judgement). There are ample commandments for educational purposes to mould behaviour of individuals and to shape financial culture and prevent repeated financial mess.

Islamic Sharia Propositions

Islamic Shariah Laws of insolvency and indebtedness are merely dispute resolution mechanism where rights of creditors/debtors and other stack holders are finely balanced. Shariah norms provide enough flexibility at the stage partnership/corporation formation to have differential formulas to share profits, but at times of windup and insolvency strict ration of capital and debt to be observed. Further, consequences of financial miss management, failed obligations/contracts with wilful misconducts are very grave and long term indeed and affect us all.

Individual Insolvency and Indebtedness

Despite all the precautions and checks and balances, individual distressed situation are dealt with comprehensively without favours or prejudices with either creditors or debtors. In circumstances beyond one’s control, creditors are urged to be considerate, and either differ the repayment schedule or accept less in settlement, as per norms and customs of social circumstances determined by independent judges.

Further, members of social network are urged to allocated Zakat, Sadaq, charitable collections and out of public funds to compensate the creditor of distressed debtors as well.

AAOIFI Sharia Standard # 43 has outlined briefly required Sharia considerations in principle only. It should be noted, as advocated by the standard also, that Sharia is not very particular about procedures and manners in which balance and fairness is administered. It is left to local jurisdictions and customs to deal effective and efficiently with general guidance of maintaining fairness and justice, balancing and protecting rights of all stack holders in the incidents of insolvency and indebtedness.

Limited Companies And Corporation’s insolvency

Modern economies go through the cycles of boom and recession. These cycles coincide with high and low levels of bankruptcies. Deeper and longer the recession higher the rates of insolvency. Ever since financial crises of 2008, insolvency and bankruptcy regimes have come under scrutiny and there are serious calls to reform them to achieve better balance between the rights of various sack holders. Further, European sovereign default and debt restructuring has added another dimensions to the whole phenomenon.

Shariah compliant businesses are not immune to general economic environment. Though Sharia based products and institutions demonstrated a little higher degree of resilience during the down turn, but they still suffered their fair share of insolvency and debt restructuring. In dealing with insolvency, Sharia principles seem not treating corporations and individual partnerships differently. As evident from AAOIFI Shariah Standard #43, there are very few distinct Islamic characteristics of insolvency regimes, apart from fairness, justice, and stack holder considerations as per customs and practices of judicial system. Therefore I propose that Islamic Financial Services Board, IFSB, to formulate guidelines of incorporating AAOIFI Standard #43 into various national jurisdictions and legal formulations.

Effective insolvency and creditor, investor and debtor regimes generally enable market participants to more accurately price, manage and control default risk and corporate failure. Effective regimes encourage sound credit practice and promote responsible corporate behaviour. They also encourage higher standards of corporate governance and financial discipline to avoid the consequences of insolvency. For instance in cases of individual executive negligence and wilful misconduct, they should not be immune to prosecutions and imprisonment as it is currently implicit that most executives and directors are let off post winding ups and insolvencies.

Shariah Approaches to Debt Restructurings

It is noteworthy that modern insolvency systems allow for rehabilitating financially distressed but viable enterprises, while enabling reallocation of assets to more efficient market user through efficient liquidation systems, thereby creating conditions contributing to preserve employment, a factor often absent in classical insolvency regimes. Collective restructuring schemes are considered improper under Shariah.

Shariah compliant restructurings have generated a lot of attention not only because their large-scale nature was unprecedented but also because of the requirement for a majority of these restructurings to remain Shariah compliant.

Some of the more visible examples of Shariah compliant restructurings in recent times include those of The Investment Dar and Global Investment House in Kuwait, and Dubai World in the UAE. These restructurings have highlighted some pivotal issues to be considered and addressed when arranging a Shariah compliant restructuring. They also offer lessons for the future.

Involvement of Shariah Boards

A key element to the success of Shariah compliant restructurings is the involvement, and ongoing dialogue with, the relevant Shariah boards from the outset. It is clear from recent Shariah compliant restructurings that Shariah boards are willing to revisit the fundamental principles of current Shariah compliant financing arrangements and are open to considering other innovative structures. The key to all of them has been balancing the interests of multiple Shariah boards with sometimes competing interests of a diverse creditor group.

Secular jurisdiction clauses of Shariah compliant contract are a useful interface between Shariah and default/insolvency resolution courts. This interface is illustrated in East Cameron Oil and Gas Sukuk case in US and Beximco V Shamil Bank case in the UK. Issues pertaining to settlement such as delayed debt payments, equity conversion, asset sale and differential equity concepts are under active consideration of Shariah research and development.

In conclusion, it is fair to assert that, the shared values of risk-sharing, ethical conduct and exercise of forgiveness provide a workable interface between insolvency regimes of Islamic financial transactions/institutions and conventional financial systems. It is also a shared interest between regulators, legislators, judges and creditors/debtors that mechanism for the orderly and equitable resolution of insolvency of Islamic transactions and entities.

Farmida BI, *Partner*, Norton Rose, LLP, London, U.K.

CHAPTER 11 OF THE US BANKRUPTCY CODE

Background

The principal goal of Chapter 11 and the US Bankruptcy Code (Chapter 11) is to reorganise the business of a company in financial distress and to allow the debtor to emerge from Chapter 11 as a going concern, or the debtor's business to be sold to realise value for its creditors on a full going concern basis. Where a rescue of the debtor is unachievable, Chapter 11 can also be used to effect the liquidation or sale of the debtor's assets for the benefit of its creditors.

Chapter 11 assumes that the most effective way to reorganise the business of a company and achieve one of the two results above is to retain the business's management and enable multiple outcomes either through a plan of reorganisation, a series of going concern sales and even a liquidating plan. Chapter 11 enables a wide range of proposals to be put into a reorganisation plan, including having the company and its management survive the process.

During a Chapter 11 process, the debtor's management, including the board of directors, continue to control the debtor's business and assets, albeit with oversight from the office of the US Attorney General (in the formal role of the **US Trustee**), the bankruptcy court, the appointed creditors' committee, other unofficial ad hoc creditors' committees and, often, turnaround specialists appointed to the debtor's management at the instance of its creditors.

Details of the Chapter 11 procedure

Commencement and automatic stay

Chapter 11 is usually commenced voluntarily with the debtor filing a petition with the court, which includes a list of creditors and a summary of assets and liabilities. The application must be in 'good faith' with the intention of reorganisation, or to effect a liquidation or sale of a company, and creditors may apply to have petitions dismissed where this is not the case.34 Creditors may file an involuntary proceeding if certain conditions are satisfied.35

Upon filing a petition the debtor automatically assumes the identity of the "debtor in possession" (the DIP).36 The term refers to a debtor that keeps possession and control of its assets while undergoing a reorganisation under Chapter 11, without the appointment of a case trustee.

Immediately upon the filing of a bankruptcy petition, a moratorium or "automatic stay" takes effect. The automatic stay provides a period of time in which all judgments, collection activities, foreclosures, and repossessions of property are suspended and may not be pursued by the creditors on any debt or claim that arose before the filing of the bankruptcy petition. A party who takes any action in violation of the automatic stay risks contempt of court actions and penalties. Also, any act done in contravention of the stay is retroactively made void or voidable by the court. The stay is effective during the entire time the case is pending but creditors and other parties may make motions to lift or modify the stay.

Lifting the stay

There are a number of grounds on which the court may be prepared to lift or amend the terms of the automatic stay with regard to a particular creditor, including the lack of adequate protection of the interests of a secured creditor.

Generally, any affected party can apply to court at any time after the filing of a bankruptcy petition for relief. Once such a motion is made, the stay will expire after 30 days unless within such time a court continues the stay pending a final hearing or the affected party consents to such continuation pending a hearing. The court may terminate the stay, modify it or subject it to conditions. The court may lift the stay for cause, but is generally reluctant to do so during the initial stages of a Chapter 11 case because of the general presumption that a debtor should be given a chance to reorganise and prepare a reorganisation plan.

The reorganisation plan

[34] US Bankruptcy Code paragraph 301, 303

[35] US Bankruptcy Code paragraph 301, 303 states that a large company may also be involuntarily pushed into a Chapter 11 case if three creditors holding unsecured non contingent undisputed claims aggregating more than USD 11,625 file an involuntary petition against the company and if the company is "generally not paying [its] debts as such debts become due". The company may contest the petition and if the above standard is not met, may file suit against the filing creditors for costs and/or reasonable attorneys fees or, if filed in bad faith, damages, including punitive damages.

[36] US Bankruptcy Code paragraph 1101

The reorganisation plan is a court-approved document that sets out the terms of the debtor's agreement to reorganise and may also include a proposal for the sale of all of the debtor's property and the debtor's eventual liquidation.

The debtor has a period of 120 days from the date of the Chapter 11 order during which it has the exclusive right to propose and file a reorganisation plan (the Exclusivity Period).37 The debtor may then seek creditors' binding agreements to the plan (known as "soliciting acceptances") for a total of 180 days from the date of the Chapter 11 order.38

Before solicitation of acceptances of the plan, the debtor or trustee must prepare a disclosure statement which must be approved by the court. The disclosure statement must contain information concerning the assets, liabilities, and business affairs of the debtor sufficient to enable a creditor to make an informed judgment about the debtor's reorganisation plan.39 The contents of the reorganisation plan must include a classification of claims and must specify how each class of claims will be treated.40 At least 25 days notice of the hearing to consider the disclosure statement must be given to creditors. If the court approves the statement, it will also fix voting procedures and set a confirmation hearing date on at least 25 days notice to creditors. As a practical matter, once a plan is timely filed, the Exclusivity Period is likely to be extended. This is more likely if the disclosure statement has been approved and the plan has been sent out for vote.

After the end of this period the creditors' committee or any individual creditor can propose its own reorganisation plan. Creditors' committees can play a major role in Chapter 11 cases, especially with regards to the proper management of the company's business by the DIP. The creditors' committee is appointed by the US Trustee and ordinarily consists of unsecured creditors who hold the seven largest unsecured claims against the debtor.41 Amongst other things, the creditors' committee consults with the DIP on administration of the case, investigates the debtor's conduct and operation of the business, and participates in formulating a reorganisation plan.42 A creditors' committee may, with the court's approval, hire an attorney or other professionals to assist in the performance of the committee's duties.

Chapter 11 requires creditors to be designated into classes: for each class whose rights have been impaired, that class have the right to vote in favour by a majority in number and two-thirds in amount of those actually voting.43 The minority is bound by the class vote, provided that the plan provides to each creditor at least what it would have received in a liquidation of the debtor (this is known as the "best interest" test.)

The classification of creditors is based upon the premise that claims that are substantially similar should be classified together. Secured creditors holding liens with different priorities on the same collateral are to be separately classified and as a general rule, unsecured creditors are classified in one class. There may, however, be reasons why certain unsecured creditors should be treated differently: some variation in plan treatment, as among creditors having a pari passu right against the debtor, is permitted, provided that such difference does not unfairly discriminate against a class of creditors. Generally, the classification scheme is part of the debtor's reorganisation plan proposal.

The Exclusivity Periods may be extended by the court up to a maximum of 18 months for the filing of the plan and 20 months for the solicitation of acceptances.44 It is likely that the plan will provide for one or more of the following:

- an infusion of new equity from existing holders or from third-party investors;
- new cash funding from third-party lenders;
- new debt issued to creditors to replace, or partly pay their existing debt;
- a debt for equity swap;
- a sale of the non-core aspects of the debtor's business; or
- a sale of all or substantially all of the debtor's assets and a distribution of the proceeds to creditors.

In practice, debtors typically seek extensions of both the plan filing and plan acceptance deadlines at the same time so that any order sought from the court allows the debtor two months to seek acceptances after filing a plan before any competing plan can be filed.

If the Exclusivity Period expires before the debtor has filed and obtained acceptance of a plan, other parties in interest in a case, such as the creditors' committee or a creditor, may file a plan. Such a plan may compete with a plan

[37] US Bankruptcy Code paragraph 1121(b)
[38] US Bankruptcy Code paragraph 1121 (c)
[39] US Bankruptcy Code paragraph 1125
[40] US Bankruptcy Code paragraph 1123
[41] US Bankruptcy Code paragraph 1102
[42] US Bankruptcy Code paragraph 1103
[43] US Bankruptcy Code paragraph 1126(c)
[44] US Bankruptcy Code paragraph 1121(d)

filed by another party in interest or by the debtor. If a trustee is appointed, the trustee must file a plan, file a report explaining why the trustee will not file a plan, or submit a recommendation for conversion or dismissal of the case.

In a Chapter 11 case, a liquidating plan is permissible. Such a plan often allows the DIP to liquidate the business under more economically advantageous circumstances than Chapter 7 liquidation (where proceeds are distributed to creditors without continuing the debtor's business). It also permits the creditors to take a more active role in fashioning the liquidation of the assets and the distribution of the proceeds than in a Chapter 7 case.

A Chapter 11 case may continue for many years unless the court, the US Trustee, the committee, or another party in interest acts to ensure the case's timely resolution. The creditors' right to file a competing plan provides incentive for the debtor to file a plan within the Exclusivity Period and acts as a check on excessive delay in the ase.

Adversary proceedings

Before confirmation of a reorganisation plan, several activities may take place in a Chapter 11 case. Continued operation of the debtor's business may lead to the filing of a number of contested motions. The most common are those seeking relief from the automatic stay, the use of cash collateral, or to obtain credit.

There may also be litigation over executory (i.e., unfulfilled) contracts and unexpired leases and the assumption or rejection of those executory contracts and unexpired leases by the DIP. Delays in formulating, filing, and obtaining confirmation of a plan often prompt creditors to file motions for relief from stay, to convert the case to Chapter 7, or to dismiss the case altogether.

Frequently, the DIP will institute a lawsuit to recover money or property for the estate. Adversary proceedings may take the form of lien avoidance actions, actions to avoid preferences, actions to avoid fraudulent transfers, or actions to avoid post-petition transfers.45 At times, a creditors' committee may be authorised by the relevant bankruptcy court to pursue these actions against insiders of the debtor if the plan provides for the creditors committee to do so or if the debtor has refused a demand to do so. Creditors may also initiate adversary proceedings by filing complaints to determine the validity or priority of a lien, revoke an order confirming a plan, determine the dischargeability of a debt, obtain an injunction, or subordinate a claim of another creditor.

Generally, any creditor whose claim is not scheduled (i.e., listed by the debtor on the debtor's schedules) or is scheduled as disputed, contingent, or unliquidated must file a proof of claim (and attach evidence documenting the claim) in order to be treated as a creditor for purposes of voting on the plan and distribution under it. If a scheduled creditor chooses to file a claim, a properly filed proof of claim supersedes any scheduling of that claim.

Confirmation of the reorganisation plan

A Chapter 11 proceeding concludes with the relevant bankruptcy court's confirmation of the reorganisation plan. A reorganisation plan can be confirmed if at least two-thirds in principal amount and one-half in number of the allowed claims (being claims that the court has approved for payment under the plan of reorganisation) of each class of impaired creditors and shareholders, respectively, have accepted the plan (unimpaired creditors are conclusively deemed to accept the plan).46 Creditors whose claims are "impaired," (i.e., those whose contractual rights are to be modified or who will be paid less than the full value of their claims under the plan), vote on the plan by ballot.

The court may confirm a reorganisation plan even if the voting thresholds above have not been achieved in any impaired class (including shareholders) if the plan does not "discriminate unfairly" and is "fair and equitable" with respect to the dissenting class. In other words, the court can, in appropriate circumstances, force creditors to accept a plan (known as a “cram down”).

This allows the debtor and its creditors to agree, for example, to a plan that provides for the issue of new shares in exchange for debt, despite the objections of certain junior creditors or shareholders. When invoking cram down in respect of dissenting shareholders, the debtor only has to show that the plan of reorganisation would pay the shareholders at least the liquidation value of their shares.

Once the plan is confirmed it binds all creditors and the property re vests in the debtor company clear of all pre-petition claims (and subject to any of the terms of the plan).47 Where a debtor is unable to confirm a plan, the Chapter 11 case may be dismissed or converted to a Chapter 7 case.48

There is no prohibition against re-filing for Chapter 11. This is true even if a case is dismissed, or even if a case ends with a confirmed plan.

Discharge

[45] These proceedings are governed by Part VII of the Federal Rules of Bankruptcy Procedure
[46] US Bankruptcy Code paragraph 1126(c), 1126(f)
[47] US Bankruptcy Code paragraph 1141
[48] US Bankruptcy Code paragraph 1112(b), 1112(c)

Confirmation of a plan discharges a debtor from any debt that arose before the date of confirmation.[49] After the reorganisation plan is confirmed, the debtor is required to make plan payments and is bound by the provisions of the reorganisation plan. The confirmed plan creates new contractual rights, replacing or superseding pre-bankruptcy contracts.

Shariah in Chapter 11

There is essentially no precedent on Shariah contracts being enforced in US courts. The East Cameron oil and gas sukuk is the first Shariah compliant instrument to be considered by a US Bankruptcy Court in a formal bankruptcy or insolvency proceeding. The East Cameron Partners Sukuk (the ECP Sukuk) was issued in July 2006 and raised USD 175 million of sukuk certificates due July 2016 and on 16 October 2008, East Cameron Partners (ECP) filed for bankruptcy under Chapter 11. Pursuant to a settlement among ECP, the trustee for the ECP Sukuk and certain of the ECP Sukuk investors worked together on the sale of ECP's assets, which approved by the Bankruptcy Court. The ECP Sukuk has effectively been consensually un-wound by the ECP Sukuk investors, with the underlying assets being transferred for the benefit of the ECP Sukuk investors.

The ECP Chapter 11 reflects that conventional bankruptcy law may be adequate for dealing with Islamic structures when the Issuer files for bankruptcy protection in the United States. However, so far as we know, the ECP Chapter 11 case and related litigation did not produce any controlling and binding precedent or other meaningful insight regarding how a sukuk (or other Islamic structure) would be handed by a Bankruptcy Court in the United States that may be used to require the same outcome in a future Chapter 11 case involving another Islamic structure, because the disputes concerning the validity of the ECP Sukuk were resolved in large part through a consensual settlement, rather than a judicial decision.

Humayon DAR, *Professor*, London, United Kingdom

INSOLVENCY & DEBT RESTRUCTURING IN ISLAMIC FINANCE

Introduction

While insolvency is a well-established area of interest in Islamic law and finance, debt restructuring is attracting a lot of interest in the context of the practice of Islamic banking and finance. While it may be argued that the issue of debt restructuring must be addressed urgently in light of an increasing number of high-profiled defaults in Islamic finance, the issue must be dealt with caution, as it may prove to be a back-door entry for the acceptance of interest in an Islamic economic framework.

There are already some voices being heard in the Islamic financial markets that the default penalty be institutionalised in the form of a permanent feature of the contracts used in Islamic banking and finance. These arguments are based on the misunderstandings around the notion of the "time value of money". In the context of Malaysia, there are some very high-profiled Islamic banking and finance practitioners who very openly advocate for trading in debt, any decision taken on debt restructuring is bound to open a floodgate of malpractices in Islamic banking and finance, in the name of necessity and exceptions. As we are all aware, most Islamic bankers bring many cases to their respective Shari'a boards in the name of necessity and exception to seek favourable decisions on the transactions that are otherwise clearly against the letter and spirit of Islamic law. If a hasty solution is created around debt restructuring in Islamic banking and finance, it could be disastrous in its results.

The Nature of Debt Restructuring

The need for debt restructuring arises from the inability of the debtor to pay their debt on time. There is clear Quranic injunction on the treatment of inadvertent default by the debtor. Admittedly, an unambiguous reference in this injunction is to the personal loans. However, this should be applicable in case of the corporate debt as well, as long as the default is inadvertent. The case of advertent default is condemned by the Prophetic tradition, and this condemnation should be relevant to both the individuals and the businesses.

While debt remains a viable option in the conduct of an Islamic business, it must be understood that it is hard to find a justification for inclusion of debt in the capital structure of an Islamic firm. The use of debt takes the form of buying on credit, and the contemporary use of Sukuk in raising capital in the form of debt is a modern phenomenon. It is, therefore, important to debate the issue of debt restructuring in the context of capital structure of an Islamic firm.

[49] US Bankruptcy Code paragraph 1141(d)(i)

In the context of Sukuk, the issue of debt restructuring should be taken up with reference to recourse to the assets underlying a Sukuk transaction. In my opinion, there should ideally be no provision for debt restructuring but if it has to be done, this shouldn't involve the change in the lending rate (arising effectively from an increase in the price of the commodity solved, eg, in case of a Murabaha credit sale). The use of commodity Murabaha in this context should be restricted; otherwise it will open a back door for the acceptance of interest in Islamic finance.

Mohammad Omar **FAROOQ**, Head, Centre for Islamic Finance, Bahrain Institute of Banking and Finance, Bahrain

INSOLVENCY AND DEBT RESTRUCTURING IN ISLAMIC FINANCE

(Please note that due to Dr Farooq illness he had to cancel the trip and comments remained incomplete but provided at the organizer's request)

Insolvency, delinquency and even bankruptcy have been part of the business and financial mosaic of human society. With the complexities of the modern times, the issues have become a lot more challenging and elusive.
The problems of insolvency and debt structuring are integral part of the conventional finance. Being closely tagged to its conventional counterpart, Islamic finance also has, comparable challenges. With higher expectation from the Muslim society and greater scrutiny from the conventional counterpart, it is important to explore these challenges so that the contentions from the Islamic finance side and the methods and approaches to solving problems are grounded in both research and reality.
What is presented here is not a coherent, self-contained, adequately articulated article, but an outline of some of the issues that should be part of any substantive discourse about insolvency and debt structuring.

a. Insolvency and debt structuring

A person is insolvent if they are unable to pay their debts when they are due. Insolvency leads to varying degree of consequences, some of which can be mitigated or minimized by suitable debt structuring. There are issues/challenges pertaining to prevention of insolvency and there are other issues when insolvency does occur which would require major steps, including debt structuring.

b. The challenge of debt culture and debt-orientation

It is unfortunate that quite like modern medicine where there is primary emphasis on treating the ill than on preventive health, there is a much greater focus of post-crisis solutions than on preventive measures.

Modern economic and financial systems are heavily debt-oriented and based on a deeply-rooted debt culture, where the entire life-style or standard living can be highly and unsustainably leveraged.

Contemporary Islamic finance identifies interest as the core or central culprit. However, while interest has its effects that can be negative, even at zero interest rate borrowing parties can accumulate debt that can be excessive or unserviceable.

c. Debt creating modes in Islamic finance

Islam is not against debt, when needed, but Islamic values are against debt culture and debt-orientation. While criticizing and condemning the western conventional system, Islamic finance is demonstrating similar trend toward debt-orientation and even fostering a debt culture. Notably, overwhelming majority of the Islamic finance modes is debt-creating, which has economic consequences similar its conventional counterpart. Unfortunately, this is not only being commonly ignored, but also credit-based lifestyle is being actively and systematically promoted by various IFIs.

d. Normal "debt structuring" (simple refinancing) vs. "troubled debt restructuring" (TDR)

Simple refinancing is not a major issue of concern, but TDR is. Three factors to identify TDR include: (a) an existing credit agreement requiring formal renewal, extension and/or modification; (b) financial difficulty of the borrower; (c) a concession from the lender that otherwise would not be considered/available.

TDR is an important issue, but more often than not it is dealt with after-the-fact, which is discussed below

e. Prevention and due diligence on the part of borrowers and lenders

An important aspect of most economic/financial crises is that after every crisis some things are tweaked to help prevent or minimize in future. However, after a while the relevant actors forget the previous crisis (crises) and start becoming complacent as usual or engage in different ways to get around, undermine or subvert the system.

There is hardly any exception in major crises where there was no failure whatsoever in due diligence on the primary actors. For example, in the most recent global financial crisis that originated in USA's sub-prime market, the lenders became irresponsible in lending and were failing in their due diligence, the borrowers were becoming greedy in seeking credit at a level that could not be defended based on their own due diligence, the policy makers, the regulators and legislators, all were sucked into an environment where their own due diligence was being compromised. Even the educators, professors, researchers were espousing their orthodox views and textbook theories, where the text book models have diverged too much from the realm of the real world to the extent that late Nobel Laureate MIT's Paul Samuelson had to admit: "What we know about the global financial crisis is that we don't know very much" and the haloed genius Alan Greenspan had to confess that his economic philosophy and understanding about the self-correcting or self-regulating of the market was flawed.

What is unfortunate is that Islamic finance is focused at the micro level of contracts and institutions, but the economy-level understanding, research and discourse have been basically seriously underdeveloped.

f. Hardship with transparency vs. without transparency

When we fail to do our due diligence and prevention to the best of our ability, of course, there will be consequences and one such consequence is insolvency and the need for "troubled debt restructuring (TDR).
 There can be many reasons for insolvency: misfortune (unfavorable economic conditions; weakened competitive position; firm specific issues, etc.); poor/bad strategy; poor/bad execution (mismanagement); over leverage; fraud, etc.

What is important is that the cases without transparency require greater scrutiny.

Conventionally, the distinction between "simple refinancing" or "troubled debt restructuring" (TDR) needs to be noted.

In case of TDR, three factors are essential:

If all three factors are present, a troubled debt restructuring has occurred, and various issues must be considered and appropriately accounted for. Some of these issues include the Statement of Financial Accounting Standards (SFAS) 114 portion of the allowance for loan and lease losses, revenue recognition and internal credit risk grade. Under SFAS 114, a troubled debt restructuring is considered to be impaired, and an impairment analysis must be performed.

While three impairment measurement techniques are available, the valuation technique generally prescribed is the discounted cash flow method. This method results from the fact that the lender and borrower have established an expected stream of cash flows. If these underlying cash flows are separate from collateral liquidation or loan sales, then the fair market value techniques are not available.

Consider Interest Income Recognition

Another measurement to consider is interest income recognition. Generally, if a credit was on nonaccrual prior to the restructuring, regulatory guidance indicates that the credit should remain on nonaccrual until the borrower displays a willingness and ability to repay. If the credit was on accrual, income may continue to be recognized, provided that a documented analysis of the borrower indicates that performance is assured. Lastly, troubled debt restructurings should generally remain within an institution's criticized or classified internal credit risk ratings until repayment is reasonably assured, well-defined weaknesses have subsided and loss is not anticipated.

Use Sound Risk Management
Sound risk management practices are an important aspect when considering the issues and risks associated with troubled debt restructurings. The foundations of these practices include the development and implementation of appropriate policies, procedures and limits; sound management information systems; and adequate internal controls. An institution's credit policies and procedures must provide a clear understanding of what a troubled debt restructuring is, how it is to be handled, who has the ability to authorize such transactions and what associated limits are in place

(authority as well as risk tolerance limits). From a management information systems perspective, procedures must be established to ensure that restructurings are correctly reported in regulatory as well as financial filings. In addition, reporting should keep senior management and the directorate apprised of the extent of this activity and its relative success.

Moreover, effective internal control systems are needed to effectively identify and manage associated risks. Two very important control functions are internal loan review and internal audit. An effective loan review function will report on compliance with established policies and procedures, assist in the identification of troubled debt restructurings, attest to the appropriateness of restructurings, and ensure that appropriate internal credit risk ratings are maintained. Sound internal audit functions verify that appropriate reporting procedures are in place and reporting is accurate. They ensure that troubled debt restructurings are included within

the SFAS 114 portion of the allowance for loan loss analysis and that the impairment measurement technique used is correct. Finally, they attest that sound revenue recognition practices have been established and are being followed.
http://www.stlouisfed.org/publications/cb/articles/?id=1836

Nicholas HD FOSTER, *Senior Lecturer in Commercial Law*, School of Law, SOAS, University of London (School of Oriental and African Studies)

OPERATING WITH A TRUNCATED LEGAL SYSTEM: FINANCIAL LAW WITHOUT INSOLVENCY LAW

Introduction

In this paper, a few thoughts are provided concerning some legal issues underlying insolvency in Islamic finance. The paper is brief and has been drafted with a view to stimulating discussion. It therefore does not contain references or qualifications to simplistic statements.

Modern Insolvency Law

A modern insolvency law regime has several characteristics, including notably:

- a clear legal definition of insolvency, such as that contained in s136 UK Insolvency Act 1986;
- collective procedures, ie coherent bodies of rules (eg UK liquidation or administration) which replace the rules which normally apply and enable the orderly distribution of assets of the insolvent person or, latterly, bodies of rules which can enable an insolvent business to be saved or liquidated at a better cost than in the normal liquidation procedure;

- a legally defined order of payout of the insolvent person's assets to different classes of creditors;
- a law of security and a coherent link between security law and insolvency law; and
- institutions, such as courts and organised (and regulated bodies) of specialist professionals to apply administer the system.

Insolvency in the Classical Sharia

Some of us concerned with Islamic finance claim, implicitly or expressly, that legal mechanisms equivalent to those of modern law can always be found in the classical past or, at the very least, the classical sharia legal system always contained something of substance and relevance on every topic relevant to Islamic finance. This is, at best, misleading. The society, the economy and the financial system of the classical Muslim world, the world which existed before its Western-based transformation, had a legal system which was sophisticated for its day and, apparently, sufficient for its needs. But those needs were not our, contemporary, needs, they were much simpler. So the classical law was correspondingly simpler.

As far as insolvency is concerned, Western law did not have anything approaching modern insolvency law until, in terms of legal history, a very short time ago. Although England passed its first Act of Parliament in the area in Henry VIII's time, this was not concerned with the insolvency of companies as we know them, for such companies did not exist until the 19th century (in the United Kingdom 1844, or taking another view, 1856).

It is hardly surprising, then, that the sharia, although it had some rules relating to individual inability to pay debts (iflas) and some procedures to facilitate settlement between a debtor and his creditors, it had no equivalent to modern insolvency law.

Insolvency in Islamic Finance

The political, and therefore the legal, structure of the world is entirely Western. The world is divided into nation states, each of which his its own legal system or systems. Relationships between the nation states are determined by another system, that of international law.

Any other system with pretensions to being legal has to fit in with this structure. The legal (sharia/fiqh) underpinnings of Islamic finance (call this 'Islamic financial law') is no exception. Islamic financial law has to function within, and relying on, Western-style legal systems such as English, Malaysian or UAE law. Call them 'vehicular systems'. Those legal systems are of different types, especially as regards their relationship to Islamic law and their level of complexity. However, they are all indubitably nation state legal systems.

Furthermore, Islamic financial law, and the emergent parts of what may eventually become a legal system (in a rather special sense of the term 'legal system': call these parts 'the emergent IF legal system') is, for the moment at any rate, primarily concerned with legitimacy, or sharia-compliance. The emergent legal system is primarily concerned with the production of rules for the purpose of constructing halal products. Or, to put it another way, rules for the purpose of answering the question: is a given transaction halal or haram? The emergent legal system is not concerned with what happens on default, nor does it have a dispute resolution system, let alone rules, procedures and mechanisms to deal with what happens when a party is unable to pay its debts.

We can also see, by recalling the sketch above of what is needed for a modern insolvency law regime, that there are numerous, perhaps insoluble problems in the way of the emergent legal system producing such things.

Among the first set of problems, consider that such things are products of the nation state, and hardly any of them could be created outside it.

So the UK liquidation and administration procedures are not just complex bodies of rules, they depend on the existence of an administrative and organisational infrastructure which could not be duplicated in a non-state context.

Those procedures are the product of considered decisions, taken after much deliberation and debate, about the distribution of assets as between groups of creditors, and are deeply rooted in a particular view of world. The list of priorities is, accordingly, under the tight control of the nation state, is afforded public policy status and, with certain exceptions, is protected by the law and cannot be altered.

To put it another way, few areas of commercial law are so linked to the socio-economic ideology of a society as insolvency law, for it determines which group gets which resources when there are insufficient resources for everyone. Hence the wide divergence among legal systems in their insolvency law and the considerable difficulty in achieving any degree of harmonisation. A good example is the failure of harmonisation efforts in the European Union, and the compromise solution of the Regulation on Insolvency Proceedings.

And, just as fundamentally, the legal entities which are such important actors in the modern commercial and financial world, including Islamic finance, are products of nation states, depending entirely for their existence on municipal law, and their insolvency is inextricably linked to the nation state which gave birth to them.

Another set of problems relates to the fact, seen above, that the classical sharia contained practically nothing which could be used as a model, or even a starting point, for the construction of an Islamic finance insolvency law. Such a regime would have to be made out of whole cloth, made up from scratch - a mammoth undertaking necessitating not only the construction of insolvency law itself, but security law, the coordination of the two, and so on.

Conclusion

For the future – or at any rate, the future as seen from this computer keyboard late on a Friday night after a long week – it is difficult to see how Islamic finance can do anything other than depend on the insolvency law regimes of nation states. That may give us some food for thought, such as (speculating rather wildly for a moment) choosing a vehicular law because its insolvency regime is more sharia-compliant than another, or reforming the law of a Muslim-majority jurisdiction in order to make it as sharia-compliant as possible, or creating an exceptional regime for Islamic finance.

Michael S. GASSNER, *Founder*, IslamicFinance.de

INSOLVENCY & DEBT RESTRUCTURING IN ISLAMIC FINANCE
SELECTED ISSUES AND OPEN QUESTIONS

Debt remains to be the major instrument for financing economic activities. As discussed in previous years the concept of equity finance (all variants of PLS) is not taking off, not with Islamic financial institutions nor with conventional ones. Many discussions are held about it and the arguments shall not be reiterated here entirely. My personal view can be seen at http://www.islamicfinance.de/?q=node/4012 Basically, the tax deductibility of interest and the capital weightage under Basel II for equity finance making debt finance more competitive economically preferable for individuals but driving the economy systemically away from a state of equilibrium towards continuous instability with boom and bust following each other. The often cited issue of moral hazard is thereupon in my view less relevant, following the paper of Wahrenburg (http://libra.msra.cn/Publication/4890621/financial-contracting-with-adverse-selection-and-moral-hazard) proving that in regard to moral hazard a bank should offer a menu of debt and equity instruments. The virtual non-existence is due to regulatory and tax impacted pricing of equity.
Having stated this we will need to explore the regulation of financial distress as an issue we have increasingly to deal with. Boom and bust will force us to:
Any transaction done in the business world is wise to be analyzed by its achievement of fairness and justice, not alone as an Islamic requirement but business acumen – it will avoid major losses through fraud and lesser misbehavior. Hence any credit transaction shall be fair to the creditor and debtor, this should go without saying.

Regarding fairness towards the debtor:

Fair treatment of the debtor is beyond the legal side a moral injunction of the Quran recommending leaving the debtor more time to recover and by the prohibition of Riba banning the exponential growth of the debt for the unable debtor. For discussion at the workshop and beyond I include the Principles of Responsible Credit in Annex 1 (http://wiki.islamicfinance.de/index.php/Principles_of_Responsible_Credit) as food for thought.
Could we come up with a Sharia Standard for responsible credit terms? Should we foster to include basic financial knowledge to teach at schools?
What are gaps we perceive in terms of legality vs. fairness? Last year we briefly touched the issue of the defaulted debtor of a Murabaha mortgage, being required due to his default to pay the whole sum without any discount immediately due to his defaulting. He hence is left with a much larger debt than if he had taken out a conventional ribawi facility.
The legality of demanding a fixed price in Murabaha is undoubted, the enforceability of a discount would touch the Quranic prohibition of paying later a higher price, just a bit reverse by paying less now.
The fairness of this transaction is, however, strongly contested as the client is treated unfair. Morally the bank should give a voluntarily discount. Beyond that, it is not the fixed price in Murabaha, which is problematic per se; it is the legal clause of ***acceleration*** of a debt, which needs further discussion and questioning regarding its acceptability with Fiqh Muamalat.
A default without acceleration clause would need other means to secure the bank, such as unwinding the sale by returning the property and paying a rent for the time as actual damage. The bank then would be at risk to receive less for the property than its previous cost price. A fair solution to the price risk must be found.

Regarding fairness towards the creditor:

There is old saying in Germany: “If you borrow a thousand you have a problem, if you borrow a million the bank has a problem.” Hence, issues of fairness arise especially among larger debtors, which are in position to get financed based on their own terms & conditions.

Related issues for discussion can be shown with some contemporary Sukuk cases:

1. XS0463422088, Dubai DOF Sukuk Limited and Trustee and Lessor

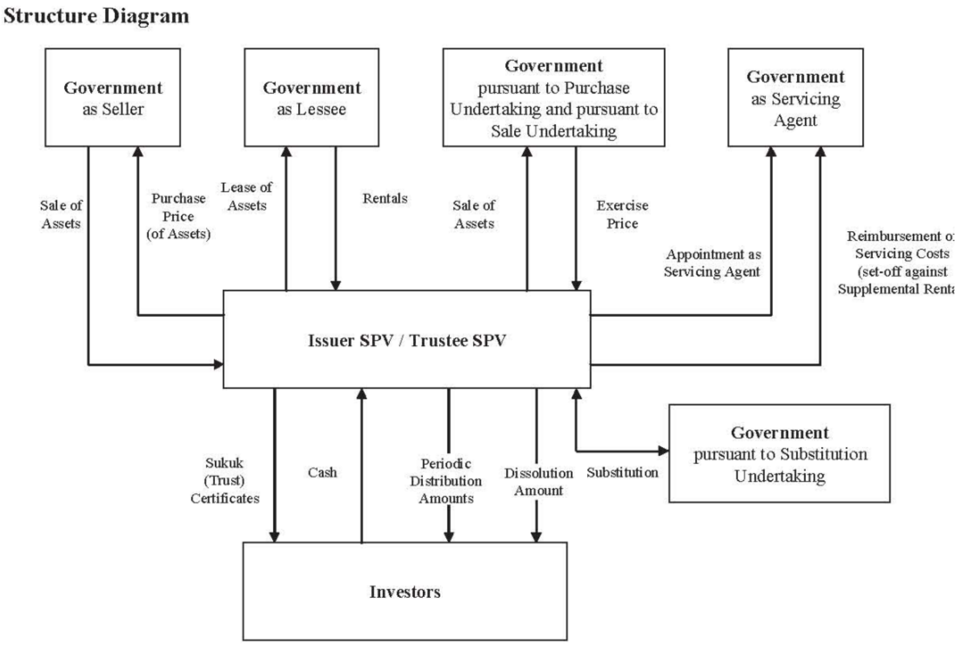
http://www.londonstockexchange.com/specialist-issuers/islamic/dubai-dof-fix-supplement.pdf

While looking at the structure and the underlyings (Airfield Infrastructure, Storm Water Drainage System, Emirates Operations Tunnel, Crisis Centre, Car Park Building) a state has several possibilities to leverage its strong position:

a) Ranking of Purchase Undertaking unclear after reading. What happens if other conventional debtors being serviced, but the Muslim financer not, as his debt is only due after the Purchase Undertaking is executed, and this needs to be enforced in courts in the jurisdiction of the Government debtor?
b) What is with Government owned assets? In case of default how they should be publicly auctioned? Very unlikely, and may be some of the workshop participants could shed light on this point, also in regard to the new Egyptian Sukuk law, where this is a central point of debate, especially if it is fair to sell public assets to foreigners and where to draw the line.

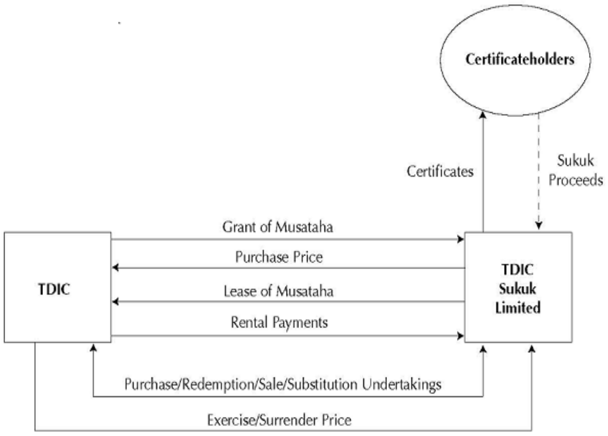
c) Multiple jurisdictions: Sukuk are often subject to several jurisdictions. Can the DIFC law reform help to reduce legal complexity?

d) Transaction Documents: Which independent party is really reviewing the Transaction Documents in the best interest of the creditor?



2. XS0457216124, TDIC SUKUK LIMITED

http://www.rns-pdf.londonstockexchange.com/rns/0676A_-2009-10-1.pdf



Fitch Affirms Tourism and Development Investment Company PJSC at 'AA'; Outlook Stable

Quote: "The primary rating driver for TDIC is its strong ties to the sovereign. The agency would not be able to rate this entity on a standalone basis due to its very limited operational assets."
Why a debtor creates a fully owned entity, issuing a debt paper with "its very limited operational assets"? The notion of Fitch to use as primary rating driver sovereign ties is strange after the experience of Nakheel (see: http://www.islamicfinance.de/?q=node/719)

Last not least, the occurrence of subordinated Sukuk is in principle very interesting to follow, after Saudi Hollandi, Abu Dhabi Islamic Bank followed with a modern version. Its basic structure looks as follows:

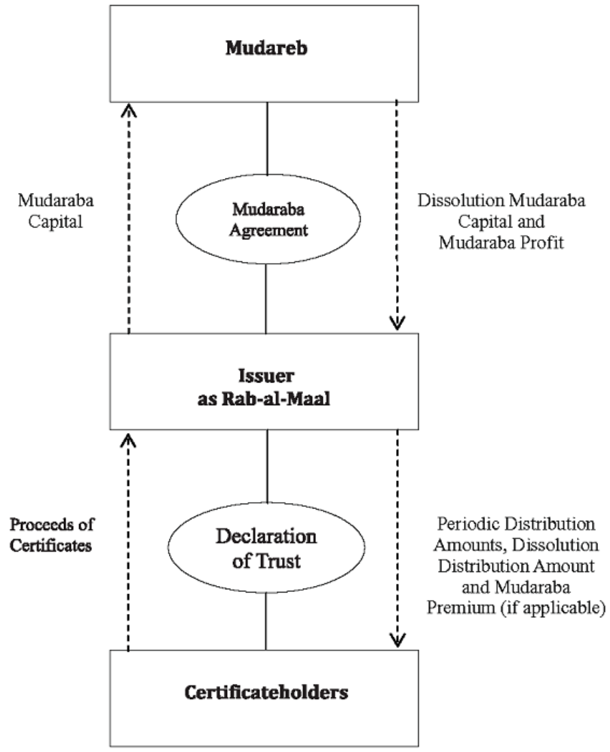
3. XS0851081660, ADIB CAPITAL INVEST 1

http://www.rns-pdf.londonstockexchange.com/rns/4402R_-2012-11-19.pdf

"8.2 Non-Payment Election
Notwithstanding Condition 7.4 (Periodic Distributions), ADIB may in its sole discretion elect that Mudaraba Profit will not be paid to the Trustee (in its capacity as Rab-al-Maal) on any Mudaraba Profit Distribution Date or that Final Mudaraba Profit will not be paid to the Trustee (in its capacity as Rab-al-Maal) on any Mudaraba End Date, and ADIB shall, in each case, instruct the Trustee not to make payment of a Periodic Distribution Amount to Certificateholders on such Periodic Distribution Date or (as the case may be) not to make payment of any Outstanding Payments otherwise payable on redemption or repayment of the Certificates (each a ''Non-Payment Election'').
"

What exactly are the rights to receive the profit share in the Sukuk? The wording above is at least hard to follow. Does it really mean that the investor is not entitled to a share in the profit, if any? Does the creditor receive the Mudaraba Profit only in the issuer's sole discretion?

Structure Diagram



Another open question is the frequently used Wakala Interbank Agreement, which replaces more and more Tawarruq. Per se a good step. But if funds are transferred based on short term money market rates, and formally it is a Wakala, then basically this is really cheap equity, because the high risk is shared with the creditor but 99 % of the upside remains with the debtor. From a fairness perspective this would be surely a nice talking point. The current practice is interestingly pretty close to the Jewish practice of Heter Iska, where losses must be proven by two witnesses if the anticipated profit is not paid.
While looking for and reading through literature on credit collaterals and covenants in Islamic finance, I sense a big gap for further research and publications. The English language world has not even a good book on pledges, let alone about a wider Shariah perspective on securing credits. Some questions for discussions on this end:

- 'Pledging' of debts as collateral – What are the pertaining issues?
- Promissory Notes – Are they fair?

- What is the contemporary role of Iqrar, the acknowledgement of debt used in classical times extensively to bridge risk of legal interpretations? Could it help to reduce complexity in Sukuk's legal documentation?

Annex 1

Principles of Responsible Credit

From Islamic Finance WIKI

The Principles of Responsible Credit were formulated by the European Coalition for Responsible Credit, a networking and policy influencing association of consumer agencies, academics, and other non governmental organisations formally created in 2006.
It is not related per se to the Islamic finance industry.
GOALS
Goals of the Coalition:

- Further the idea of responsibility in credit and banking and promote a set of principles for responsible credit and fair lending.
- Organise and maintain a continuing dialogue among consumer and money advice organisations, social welfare organisations and trade unions, alternative financial institutions and other NGOs.
- Influence bank thinking, strategies, products and services to benefit underserved and excluded groups.
- Promote the production of research and transparency.
- Organise conferences and other forums that increase people's and NGO understandings and abilities to promote fair access to lending products and services.
- Act as a collective voice for underserved people to the public with respect to financial services.

PRINCIPLES
Principles:
P1: Responsible and affordable credit must be provided for all.
1. Credit is an essential for full participation in society.
2. Banks should not discriminate and should provide real access.
3. Credit to Consumers and Small Businesses must be supervised.

P2: Credit relations have to be transparent and understandable.
1. Competitive transparency requires a standardized mathematically correct form of "one-price" disclosure (the Annual Percentage Rate of Charge or APRC).
2. Social transparency requires a standardized pre-contractual payment plan.
3. Consumers should be provided with adequate time for reflection and with access to independent advice.
4. Consumers should have access to independent financial, credit and debt advice.
5. Both parties in the credit markets have to take part in a mutually productive process of financial education.

P3: Lending has at all times to be cautious, responsible and fair.
1. Credit and its servicing must be productive for the borrower.
2. Responsible lending requires the provision of all necessary information and advice to consumers and liability for missing and incorrect information.
3. No lender should be allowed to exploit the weakness, need or naivety of borrowers.
4. Early repayment, without penalty, must be possible.
5. The conditions under which consumers can refinance or reschedule their debt should be regulated.

P4: Adaptation should be preferred to credit cancellation and destruction.
1. There is a need for effective protection against unfair credit cancellation.
2. Default charges should be adequate to cover losses only.

P5: Protective legislation has to be effective.
1. Credit regulation has to cover all non-commercial users.
2. Credit regulation has to cover all commercial forms of credit provision.
3. Credit regulation has to cover the whole process of credit extension as experienced by its users.
4. Credit regulation has to encourage efficient social and economic effects of credit extension.

P6: Overindebtedness should be a public concern.
1. Profit-driven systems cannot cope with over-indebtedness.
2. Consumers should have a right to discharge.
3. Bankruptcy procedures should lead to rehabilitation and not to retorsion.

P7: Borrowers must have adequate means to defend their rights and be free to voice their concerns.

1. There should be adequate individual as well as collective legal procedures to enforce borrowers' rights.
2. Critical public awareness is crucial for the development a fair and responsible distribution of credit.

Rafe HANEEF, HSBC Malaysia, Kuala Lumpur, Malaysia

INSOLVENCY & DEBT RESTRUCTURING IN ISLAMIC FINANCE

Defaulting individuals

Islam recommends the debtor in distress to be given more time to settle the debt as mentioned in the Quran:

(2:280)وَإِن كَانَ ذُو عُسْرَةٍ فَنَظِرَةٌ إِلَى مَيْسَرَةٍ وَأَن تَصَدَّقُواْ خَيْرٌ لَّكُمْ إِن كُنتُمْ تَعْلَمُونَ

If, however, [the debtor] is in straitened circumstances, [grant him] a delay until a time of ease;
and it would be for your own good -if you but knew it -to remit [the debt entirely]
by way of charity

In the historical context, individuals took consumption credit when they were unable to sustain their daily needs like food, water and shelter. They took credit as a last resort and often in emergency situations. The Quranic position above on giving the creditor more time or write-off the debt voluntarily makes absolute sense.

Today, individuals usually take credit to enhance their lifestyle for example, by buying on credit brown and white goods, vehicles and houses. Often such credit is taken at the expense of saving now and buying later. Instead of saving and then buying a TV, they prefer to buy it now on credit. Instead of saving and then buying a car, they prefer to buy it now on credit. Another form of easy credit is credit card which often influences many to indulge in impulsive buying, often beyond their means. If such debtor delays the payment to the creditor, is the Quranic position on giving him more time justifiable? Can we make a distinction between a debtor who has taken credit for emergency or essential purposes versus a debtor who has taken credit to enhance his lifestyle or indulged in impulsive buying? Or, is the Quranic position to be applied universally without any discrimination?

One can argue that in some places, it has become impossible to commute to work without owning a car. They have no option but to buy the car on credit to sustain their livelihood. Similarly in most countries, it is not possible to own a home without taking a home financing. In these scenarios, if the debtor delays payment will the creditor be obliged to give more time? What if the debtor has the option to rent the car and the house instead of buying on credit? If the option to?

What is the effective cause (illah) and rationale (hikmah) of the recommendation to give more time to the debtor?

Today, Islamic banks are operating within a conventional banking platform and rely on customers' deposits to make advances (in the form of financing) to consumers of credit. The customers' deposits are treated as a liability on the balance sheet of Islamic banks. This means that Islamic banks have to return the funds deposited regardless of what happens to the advances given. If for example the consumers of credit face financial difficulties, the banks may not be able to give them more time to settle their debt. Many Muslims criticize Islamic banks for not according more time to debtors. Often they fail to realize that the banks' ability to grant more time is linked to the terms of the deposits taken by the banks. If for instance, the critics have deposited their surplus funds with Islamic banks, would they agree if the banks inform them that they will not be able to access say 20% of their deposits because 20% of the credit consumers are facing difficulties in paying their debt on time to the banks? The usual argument is that banks are large institutions and have deep pockets to absorb losses, unlike individuals. What if the bank is owned by say a fund, like the pilgrimage fund, managing the savings of thousands of individuals. Is it fair for such a fund to absorb losses of debtors delaying their payment? Or is it fair for the bank to inform their depositors that the they will not be able to access some of their deposits?

Islamic banks are also encouraging debt accumulation by increasing their marketing efforts to entice consumers of credit. Often, the debtors are left on their own to determine whether they can really afford the debt taken. Islamic banks often hide behind the "buyers beware" disclaimer. If Islamic banks are less responsible in extending credit to the consumers, should they be compelled to give more time to the debtor or even write-off the debt? Shouldn't Islamic banks be subjected to a higher standard like "sellers beware", given the constrained scope of debt in Islam?

Clearly, the Quranic recommendation to give more time to debtor in distress or voluntarily write-off the debt needs to re-evaluated in the context of modern practices and prevailing competing interests between the debtors and creditors.

Defaulting Corporates

The Quranic recommendation of debtor in distress becomes even more complex in the context of defaulting corporates. Today, corporates are limited liability entities established to shield the owners from the debt assumed by the corporate. A Muslim is not absolved of his debt upon death: either his estate has to pay for his debt or else he has to pay in another form in the hereafter. By incorporating a limited liability company a Muslim can shield his debt obligation by facilitating the limited liability company to incur the debt. The unsecured creditors of the company will only have access to the assets of the company to the extent they are not taken by the secured creditors. Neither secured or unsecured creditors have any claim on the shareholders of the company.

The Quranic injunction recommending more time to be given to the debtor in distress or the write-off of debt voluntarily does not seem to fit the situation of a limited liability company. It is not uncommon for the creditor who gives more time to end up getting less in a winding up settlement, compared to another creditor who enforces his rights immediately. Given that Islamic banks are not entitled to benefit from any late payment charges received from the debtor, Islamic banks are incurring a loss during such delay, given that they still have to pay a return to the depositors. Would depositors agree to a reduction or delay in their returns on deposits whenever the banks are giving more time to the corporates to pay their debt? Again, the critics would argue that banks have deep pockets to absorb the risk of delay or default unlike the depositors. But, how do we manage the competing interest of a shareholder (like the pilgrimage fund) who has to solely bear the loss of the defaulting debtor and the interest of the depositors who want their share of return on time come rain or shine? Would the position be any different if the depositor is in better financial position than the bank; for example, Petronas or Saudi Aramco? Can we say to such depositors that their deposits would be delayed given that the banks have given more time to their debtors as recommended by the Quran?

Until Islamic banks move to the Shariah-based platform which runs on profit-and-loss sharing arrangement between the savers and consumers of funds, the issue of defaulting debtors need to be managed based on the prevailing standards applicable to the conventional banking system. Otherwise, there will be an arbitrage position where potentially weak consumers of credit will choose Islamic banking with a view of getting a better treatment (than conventional) in the event of any delay or default. We saw this weakness in the past, when Islamic banks were not charging any late payment charges for delay in payment. The debtors would pay the conventional banks first to avoid any late payment interest and would delay the payments to Islamic banks as long as they could, given that there is no punitive measures imposed on them by the Islamic banks. To avoid this arbitrage, the scholars allowed Islamic banks to impose late payment charges on delays provided such late payment charges are donated to charity upon receipt. By aligning the late payment treatment to the punitive measures prevailing in the conventional banking system, the Islamic banking system was able to avoid any potential arbitrage opportunities. The same measure has to be adopted in cases of debt restructuring and insolvency matters to avoid any undue advantage taken by the debtors of Islamic banks and any dilution in the priority of Islamic banks in the winding process.

Aznan **Hasan,** *Sharia Scholar and Associate Professor*, IIUM, Kuala Lumpur, Malaysia

INSOLVENCY & DEBT RESTRUCTURING IN ISLAMIC FINANCE.

Defaulted debts and bad loans have becoming one of the main problems in economic, especially in the modern economy system, where debt instruments have been used by individuals to fulfill their needs, by corporate as a tool for its funding, or even by countries to finance the expansion of the economic, financing the deficit in the budget etc. If the creation of debt is done in the economically healthy environments, and done with a proper procedure and regulation, the potential for default may be minimized. Yet, the lack of moral persuasion and weak regulation has inflated the default rate at various level of society, be it on individual or corporate level.

As Islamic finance is also a type of finance, the issue of default in debt obligations arising from various instruments of financing, insolvency and bankruptcy is also very important to be discussed.
From Shariah point of view, regardless of the reasons for the creation of the debt, it is the responsibility of the debtor (be it individual or corporate entity) to pay the debt. The Shariah has differentiated two types of defaulters; those who are really in distressed situations and those who able to pay but refuse to meet their obligation. Whilst Shariah encourages the creditor to give leniency to the former, it allows for the punishments to be imposed on the latter. Nevertheless, when it comes to the practice, it is hard for Islamic financial institutions to determine (without really looking at the details of the situations) whether the default arises from a genuine reason or otherwise. Since there is no framework to determine this, Islamic financial institutions use the general rule that once the customer defaults, unless proven otherwise, he is considered to be from the second group. Though this act is justifiable, one may argue perhaps it

may be more acceptable if only the delinquent debtors are "punished". To do that, a framework should be put in place to determine the "genuine" debtors from the delinquent ones.

Also, the creation of unnecessary debt at individual level should also be controlled. In doing so, certain mechanism need to be put in place by the relevant authorities to determine whether a person is eligible for financing /loan or not. I take note that currently, there is regulation in many countries on the calculation of debt to income ratio of a person for the purpose of financing / loan application. Yet, it seems that that alone is not enough. Another set of framework may be needed to regulate this. To avoid cannibalizing Islamic finance, this regulation should be applicable to both, Islamic, as well as conventional finance.

Also, when the financing is extended to the client, securities shall be imposed on the client, so that in case of non remediable default, financial institutions shall have recourse to the underlying collateral.

This is on individual level.

On corporate level, the principle of wise financing, even for the purpose of expansion is still very much important. It will ensure the healthiness of the financial position of the company to meet the debt obligations of its creditors in various instruments of financing. Having said that, I reckon that in an economic downturn, originally healthy companies may find themselves in a position of not being able to meet their debts when they are due. In worst case scenario, if the negotiation to restructure the debt fails, the company may be liquidated. If that happens, the creditors will receive only the proceeds from liquidation, according to their ranking. Most of the time, they will receive the proceeds less that the value of their original debt. Hence, it will be for their own interest, if possible, to restructure the debt, so as to allow the company "a grace period" to continue in business, with the hope (of course with various business plans, controls, conditions etc) that the company will recover and able to pay back the debt.

The process for potential restructuring may involve these situations:

1) It may be that certain instruments are only restructured, but the structure of the company remains. Or;
2) The company will have to undergo certain restructuring process, including certain (or may be all) of its instruments.

Definitely, the second situation will require a more tedious process compared to the first one.

More often than not, the restructuring of the company and /or the instruments will require certain compromises, including seeking a haircut in the amount of debt that is to be paid, freezing of further interest charges and deferment of payment of debt.

In Malaysia, there is no hard and fast rule for this restructuring exercise. Nevertheless, Section 176 of the Companies Act, has a provision of law that underlying generally, the scheme of arrangement mechanism (which may be elaborated further during the discussion).

In the sphere of Islamic finance vis-à-vis restructuring, there are several issues that may arise in the process of restructuring. Among others are:

1) Whether the restructuring will be Shariah compliant or not. If the decision is to restructure the company to be Shariah compliant, then various considerations needs to be put to ensure that the structure and the instruments to be used for restructuring are Shariah compliant.
2) If the restructuring is to be done on the instruments only, for instance, restructuring of sukuk, then we need to consider various issues, including the existing sukuk structure, and what is the proposed structure that is suitable for the restructuring exercise. The restructuring team may want to remain with the existing structure or to suggest new structure, depending on the suitability of the proposed instruments vis-à-vis the restructuring exercise.

In all circumstances, consent from the creditors is needed.

Based on my experience, due to legal certainty, the restructuring of company and /or instruments is relatively easy to contemplate if the company fully operates within Malaysian jurisdiction, and the instruments issued (like sukuk) is also issued out of Malaysia. The difficulties are when the company operates in more than one jurisdiction and each jurisdiction has its own legal framework, or in case of sukuk, the sukuk is issued in one jurisdiction and the Issuer domiciles in another jurisdiction.

Though there is a law to tackle the issue, like UNCITRAL Model Law on Cross Border Insolvency, there is no specific guidelines specific for Islamic finance to tackle the issue of cross border restructuring. Perhaps international standard-setting organization relevant to Islamic finance like IFSB would like to study and suggest suitable mechanism, rules and guiding principles with regards to the restructuring of Islamic finance instruments, not only on jurisdictional basis, but also on cross border basis.

Wallahu 'Alam.

Mohamad Akram LALDIN, *Executive Director*, International Shari'ah Research Academy for Islamic Finance, Kuala Lumpur, Malaysia

INSOLVENCY AND DEBT RESTRUCTURING IN ISLAMIC FINANCE

Islamic finance, just like any other business, is not free from the case of default and insolvency. The current structure of Islamic finance that is dominated by deb-based instruments put the system closer toward the case of default and insolvency.

This requires the architect of modern Islamic finance to think and provide solutions how Islamic financial system manages default and insolvency cases and the impact created from default and insolvency.

In Islamic law, the concept of Iflas (bankruptcy) and taflis (insolvency) covers both the modern senses of (1) balance sheet insolvency (assets less than liabilities) and (2) liquidity insolvency (insufficient cash flow to pay debt). A bankrupt person (muflis) is one whose debts exceed his assets and/or a person whose current expenditure exceeds his current revenues.

Islam recognizes debt as part of the transaction system. Islam also puts guidelines: technical-legal and moral-ethics, on how to deal with debt.

Islam is also concern about defaulting in the payment of debt. In one Hadith the Prophet said, "The defaulters are committing injustices and liable to be punished". Ibn Hajar commented on the status of this Hadith by saying that its chain is good. Al-Hassan commented the word "irduhu" means doing injustice and the word 'uqubatuhu' means imprison. Al-Hafiz ibn Hajr while commenting on the meaning of this Hadith reiterated that it is allowed to detain the defaulters if he refuses to pay his debt when he is able to do so. This punishment is imposed as a lesson and to discipline him. On the same issue, Ibn Mubarak said, the defaulter shall be dealt with harsh and shall be imprisoned. Similarly, Al-Azim al-Abadi have said in the commentary of this hadith, "If a wealthy person defaulted, it is allowed for the creditor to use harsh words on him, and to effect his dignity, similarly the judge has to be firm on him by sending him to prison as he has committed injustices which is forbidden even though minor injustices. Injustices will lead to punishment in the Day of Judgement and Allah has forbids injustices on His servants as He forbids it upon Himself. It is narrated in Hadith Qudsi, "O My servant, I have made injustices forbidden upon myself and forbid it upon you, so do not indulge yourself in injustices.

Al-Khattabi said, "This Hadith indicates the debtors who are unable to pay the debt for valid reason shall not be imprisoned as the commandment is confined to those who are able to pay but refuse to do so. The jurists have different views on this issue. Surayh and the jurists from the school of al-rai held the view that both categories of defaulters have to be imprisoned. Imam Malik is of the view that those who have no means to pay shall not be imprisoned instead they shall be reminded. The Shafi'es held the view similar to Malik and reiterate that those who have the means to pay but refuse to do so shall be imprisoned. Malik says, "If the defaulter is found to conceal his wealth, the judge shall imprisoned him, in contrast, if nothing is found with him, he shall be freed. Allah says, "…

If the authority accused him of concealing his wealth, he shall be imprisoned till he declare his wealth, and the rights of people be fulfilled, or in contrast it is apparent that he does not have any wealth, then he shall be freed. The creditor has no right to impose and prevent them from being freed for the sake of Allah.

Ibn Qudamah said, "If a debtor who are able to pay his debt defaulted, it is the right of the creditor to go after and demand the debt from the debtor. He may be harsh with in addressing him by saying you are doing injustice and a transgressor. This is based on the saying of the Prophet, "The defaulters are committing injustices and liable to be punished". He (Ibn Qudamah) further clarified the meaning of 'habsuhu wa 'irduhu' means: His dignity can be address by harsh words as it is permitted according to a Hadith from the Prophet s.a.w. which says: "The right's possessor has the liberty to speak up (against the defaulter)". Ibn 'Abidin says, "Debt shall be paid equally meaning the debtor shall guarantee to pay the creditor as he (the creditor) has accepted the debt and possess it, therefore the creditor has the right to get back his dues".

In general, there are two main characteristics on Islam's approach towards insolvency and debt settlement by the creditor and debtor.

First: Islamic law delineates balance approach to the creditors and debtors in the case of insolvency and bankruptcy. Both parties have right and obligation and the settlement sought would take the interest and benefit of both the creditor and debtor. Therefore, it cannot be said that Islamic law is 'pro-debtor' (as the common law system) or 'pro-creditor' (as the countries whose legal frameworks have origins in the Napoleonic code/the Franco Latin approach).

On the part of debtor, Islamic law puts guidelines:

- The debt, either created through loan (qard), credit purchase, lease, partnership and etc, must be paid.
- Debt settlement is considered as obligation to fulfill the covenant in which the Qur'an obliges "O you who believe, you shall fulfill your covenants".
- A debtor delaying paying a debt or an obligation without a valid excuse, even to a wealthy person, is unjust (ẕ ulm). For this reason, some sort of punishment and penalty is allowed.
- In the case of default and inability to pay back debt due to economic hardship, he should consult the creditor asking for more time and facilities to settle the debts.

On the part of the creditor:

- The debt created from him essentially emerged from his social responsibility and moral commitment of benevolence.
- He has the right to get back the debt from debtor, but this does not mean he has the authority/power to exploit the debtor by threatening or by increasing the amount of debt.
- In the case of default, the creditor is expected to ease debtor by giving more time or other ways in which the debtor could reduce and hence settle the debt accordingly. This is based the Qur'an (2: 280) which says "if a person is in difficulties, let there be respite until a time of ease. And if you give freely (i.e., if you forgive the debt voluntarily) it would be better for you, if only you knew".

Second, that balance approach and position of debt settlement and bankruptcy/insolvency comes from the Islamic ethics/values expected to be hold by both the creditor and debtors. In this regard, both the debtor and creditor are expected to have the prescribed norms and values in debt creation, settlement also in case of insolvency as guided by the Islamic principles.

Some of the guidelines are as follows:

- Debt due to delayed payment, under Islamic law, will not increase over time. It is unlawful in Islam to either lend or borrow a sum of money at interest. This is in contrast with a draconian system (i.e., as in ribā jahiliyyah) which strongly favored creditors whereby if the debtor sought a reprieve, it came at the price of a doubling of the debt. This make the debtor has a lifetime opportunity to whittle it down. In other word, the amount of debt can only go down over time, whereby the debtor can eventually settle it back any time in his life.
- Islam requires a fair treatment and avoidance of punishment for an inability to pay back debt due to economic hardship.
- In Islamic framework for debt settlement in the case of insolvency and bankruptcy, the debt settlement is done through recourse to the assets. Debtor's asset could be utilized to pay off his debts. In recent development of sukuk, an asset-backed sukuk whereby the sukuk holders had claims to specific assets.
- Under Islamic concept of settlement (sulh) a creditor could accept a compromise or reduction of the debt. The moral theory for such reduction is that creditor would make a donation or charitable forgiveness of the remaining balance as propagated in the Qur'an (2: 280).
- Judge (qadi) also plays very central in finding appropriate resolution to the cases brought before him. A bankruptcy proceeding is commenced by the creditor. The burden, in Islamic law, is on the creditors to show proof of the debt and that the debt had become due.

One important point need to be stress here is that every step and planning have to be taken before an entity falls into trouble. The maxim which says harm shall not be inflicted nor reciprocated shall be the guiding principle here. Islam always stresses the importance of planning and avoiding any harm from happening. Insolvency, no doubt is considered as harm not only to individual but also to society and the economy in general. Therefore, it is the role of the regulator and governments to ensure all mechanisms are intact in order to prevent insolvency. If, despite all the measures, it happened, then there must also be the mechanism to ensure minimal impact of such happening to individual, society and economy. It is important to note that such planning become mandatory (wajib) if without it may harm the ummah.

Finally, Islam emphasis the principle of justice to all parties related when there is case of insolvency. What is important is the role of the court to ensure that justice is done to everyone and no one party should be given preference over the others. Islam does not rank the rights of the parties involve when claiming their rights, rather it is left to the wisdom of the court to determine the rights of all are protected.

Neil D MILLER, *Global Head of Islamic finance,* KPMG

BANKRUPTCY & INSOLVENCY IN ISLAMIC FINANCE

1) Introduction

a) We are here to talk about whether or not existing insolvency laws in many Muslim countries where Islamic finance is practiced are able to deal with the peculiarities of Islamic finance when either:
   i) A debtor of an IFI faces bankruptcy / insolvency etc.; and/or
   ii) An IFI is threatened with the same.
   Debate needs to examine issues from the perspective of both debtor and creditor.

b) **Preliminary insight** – I think it's helpful to formulate a sense of what you think you want to achieve at the outset of this sort of discussion. I have discussed this topic before and in preparing for previous events came across the words of the former President of INSOL[50], Sumant Batra, in his introduction to the Euromoney 2011/12 Global Insolvency & Restructuring review. I am paraphrasing slightly:

> *" An efficient and effective insolvency regime … promotes … higher standards of corporate governance … [and an] effective system of rehabilitating sound but financially distressed enterprises, while assuring the maximisation and a fair reallocation of the enterprise value to creditors and other stakeholders."*

c) To my mind this provided a reasonable decent description of what an acceptable Shari'a outcome might be. We will want to discuss in greater detail during the event what Shari'a might suggest or demand should / should not be done in an insolvency context but I would submit that an outcome which includes the elements of :

   i) **Transparent corporate governance** – helping to remove moral hazard;
   ii) **Recognises distress** - may affect otherwise sound businesses;
   iii) **Preserves value** - by allowing a firm to stay in business;
   iv) **Is fair** - as between the various stakeholders
   v) Is heading in the right direction from a Shari'a perspective[51].

2) Parallels between Shari'a jurisprudence

a) **Up front** – worth saying that in my view there are many parallels between Shari'a jurisprudence and both:
   i) **The common law tradition** – I have spoken about this before - particularly the equity component which is concerned with justice and fairness – and in areas like the construction of contracts – FYI - I was the lawyer who drafted the Shamil v Beximco documents and devised the restructuring using the 'Exchange in Satisfaction and User Agreements'; and
   ii) **Civil Code** – where some would even argue that laws such as the Napoleonic Code contain the influence of classical Islamic law.

b) **But there are of course important areas of difference and divergence** - it is being able to identify and accommodate these areas where the balance is to be struck on writing new laws that seek to provide Shari'a compliant solutions to bankruptcy and insolvency.

c) **Limited literature** - finally, seems to be a relatively limited literature on the treatment of this subject from a Shari'a perspective. Much of what I have found – to the extent that it describes the Islamic basis of insolvency proceedings - recycles earlier papers, so there has been little original thinking.

3) Removing some misconceptions

a) **Nothing to say** – notwithstanding the remark in paragraph 2) c) above, that commentators on Islamic jurisprudence have been relatively silent on the issues involved – in fact Islamic law does have quite a lot to say about:
   i) The performance of contracts and honoring obligations – in many respects this is the most important characteristic of Shari'a – the contract between man and God – all other contracts are a proxy for this…;

[50] INSOL – the international body that represents insolvency practitioners around the world.

[51] NB: Dr Mohammed Al-Sheabi, Head off the Legal Department at the Saudi Arabian Monetary Agency (SAMA) has talked of the need for a model insolvency law that allows for a 'balancing of the interests of the creditors and debtors'.

   ii) Avoiding disputes through proper documentation – addressed in the Qur'an (see relevant Surah); Prophet Muhammed (PBUH) encouraged businessmen to find a scribe, somebody they trusted to write down what had been agreed;
   iii) The desirability of conciliation and forbearance – again from Qur'anic injunction.

b) **As a contributory factor** - That Islamic finance has in some way a contributory factor to the difficulties encountered in several deals - some of the press coverage has suggested the problems stem from the Islamic character of transactions. This is not the case …

c) **Transactions** - The most talked about transactions include:
   i) **The Investment Dar default** –arguably over expanded but also too reliant on short term debt – plenty of examples of this perennial around the world in the past;
   ii) **The Saad *Sukuk*** – the *Sukuk* was a tiny fraction of the $22 billion that became a subject matter of fraud allegations etc.; [NB: I acted on this Sukuk financing]
   iii) **East Cameron Gas** – poor credit risk from the start, CCC +rating at issuance – from the *Sukuk* holders' perspective the courts actually found there had been a true sale so decided in their favour;
   iv) **The 'near default' of the Nakheel *Sukuk*** – The *Sukuk* leverage was only a part of the Nakheel exposure (much of which was conventional) in an entity which had simply run up too much debt for its grandiose schemes. Shone a light on the lack of a bankruptcy/insolvency regime; led to Law No 57 – a cobbled together solution uniquely designed to facilitate a restructuring; a new bankruptcy law is being drafted. The restructuring was difficult but the compromise will see trade creditors achieve some recovery. The subject matter of the new *Sukuk* may be debatable.

d) **Smart decisions** - some of these transactions may not have been smart business decisions from either a commercial perspective or an Islamic perspective but the structuring of the deals was never a causal factor, or trigger, for the difficulties subsequently encountered.

e) **Shone a light** – what these transactions have however done is illustrate areas of stress, ambiguity and difficulty within the structures that should ideally be addressed for future deals – the test is whether or not the industry will learn from the lessons – this ALWAYS happens in times of financial stress – there is nothing new about this phenomenon.

f) **The English law experience** – finally – something that constantly annoys me about the way people look at some of the English case law. Let me make two points:
   i) **Shari'a** – critics complain that the English courts 'ignore' Shari'a or are not willing to take into account Shari'a interpretation – this is exactly what the lawyer drafting these documents <u>in consultation with Shari'a scholars</u> intended. The presumption has always been that English courts and judges will enforce the bargain agreed between the parties and not explore the 'what if' scenarios – broadly this is what has happened. The outcomes we predicted have arisen – this is why English law has been so helpful for the international proliferation of Islamic finance – international bankers have got comfortable with it.
   ii) **Real world** - Every *Murabaha*-based contract taken to the courts (so far as I am aware) has been enforced as it should have been – in my view every defendant debtor who claims the contracts were a sham (i.e. a loan dressed up Islamically) is acting fraudulently in making such a representation– I can say this from personal experience - the obligors know what they are doing when they enter into these transactions – raising trade credit on *Murabaha* terms usually to finance working capital etc. The only criticism of the industry in these cases might be:
      (1) **Post draw down monitoring** - They do need to ensure that genuine transaction are taking place with funds drawn down – so there may be a higher standard of monitoring required than in a conventional loan (the 'agency' approach may have been a little too carefree); and
      (2) ***Murabaha*** - the industry needs to stop castigating *Murabaha* modes of finance and accept that for the foreseeable future it has a role to play. [NB: but does need to better explain the different modes of using *Murabaha* - pure asset financing for trade finance and in its *Tawarruq* form as a placement/lending tool.]
   iii) **On the TIDC v Blom case** – in my view this was a case pursued on fundamentally flawed legal advice that failed to take into account the ethical proposition embedded within Islamic finance – i.e. TID should never have commenced the litigation the way they did. In the end, the TID scholars prevailed and subsequently reprimanded the bank for taking the approach they did in the proceedings and stopped further progress in the litigation. Intra vires issues are absolutely typical cross-border international finance issues addressed every day. Lawyers and analysts who suggest otherwise do some from a lack of experience in handling such matters.

4) Is bankruptcy/ insolvency adequately dealt with in Muslim states?

a) **Classical Islamic law** - Many Muslim states have bankruptcy codes[52].

b) **Priorities** – it is possible to discern a system of priorities in classical Islamic law (some of which are adopted by various of the 4 main schools of thought) such that:
   i) **The receiver** – fees and expenses etc;
   ii) **Reclamation creditors** – notions of retention of title and the ability to recover goods sold but not paid for (AAOIFI Shariah Standard No 3 adopts some of this);
   iii) **Lessors** – a creditor for unpaid rent where lease has commenced and rent is unpaid whether lease term continuing or has expired; where lease term has not commenced lessor can annul;
   iv) **Secured creditors** – first priority against their collateral; good in principle but many Muslim countries have uncertain laws regarding the creation and perfection of security interests so 'secular' rules create the problems;
   v) **Personal exemptions** – debtor's reasonable living expenses etc.; and
   vi) **Various other types of preferential unsecured creditor** – e.g. certain classes of worker for wages etc; and
   vii) **All others** - regular creditors with no priority.

c) **Remedies** - interestingly, the main remedy in classical Islamic law was to request the imprisonment of the *muflis* until he paid his debts – this is (presumably) the history behind the approach that still persists in much of the Middle East today[53]. Alternative approaches, were to follow the debtor in his daily business and find asset to be liquidated or to limit his ability to travel.

d) **Classifications** –Shari'a does make distinctions between:
   i) and debtors who are able to pay (i.e. solvent) but refuse to do so; and
   ii) insolvent debtors that are unable to pay through causes outside their control (will typically be insolvent).

e) **Not written down** – the problem is that much of the classical Islamic law does not exist in a codified form in many Muslim states – so legislators would need to look to it as guidance for new legislation.

f) **Understanding the current position** - If the mere Shari'a characterisation of a transaction does not determine whether or not it will go wrong, why, when there is a problem? Is there also a perception that Islamic finance makes an already difficult position even worse? I would suggest that you need to distinguish between macro level and micro level issues?
   i) **The macro level** - looks at issues of legislation, regulation and policy.
   ii) **The micro level** - looks at the specificities of transactions and the actual structures as they are deployed on a case by case basis.

   To further complicate matters, in both cases the issues have to be examined on a jurisdiction by jurisdiction basis.

g) **Where issues arise** - the problems and concerns I have seen have usually been driven by several linked factors at the macro level, as follows:
   i) **Lack of substantive bankruptcy and insolvency legislation** - in developing and transitional countries, thus:
      (1) **General statement** - this risks being an over generalisation but at its simplest the laws are relatively unsophisticated and tend to raise more questions than answers;
      (2) **Ambiguity as to which tribunal might becomes involved** – religious or Shari'a courts simply do not have experienced personnel to deal with sophisticated business matters; and
   ii) **Political factors** – interestingly, until recently there has been no urgency to address the effect of insolvency upon modern Islamic financial structures; on past occasions of 'financial stress' few settlements have involved the courts – settlements have been negotiated privately – of course not always perceived as fair – not necessarily good for international creditor relationships as there is no 'process and so a lack of transparency;
   iii) **Social and cultural norms** - a mindset running through the psyche of the nations involved that seeks to avoid conflict, does not wish to deal with hard issues and probably also believes that 'things will come around' if we wait;

h) This produces some interesting effects:
   i) **Classical approach** - some academic writers on insolvency under classical Islamic law describe an approach, or set of 'rules', that in many respects equate with much that can be found in Western law[54];

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[52] See Islamic Finance, Bankruptcy, Financial Distress and Debt Restructuring, introductory remarks of Ibrahim Warde (Panel discussion Harvard Law School 26 September 2011).

[53] But be aware this was modified such that if a debtor genuinely could not pay (i.e. was actually insolvent) imprisonment was pointless and so he would be released.

[54] See: Abed Awad & Robert E Michael, Iflas and Chapter 11: Classical Law and Modern Bankruptcy, 44 int'l Law 975 (2010); *Iflas* means bankruptcy (covers modern sense of (1) balance sheet insolvency and (ii) income statement of cash flow insolvency (i.e. insufficient income to pay debts as they fall due); *muflis* means a bankrupt entity. Once muflis only two ways to end: full repayment of unforgiven debts or death.

Awad & Michael describe classical Islamic law as being 'strongly analogous' to the traditional civil and common law treatment of a bankrupt prior to the enactment of Chapter 11 (i.e. the fair and equitable distribution of the debtor's asset amongst his creditors). They do not necessarily suggest this is the approach to be adopted in the future).

ii) **Difficulties** – and in any event:
(1) none of this is embedded in Shari' courts;
(2) Shari'a courts are traditionally avoided for resolving commercial disputes for fears of capricious behaviour & lack of knowledge;
(3) very many Muslim states have separate 'secular' commercial codes governing the conduct on commercial and financial activity – they lack any codified insolvency and bankruptcy laws;

i) **Tricky areas** - various problems of interpretation (or differences of opinion) exist under Shari'a regarding some basis issues, for example:;
i) **Non recognition of forms of limited liability company** – whilst the use of corporate forms is not generally *haram* there is still sufficient ambiguity in this area which means that the corporate veil may be pierced and seek to extend liability to shareholders of companies as the corporate vehicle is treated as an extension of the individual's liability;
ii) **Acceleration** – when can a creditor make claim – only on a matured debt? Can he accelerate and if so when? Just in reading for this event it is clear that views amongst Scholars vary on the ability to accelerate future due debts if an earlier obligation is not performed. [NB: See AAOIFI Shari'a Standard No 3 Default in Payment by a Debtor – deals only with a solvent debtor (and is silent regarding the treatment of an insolvent debtor) and expressly allows the balance of installments to be accelerated[55].] [However, in practice contractual 'cross default' clauses may be frowned upon and are not always understood and/or approved.][AAOIFI Shariah Standard No 4 Settlement of Debts by way of Set-Off recognises the concept of set-off.]
iii) **Voluntary insolvency proceedings** – it argued that the stipulation of honoring contracts means a debtor cannot commence voluntary insolvency proceedings.

5) The role of contracts

a) **Need for clarity** – three are many areas of Islamic finance where ambiguity prevails and to achieve any degree of certainty of treatment in an insolvency the precise commercial, legal and Shari'a attributes need to be clarified, aligned and publicized. Some examples include:
i) **Legal status of various corporate forms** – e.g. the limited liability company - ultimately in Shari'a you can look through to the shareholder, so limited liability may not be recognised;
ii) ***Mudaraba*** - contrast this with the *Mudaraba* model where the liability of the *Rab al Maal* is limited to the assets contributed - *Mudarib* will be liable if he exceeds his authority or is negligent. Theoretically, this make *Mudaraba* a more reliable model if the investor seeks to limit his liability – but little written down to codify treatment of both roles from the different perspectives of a debtor and/or a creditor of each party;
iii) **URIA & RIA holders** – what is the true status of the holder of each of these types of account? Where do they sit in the priority waterfall vis-a-vis the shareholders and each other;
iv) **Diminishing *Musharaka*** – the issue here is usually whether or not this mode of home purchase financing contract falls foul of Landlord & Tenant laws especially regarding the tricky issues of rent control and the occupational rights of 'tenant's. Do these cut across bank foreclosure rights?
v) **Sukuk** – there are several issues arising out of Sukuk. For example:
(1) **Property rights -** However, perhaps the most difficult one is establishing precisely what legal rights have been granted to the Sukuk holders in the underlying assets? A multitude of different proprietary and non-proprietary rights in a multitude of different asset classes have been created in recent years. The legal analysis has often been tricky because it invariably requires a complicated blend of foreign law, domestic law and Shari'a. The resulting conflict of laws issues are very difficult and clients are not always willing to pay for the legal analysis that would be needed to tread a path through them. In addition (and this is far more common) a structure often has to be devised that avoids the payment of an unintended tax charges that would de-rail the economics of the deal if they had to be absorbed.

[55] Sets out various criteria: acceleration only after notice allowing time to pay (suggests 2 weeks); cannot charge additional amounts; can recover legal and enforcement costs; implies some sort of title lien – although unclear how that would be enforced in secular systems without registration etc.; does allow excess charge to be donated to charity; authorises a right off set-of to be included in the contract etc (see 2/5 (c)).

(2) **Limited assets availability -** The scarcity of assets or the reluctance to relinquish possession of assets also explains the tension between the use of Ijara contracts and deployment of Wakala / Musharaka arrangements.
(3) **On / off balance sheet** – a facet of both the preceding issues but worth identifying separately as it is increasingly becoming an issue for some scholars as it goes to the genuineness of the sale – so true sale and bankruptcy remoteness issues flow from this too.

6) **Cross border (or international) considerations**
   a) **General observations**:
      i) The treatment of domestic insolvency will involve different considerations to those that may be applicable to creditors in cross-border insolvency situations;
      ii) Main consideration for a secured creditor will be in which jurisdiction can the debtor enter into insolvency proceedings?
   b) Does Malaysia offer a solution?
      i) Malaysia illustrates that a pre-existing legal architecture can, to a certain extent, take into account Shari'a principles and concerns.
   c) **Other approaches – briefly**:
      i) **United States**
         (1) **Prior to Chapter 11** – sole function of bankruptcy laws - a fair and equitable distribution of debtor's assets amongst creditors;
         (2) **Chapter 11** – described as a 'revolutionary' change – paramount purpose becomes the 'rehabilitation of the business enterprise'.
      ii) **United Kingdom** – Unlike US, UK insolvency procedures largely conducted out of court but heavily regulated. Four main types of insolvency proceeding, as follows:
         (1) **Administration -** primary objective to rescue the company as a 'going concern' but invariably through a sale of the company's assets at a sale price in excess of liquidation value; most prevalent UK procedure since 2003; secondary objective – achieving a better result for the company's creditors as a whole than would be likely if the company were first wound up, without initially being in administration;
         (2) **Receivership –** secured creditor out of court enforcement mechanism;
         (3) **Liquidation –** similar to US chapter 7 - to collect, realise and distribute assets creditor's voluntary (insolvent), members voluntary (solvent) usually ends in company being dissolved;
         (4) **Company voluntary arrangements –** consensual out-of-court restructurings. Various approval thresholds to be achieved to bind unsecured creditors. Does not trigger a moratorium.
      iii) **Germany** – Contrary to a lot of what we read in the press about the strength of the German economy, there were still a lot of German corporate insolvencies through 2009 (32,930) and 2010 (32,100)[56]. Whilst not familiar with procedures generally but interested to read about the 'double-sided' trust approach that supplements the London Rules that guide banks how to deal with debtors – involves potentially transfer of equity to the bank in exchange for funding which if eventually enable the company to turnaround/restructure is paid back will entitle the entrepreneur to his equity back - merely an example of alternative approaches / schemes that could be explored when working out what might best from a Shari'a perspective.

7) **Moving forward** - How to go about achieving developments in this area?
   a) **Working assumption** – we here are all likely to agree that creating some sort of 'universal' Islamic Model Law on Insolvency & Bankruptcy would be a desired outcome. The challenges of achieving this should not be underestimated. It seems to me that a fundamental assumption will need to be made and broad consensus obtained to the following proposition:

      As it presently stands Islamic jurisprudence does not have a solution that has been fully worked out and is 'fit for purpose' in today's world for dealing with the issues of insolvency and bankruptcy as they apply to commercial organisations, Islamic financial institutions, individuals and the various different modes of Islamic financial intermediation that currently exist.
      Whilst Qur'anic injunction and hadith provide some broad guidance, the specificities of treatment require further Ijtihad in order to formalize organised approaches that are in empathy with Shari'a and provide the sort of policy outcomes that are most likely to achieve the goals of Shari'a.

   b) **Policy issues** – a policy approach needs to be agreed.

[56] Reference: Corporate Turnaround in Germany – Trends and Methodologies, Roland Berger Strategy Consultants, Euromoney Global Insolvency & Restructuring Review, 2011 - 2012

i) **A starting point** - I referred earlier to the words of the (former) President of INSOL that seemed like a reasonable starting point. Islamic practitioners have the luxury of being able to look at a wide array of approaches that have been adopted across many countries. Although the US and UK approaches are likely to be those with which a significant majority of Islamic finance practitioners are most conversant, there will be other jurisdictions that can be studied and may have something to say on the topic.

ii) **Understanding the real differences** - consider also, the words of Ibrahim Warde[57] about the supposed differences between what might be the conventional and the Islamic approach to bankruptcy issues:

> *"an outcome-orientated, conciliatory approach advocated in the Islamic tradition stands in sharp contrast to the process-orientated, winner-take-all approach of global finance"*

Is this analysis of the current 'global finance' approach to insolvency correct? I am not sure that it really is. This suggests that more comparative analysis needs to be undertaken to more clearly identify similarities and differences.

c) **Willingness to think widely about policy and outcomes** - Qur'anic injunctions about forbearance etc., do suggest that liquidation need not be the only outcome of insolvency proceedings, so some form of Chapter 11 or Administration could be designed to provide more formulaic and predictable Shari'a compliant outcomes.

d) **Uncertainty about 'collective' proceedings** – bankruptcy has been a very much a personal matter whether as debtor or creditor – a wider acceptance of creditors being able to act unilaterally - may impact ability to enforce moratorium and/or claw-back procedures to ensure more equal treatment amongst creditors. This might need to be changed.

e) **No need to reinvent the wheel** – the issue of replication or 'cutting and pasting, from the conventional world is always a sensitive issue in Islamic finance circles. However, in jurisprudential terms, the similarities that already exist between certain aspects of common law and civil code mean that it should be feasible to 'borrow' approaches and assimilate them together to create a Model Law.

f) The need for legal injunction

i) **Analogy with Shari'a and ethics** – in a sophisticated world – however 'ethical' Shari'a law and principles may be - embedding patters on behaviour will not always be driven by internal notions of moral and /or knowing what the 'right' thing to do is; there is a role for the State and its legal frameworks to instill (and enforce) such behaviour through legal sanction.

ii) **Model Law** – ultimately, a law drafted to conform to largely agreed policy guidelines would then need to be adopted by OIC member states. This could take some time!

Mian Muhammad NAZIR, Dar Al Sharia Legal & Financial Consultancy, Dubai, UAE

INSOLVENCY LEGISLATION AND ISLAMIC FINANCE IN THE UAE

The compatibility of contemporary insolvency legislation in the context of Islamic financial institutions and Islamic capital markets instruments is an important subject which regulators, courts and other stakeholders must address sooner rather than later to ensure the sustainable and continuous growth of the industry. This issue deserves more serious consideration from the legislatures and regulators as lack of an appropriate and legal and regulatory regime on insolvency in respect of Islamic financial institutions would certainly affect insolvency proceedings and the remedies sought or granted pursuant to such proceedings.

Some of the most commonly used Islamic contracts and instruments result in automatic preference for investors and, in some cases, particularly when the competing obligations of an obligor are not shariah compliant, even a contractual waiver (either for a pari passu arrangement or sub-ordination) may not be effective. Considering the unique business model of Islamic financial institutions (IFIs) and the nature of the shariah nominate contracts and instruments, many of the well-drafted laws and regulations on insolvency may not be relevant to IFIs in the event of any insolvency or restructuring proceedings.

With the current pace of growth of the Islamic finance industry and IFIs' capability to embark on complex financial instruments, it is necessary that appropriate insolvency legislation and

[57] Ibid footnote 3.

regulations are enacted to remove uncertainties surrounding the fate of IFIs and Islamic investment instruments in the event of insolvency of the relevant institutions. The recent trend of raising tier I and tier II capital by some conventional institutions, through sukuk issuance using certain shariah nominate contracts, in the Middle East has once again necessitated the intervention of the regulators to arrange enactment and promulgation of suitable insolvency laws and regulations. Post financial crisis, the Islamic banking and finance industry was hoping to see a much more proactive and noticeable approach on this subject, but it appears that this important and very urgent matter has not received the level of attention it should have in the larger interest of the industry and to protect the interest of consumers and investors.

Shariq NISAR, *Director of Research and Operations,* Taqwaa Advisory and Shariah Investment Solutions Pvt Ltd

INSOLVENCY AND DEBT RESTRUCTURING: THE SHARI‘AH WAY

Human beings are created weak and by nature they are social. They depend on each other’s support to fulfill their daily needs.[58] While some depend on others for physical, moral and intellectual support there are many who need financial and monetary support. Islam being a natural religion has thus allowed debt which may be a result of direct lending or because of certain business transactions. However, debt by its very nature is a charitable act and therefore profiting through lending is not permissible in Islam. Incurring debt is not prohibited because then society will find it very difficult to meet their day-to-day requirements. On other hand debt could not be encouraged for obvious reasons that once a society becomes habitual of it then it negatively affects human creativity and leads to concentration of wealth and acrimonious situations.

A fine balance was thus required to be achieved where those capable were encouraged to give benevolent loans (to God) and wait or remit if they find their borrowers in difficulty and simultaneously those with limited resources were advised to live within their means and not to incur debt which they might find difficult to repay. Delinquency on the other hand was declared injustice which also validated disgrace and punishment to the borrower. Society was warned of dire consequences in the life hereafter and inheritance (even to the unprotected minors) was not allowed to be distributed unless all creditors were paid in full. Anything still left unpaid would be covered through charity and Zakah.

As against this, debt in conventional finance is an integral part of the business model. Rather it is strategic to borrow as it offers various obvious advantages such as tax benefits, lower risk and greater returns to equity holders (with limited liability). Today’s business environment has thrown various sets of challenges which are unique to its own policies. But since Islamic finance is working as a segment of the mainstream conventional finance it has become fashionable to discuss all the challenges faced by conventional finance under the premise of Shariah finance as well. Islamic finance which actually started with a promise to provide alternatives, has reconciled itself to play the role of “younger brother” of conventional finance. Therefore every challenge that the big brother - conventional financial system - faces today is being imagined and debated in the context of Islamic finance.

Restricting ourselves to the topic we will first try to delineate the Islamic position on business and debt and then move on to discuss the unfortunate situation of insolvency in Islam and its solution vis-à-vis strategic insolvencies gained through the law under the watchful eyes of the regulator.

No doubt some Islamic financial institutions try to take advantage from the differences in approach between the conventional and Islamic systems. When it helps them they choose to profess Islamic principles and when the going gets tough they are quick to take shelter under the umbrella of conventional regulation. And perhaps this dichotomy is the spur that led Harvard and LSE to choose this topic for this year’s debate.

Islamic Position on Business

In Islamic finance, unlike in conventional finance, there is a clear distinction between lending and investment and very different consequences are supposed to follow from one or the other. In conventional finance, irrespective of whether a person buys a share, puts a fixed deposit with a bank, subscribes to a government bond offering or puts money in a business, it can all be described as “investment”. In Islamic finance however it is not so. From the Islamic point of

[58] “…..it is We who have apportioned among them their livelihood in the life of this world and have raised some of them above others in degrees [of rank] that they may make use of one another for service”. (Quran, 43:32)

view, investment means deployment of money in business which has an inherent contractual risk of loss arising out of the proposed deployment, irrespective of the nature of the contract.

Accordingly, a deployment of funds is categorized as a "loan" or an "investment". Based on the above definitions, the consequence for a loan is that, under Islamic finance principles, it is not entitled to any sort of additional amount by whatsoever name called. As for an investment, it has to entail a theoretical possibility of incurring a loss.

Islamic Position on Debt

Any transaction which by its intrinsic nature involves deployment of money for a contractual repayment of the principal in full is considered as "lending". It does not matter whether any additional amount is to be returned or not and whether such additional amount is calculated as a percentage of the amount deployed or is an absolute sum or even whether it is fixed or variable, whether the amount is proposed to be deployed in business or used for a consumption purpose, whether the repayment period is fixed or open, and so on.

A corollary to this is that no matter how a debt arose whether it originated as a transaction per se or arose as a result of a business deal, such as a credit sale, it is not entitled to any increase due to subsequent deferment.

The above puts the basic Islamic position regarding bankruptcy and rescheduling in perspective. Hence any debt restructuring can only involve either rescheduling (postponement of repayment) and/or write-offs – voluntary or otherwise - of unsatisfiable claims (unless the same can be borne by the State).

FROM THE LENDER'S POINT OF VIEW:

At the time of lending:

- In Islam giving loan is highly encouraged and rewarding. At numerous places the Quran exhorts believers to give loans. The Holy Quran says, "Who is it that would loan Allah a benevolent loan so He may multiply it for him many times over….".[59]
- During the night of ascension Prophet (pbuh) saw it written on the Gate of paradise, Charity is repaid tenfold, and the loan eighteen fold. The Prophet asked: "O Jibril, how can the loan be more meritorious than charity?" Jibril replied, 'Because the beggar asks [for charity] despite having wealth, while the one seeking a loan does not do so unless out of real need."[60]

At the time repayment:

- And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease; and that ye remit the debt as almsgiving would be better for you if ye did but know."[61]
- Abu Sayeed reported that a man suffered damage during the time of the Holy Prophet in respect of fruits which he had purchased. His debt became heavy. The Messenger of Allah (pbuh) asked people: Give alms to him. So the people gave him alms but that was not sufficient to cover his (entire) debt. Then the Prophet (pbuh) said to his creditors: Take what you find, and there is nothing besides that for you. (Muslim)

FROM BORROWER'S POINT OF VIEW:

At the time of borrowing

- The Prophet (pbuh) is reported to have said, "Do not instill fear in your hearts after its security!" people asked, "What is that oh Messenger of Allah?" He said, "A debt."
- At other occasion the Prophet (pbuh) said, "A debt is the flag of Allah on the land when he wishes to disgrace a slave then he places it on his neck.
- Messenger of Allah (pbuh) said: Whoso takes loan of the properties of men intending to pay it back, Allah gives him means to pay it, and whoso takes loan intending to destroy it, Allah will destroy him on its account.[62]
- Aisha narrated that the Prophet (pbuh) used to pray saying: ".... O Allah I seek refuge with you from Ma'tham (whatever leads to sin) and from Maghram (being in debt yet not able to pay it off). A man asked: O Prophet,

[59] Quran 2: 245; 5:12; 57:11; 57:18; 64:17

[60] Ibn Maja; Bayhaqi, Shu`ab al-Iman; Tabarani, Mu`jam Awsat

[61] Quran 2:280

[62] Bukhari

why are you seeking refuge from maghram that often. He replied: If someone was in debt he would start to lie and to promise and not to keep his promises:[63]

At the time of maturity:

- Prophet has stated that a debtor delaying paying a debt or an obligation without a valid excuse, even to a wealthy person, is unjust. (Fath al-Baari Sharh Saheeh Bukhari)
- Prophet Muhammad had told his believers that the soul of the Muslim will be suspended with his debts and freed only when his debts are satisfied. (Ref:)
- The Prophet (pbuh) defends a creditor who had harshly and rudely demanded a camel that Prophet owed him. The Prophet ordered his companions to give the man a better camel, noting that "the best among you are those who repay their debts handsomely."[64]
- "Procrastination [delay] in repaying debts by a wealthy person is injustice."[65]

At the time of Death of borrower:

- Narrated Salama bin Al-Akwa: Once, while we were sitting in the company of Prophet, a dead man was brought. The Prophet was requested to lead the funeral prayer for the deceased. He said, "Is he in debt?" The people replied in the negative. He said, "Has he left any wealth?" They said, "No." So, he led his funeral prayer. Another dead man was brought and the people said, "O Allah's Apostle! Lead his funeral prayer." The Prophet said, "Is he in debt?" They said, "Yes." He said, "Has he left any wealth?" They said, ''Three Dinars." So, he led the prayer. Then a third dead man was brought and the people said (to the Prophet), please lead his funeral prayer." He said, "Has he left any wealth?" They said, "No." He asked, "Is he in debt?" They said, (Yes! He has to pay) three Dinars', He (refused to pray and) said, "Then pray for your (dead) companion." Abu Qatada said, "O Allah's Apostle! Lead his funeral prayer, and I will pay his debt." So, he led the prayer.[66]
- Abu Musa reported from the Prophet who said: Verily the greatest of sins to Allah with which a man shall meet Him after the great sins which Allah prohibited is his debt outstanding at death but leaving nothing for its payment. (Ahmad, Abu Daud)
- Abu Musa al-Ash'ari reports that the Prophet (pbuh) had said, "After the grave sins which Allah has prohibited the greatest sin is that a man dies while he has debt due from him and does not leave anything to pay it off, and meets Him with it."[67]
- The Prophet (pbhu) assured a Companion that his sins will be forgiven if he is killed fighting for God's cause and he was "patient and sincere and always fought facing the enemy and never turning your back upon him, (all your lapses would be forgiven) except debt."[68]
- Abu Qatadah reported that a man enquired: O Messenger of Allah inform me that if I be killed in the way of Allah, patient, hopeful of reward, advancing forward without retreating, whether Allah will forgive my sins, "Yes" replied the Apostle of Allah. When he retraced his steps, he called him and said: Yes, except debt. Thus said Gabriel. (Muslim)
- Muhammad-b-Abdullah reported that the Prophet of Allah said: "And by One in Whose Hand there is the life of Muhammad, if a man be killed in the way of Allah and then raised to life, and again be killed in the way of Allah and again raised to life, and again be killed in the way of Allah and again raised to life with debt due from him, he shall not enter Paradise till his debt is satisfied. (Ahmad, Sharhi-Sunnat)
- Jabir ibn 'Abdulla related that the Prophet would not say a funeral prayer over a person who died while a debt of two dirhams was due from him.[69]
- Sa'ad-b-al-Atwal reported: My brother died and left one third of one hundred dinars and left behind minor children. I wished to spend (it) for them. The Messenger of Allah said to me: Your brother is confined for his debt, so pay it off. He said: Then I went, paid it, returned and said: O Messenger of Allah! I have paid it, and there remains none except a woman who claims two dinars without any proof. He said: Pay her, as she is truthful. (Ahmad)
- Prophet (pbuh) took the responsibility for the debts of those who died without repaying it. He said, "if anyone (dies and) leaves a debt, I shall be responsible for paying it; and if anyone leaves property, it goes to his heirs."[70]

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[63] Bukhari 41:582; 12:795, Muslim 4:1218; Abu Dawud 3:879

[64] Bukhari 41:575. Similar stories are recounted in Bukhari 41:577, 578, 586; 47:777 and Muslim 10:3896-3900

[65] Bukhari 41:585; 37:486, 487; Muslim 10:3796-97; Tirmidhi 14:1312-13

[66] Bukahri, Book 37, Hadith 488

[67] Abu Dawud 22: 3336

[68] Muslim 20:4646-4650

[69] Abu Dawud 22:3337

At the time of Death of Lender:

- The Prophet (pbuh) told the following story: “Once a man died and was asked, ‘What did you use to say (or do) (in your life time)?’ He replied, ‘I was a businessman and used to give time to the rich to repay his debt and (used to) deduct part of the debt of the poor.’ So he was forgiven (his sins.)”[71]
- Abu al-Yasar, a Companion of Muhammad who the narrator noticed had “the signs of anger or that of agony on [his] face.” When asked why, he explained that a man from the tribe of Harami had owed him a debt, but when Abu al-Yasar attempted collect it, the man first hid, and then admitted that “[t]he fact is that I was hard up in regard to money.” After asking the man to confirm his financial distress by swearing by God three times, Abu al-Yasar “brought his promissory note and he wrote off (the debt) with his hand and said: Make payment when you find yourself solvent enough to pay me back; if you are not, then there is no liability upon you.” Pointing toward his heart, Abu al-Yasar explained to the narrator of this hadith that the Prophet had said, “He who gives time to one who is financially hard up (in the payment of debt) or writes off his debt, [God] will provide him His shadow.”[72]

The Court may intercede

- The Prophet intercedes in a debt collection dispute between two of his Companions, Ka‘b and Ibn Abi Hadrad, in the mosque attached to the Prophet’s home. Their verbal altercation drew the attention of Muhammad, who came out to them, “raising the curtain of his room and addressed Ka‘b, ‘O Ka‘b!’ Ka‘b replied, ‘Here I am, Oh Allah’s Apostle.’ (He said to him), ‘Reduce your debt to one half,’ gesturing with his hand. Ka‘b said, ‘I have done so, O Allah’s Apostle!’ On that the Prophet said to Ibn Abi Hadrad, ‘Get up and repay the debt to him.’”[73].
- ‘A’isha, tells of the Prophet’s having heard another loud verbal altercation outside his door: “The one demanded some remission and desired that the other one should show leniency to him, whereupon the (other one) was saying: By Allah, I will not do that. Then there came Allah’s Messenger to them and said: Where is he who swears by Allah that he would not do good? He said: Messenger of Allah, it is I. He may do as he desires.”[74]
- Abu Sa‘id al-Khudri tells the story of a man who had suffered a property loss, causing his debt to increase. The Prophet first told the community to give the man charity so he could pay, but not enough was collected to retire his debt. Finally, the Prophet seems to have limited the collection activities of the man’s creditors, saying to them, “Take what you find, and you will have nothing beyond that.”[75]
- Failure to pay is punishable conduct deduced from Prophet’s saying, “Undue postponement by one with means makes legal (an action against) his integrity and (also legitimizes his) punishment.”[76]

Islamic Position on Insolvency

According to Islamic tradition Insolvent (Muflis) is a person whose debts exceed his assets and/or a person whose current expenditures exceed his current revenues. Under Islamic law there is no distinction between balance sheet insolvency (assets minus liabilities) and liquidity insolvency (insufficient cash flow). Also there is no distinction between a business bankruptcy and an individual bankruptcy. Thus, bankruptcy under Islamic law may either describe a condition (Iflas) of a distressed debtor (Muflis), or the official action (Taflis) of declaring the debtor to be in one.

Bankruptcy Procedure in Islam:

As-sulh sayyid al-ahkam (amicable settlement is the master of all verdicts) [Quran: 4:128]

- Creditors are asked to give (unconditional) respite time till the borrower finds it easy to repay;[77]

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[70] Bukhari 37:495; 41:584; 60:304; 64:284; 80:723, 737, 755; Muslim 4:1885, 11:3944-3948; Abu Dawud 18:2893-2895; 19:2948.

[71] Bukhari 41:576; see also Muslim 10:3788-3795; Tirmidhi 14:1311

[72] Muslim 42:7149

[73] Bukhari 41:600

[74] Muslim 10:3779

[75] Muslim 10:3777-3778

[76] Ibn Rushd and others rely on this hadith as the basis for imprisonment for debt, though Ibn Rushd acknowledges that “no authentic tradition is available [explicitly] for it.”

[77] Scholars refer that reference to riba in the Quran addresses primarily the matter of debtors in financial distress. In that context, the prohibition relates to a creditor agreeing with a debtor on an extension for repayment of the latter's debt beyond the maturity date in exchange for more money to be paid at the later date. Instead of such practices, condemned in strident terms, the Quran requires

- Creditors are encouraged to forego if they see the borrower in real difficulty;[78]
- Borrower is deemed bankrupt if his wealth is not sufficient to cover his debt that is currently due;
- Court may intercede and ask the Creditors to forego their claims;[79]
- Court may give respite to the borrower after which creditors may renew their enforcement efforts.[80]
- Upon request from the creditor(s) the Court may freeze the assets owned by the borrower;[81]
- Once the assets are frozen, then any transaction with the assets by the borrower becomes invalid ;
- The Court, solely at its own discretion, may sell the assets owned by the borrower to pay off his creditors;[82]
- The borrower is not allowed to keep anything except what is necessary for his survival;
- In case the asset is insufficient to cover all that is due then all the creditors will get paid in proportion to their debt;
- The borrower may be incarcerated if the court determines that he has not disclosed all his assets. In that case creditors may be allowed to make their own efforts to find out undisclosed assets and those who are able to find out will have priority over the debts owed by other creditors;[83]
- If the borrower has not hidden any of his assets and he is really in difficult situation then he cannot be imprisoned on the ground of his inability to pay his debts;[84]
- Remaining debt can be paid through voluntary contributions from public (Charity) and/or from the collection of Zakah (Sadaqah);[85]

Comparing Various Approaches

Parameter	Islamic Principle	Conventional Principle
Approach to delinquency based on	Islamic view of peace and brotherhood	Western views of economic expediency, efficiency, and experience.
Lending	No profit (No business)	Also considered as business; hence entitled to a return and rescheduling could be in return for additional benefit.
Investment	No risk-no gain	
Debt	If charitable loan, then highly encouraged from giver's side and highly discouraged from taker's side) A debt owed to someone must be paid if possible. Muslims must fulfill their promises and obligations both to God and to man	Encouraged from both sides Tax benefits are awarded for borrowing.
Iflas	Social Responsibility/Charity Compassion	As a matter of policy
Modern policy of Bankruptcy	No clear Islamic procedure but deliberate delinquency is punishable.	Forced discharge of excessive debt. Special dispensations for voluntary filings.
Regulatory Arbitrage	Islamic financial institutions operate from various legal jurisdictions often aiming to achieve regulatory arbitrage.	No need for such an action.
Mismanagement	Heavy cost to all stakeholders and also reputational cost	Could invite criminal action In extreme cases (too big to fail)

either forgiveness of the debt, or a delay in the repayment until the debtor returns to solvency. (Hamoudi 508) [stating that original riba prohibition related to debtor in insolvency]

[78] "And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease; and that ye remit the debt as almsgiving would be better for you if ye did but know." (Quran 2:280)

[79] According to Quran it is not obligatory on creditors to remit debts, even if the debtor is in a difficulty.

[80] The precise establishment of "difficulty" and "ease" (Quran 2:280) is left to court's discretion.

[81] Imam Ibn Qudama said in his Al-Mughni Book: "In cases a man suffered bankruptcy where what he has cannot cover his debts then creditors can ask the judge or ruler to seize the wealth of the debtor and the judge is obligated to act upon it. Furthermore, it is preferable to seize debtor's wealth in public so others avoid dealing with him"

[82] Ka'b Bin Malik narrated that the Prophet (pbuh) seized the money (property, wealth and etc..) of Muaz Bin Jabal and sold it to pay off his debts [Al-Mustadrak : 2348]

[83] Prophet (pbuh) had said that if you find your property with the debtor, you are more entitled to take it back.

[84] Quran commands: "If a person is in difficulties, let there be respite until a time of ease."

[85] Zakah recipient list includes debtors (Gharimun)

		financed through public money
Litigation	Settlement is best (4:128)	Winner takes all

Umar A. OSENI, *Assistant Professor,* Department of Civil Law, Ahmad Ibrahim Kulliyyah of Laws, International Islamic University Malaysia.

INSOLVENCY AND DEBT RESTRUCTURING IN ISLAMIC FINANCE: THE NEED FOR A COMPREHENSIVE MODEL LAW

Introduction

The skyrocketing uncertainties in the global economy have rekindled the need to examine issues relating to insolvency and debt restructuring. With a focus on Islamic financial transactions and Islamic financial institutions, this paper examines the interplay between three related concepts of insolvency, bankruptcy and debt restructuring. Balancing these three situations in time of financial distress of an Islamic financial institution requires a fair consideration of the rights of both the debtors' and creditors'. In the light of this, this paper examines the current trends of insolvency and debt restructuring in the Islamic finance industry and proffers some future directions that would help reposition the industry to make it not only Sharīʻah-compliant but also conventionally viable.

As Islamic finance products and Islamic financial institutions expand into new jurisdictions across the world, there is a consequential risk of the rise of defaults, insolvency and finally bankruptcy which require some sort of standards to regulate the entire industry. Protecting the interests of creditors, investors or certificate holders is as important as consumer protection. Hence, the need for proper regulation of issues relating to defaults in the Islamic finance industry, both at the individual and institutional levels (Hassan & Kholid, 2010). The classical Islamic jurisprudence recognizes the concept of insolvency in debt-related transactions. Though some scholars have tried to distinguish between *iflās* (insolvency) and *taflīs* (bankruptcy), linguistically, they mean the same thing (Cowan, 1974: 726). However, the common term for an insolvent person in the prophetic precedents is *muflis*. While the condition of being unable to pay one's debt is *iflās* (insolvency) while the official act or procedure of declaring the person as such is *taflīs* (bankruptcy), for convenience sake, the terms are used in this paper interchangeably except where it is otherwise clarified.

Kilborn (2011b: 343) summarizes the nature of the term *falas* and its derivatives in Arabic philology:

> Rather, bankruptcy in Islamic law is a concept (called generically *falas*), reflected in several different but closely related Arabic words commonly encountered in *fiqh* discussions. Bankruptcy might describe either the *condition* (called *iflas*) of a distressed debtor (called a *muflis*), or the official *act* (called *taflis*) of declaring the debtor to be in one of two distressed conditions. The condition called "bankruptcy" might describe either simple balance-sheet insolvency (*i.e.,* that the debtor's debts equal or exceed his assets), or that the debtor has almost no property at all, just a few *fils* (the smallest denomination of currency). In any event, the condition of bankruptcy and its official declaration arise in the law only as part of the debt collection process....

One must not shy away from the fact that the classical *fiqh* does not have a clear-cut procedure for bankruptcy proceedings. But there are some fine principles that can be gleaned from *fiqh* based on prophetic precedents and developed by the earlier scholars. After all, it is the duty of scholars to piece together such fine rules and apply them to new issues. Some of these rules could contribute significantly to modern bankruptcy laws.

Modern scholars have not really explored the treasure trove contained in the classical *fiqh* relating to bankruptcy. Most countries in the Middle East and North Africa have their respective bankruptcy laws patterned after the French Bankruptcy Law.[86] While it may not be necessary to probe into the historical dynamics behind this phenomenon, one may agree with the assertion that even "though bankruptcy laws in the region today are largely dysfunctional, the Middle East has a uniquely solid and venerable foundation on which more effective insolvency laws might be built. Islam devotes particular attention to notions of peace and forgiveness – including a surprisingly specific

[86] In his presentation, Warde (2011) stated the obvious with regards modern Muslim countries and the development of their bankruptcy laws. "With Islamic law generally confined to personal status and family law, most Islamic countries adopted commercial codes – including bankruptcy laws – borrowed from European (mostly French) law. The trend persisted throughout the era of decolonization. Even in Saudi Arabia, a country that was not colonized and where the shariʻa is the law of the land, a bankruptcy system was established as part of the 1930 Commercial Court Law, and later updated with the 1996 Bankruptcy Preventive Settlement Law. The system was based on Western-based norms of receivership and liquidation, with an overlay of Islamic principles, based on the ideals of justice, fairness, and profit-and-loss sharing."

rule of bankruptcy relief" (Kilborn, 2011). In a similar vein, Hamoudi (2011) expressed similar concerns relating to the marginalization of Sharīʻah principles in the modern bankruptcy laws in the Muslim countries even though there is a lot of treasure trove of principles in the Islamic corpus juris that can positively impact the modern bankruptcy laws. These unique principles are premised on the higher objectives of Islamic law otherwise known as *maqāṣ id al-sharīʻah*. Generally, the law seeks to bring about benefits (*maṣ laḥah*) and prevent every form of harm (*ḏarar*). This is a general thread that runs through the Islamic corpus juris.

Even though the traditional conception of bankruptcy relates to individual bankruptcy since there was no clear cut distinction between commercial and non-commercial entities, the concept of *iflas* is known to the classical Islamic law (*fiqh*). The recent issuance of AAOIFI Sharīʻah Standard No. 43 on Bankruptcy has further brought to the limelight the need to protect investors in the Islamic finance industry. Furthermore, since the legal aspects of the Sharīʻah are inclusionary in nature based on the principles of *ibāḥah* (permissibility), one may arguably observe that while scholars are encouraged to come up with relevant principles on bankruptcy from the classical *fiqh*, they should be understood in the light of modern realities. Areas that are not specifically covered in *fiqh* may be adopted from modern bankruptcy laws in so far as they are not inconsistent with the *maqāṣ id al-sharīʻah* and do not violate any explicit principle of the Sharīʻah.

While the pioneering role of AAOIFI is much applauded, Sharīʻah scholars and financial experts should not remain in their comfort zones; they need to jointly come up with acceptable Sharīʻah based principles from the treasure trove in *fiqh* which may ultimately impact the modern bankruptcy laws. For a sustainable Islamic finance industry, this step is necessary to remain relevant in the global financial system. It is against this backdrop of modern realities that this paper examines bankruptcy and debt restructuring in Islamic finance with a view to proposing some future directions. The paper is organized into six major sections. The next section, which is the second, gives a brief conceptual framework of bankruptcy and financial distress in Islamic law. Section three examines the transposition of Sharīʻah rules on bankruptcy as recognized in the classical *fiqh* from the individual to corporate institutions with corporate personalities. Section four dilates on existing bankruptcy laws in some GCC countries involving national and cross border bankruptcies including the recently issued AAOIFI Sharīʻah Standard on bankruptcy. Section five gives some case studies on debt restructuring and the need to adopt best practices such as dispute management recognized in the classical *fiqh* to address issues relating to defaults and looming bankruptcies in the Islamic finance industry. Finally, section six gives the conclusion with some recommendations.

A Conceptual Framework of Insolvency and Financial Distress in Islamic Law

There are incidences which are used by both the proto-jurists and modern scholars to establish certain basic rules of bankruptcy. Just as in the modern laws, insolvency leads to bankruptcy even though the latter may be preceded by the process of debt restructuring. Hence, there are historical precedents in the Sunnah detailing some practices among the proto-Muslims during the prophetic era. For instance, it was reported that the Prophet prevented Muʻādh from disposing his property because his debts outweighed his assets. Since he was insolvent, the Prophet, being the head of state who also exercised judicial powers, sold the Muʻādh b. Jabal's property and paid off the creditors.[87]

Muslim jurists have endeavored to differentiate between financial distress (*'iʻsār*) and bankruptcy (*iflās*), and insolvency (*taflīs*). While Al-Qurtubi defines financial distress as a situation where one finds himself in a difficult situation due to lack of funds, Abu Jayib (1408) describes bankruptcy as a situation where one's debt outweighs his assets and there is no way the later can settle the former. Fruthermore, there is a sharp line of distinction between insolvency (*taflīs*) and bankruptcy (*iflās*). Once someone has become insolvent, he may be declared bankrupt and the creditors can get relief from the entire of all his properties.[88] This is done through an interdiction (*hajar*) on his properties by the creditors. The bankruptcy proceedings should ordinarily be managed by a constitued authority, usually the *qādi*. All the properties of the bankrupt person are sold with the exception of some necessaries such as food, drink and clothing. The proceeds of such sale are divided among the creditors. If the debt of any of the creditors is something concrete and recognizable among the properties of the bankrupt person, it is restored immediately without selling it.

The conceptual basis of the three concepts of *iʻsār*, *iflās*, and *taflīs* are found in the principles of social responsibility highlighted in the Qur'an: "And if the debtor is in a hard time (has no money), then grant him time till it is easy for him to repay, but if you remit it by way of charity, that is better for you if you did but know."[89] This legal rule does not suggest that the debtor should evade repayment of a debt (McMillen, 2012). While contractual transactions are meant to be fulfilled as a general principle, this exception of debt restructuring or cancellation is meant for special circumstances. In a related prophetic precedent, it is reported that the Prophet once said: "If anyone would

[87] This hadith was related in *Sunan Al-Baihaqi*, vol. 6, p. 48. *Talkhis al-Khabir*, vol. 3, p. 37. *Al-Mausu'ah al-Fiqhiyyah*, vol. 5, p. 301.
[88] A relevant hadith on this principle provides: "He who finds his property intact with a man (who bought it but who later on) became insolvent (or a person who became insolvent), he (the seller) is entitled to get it more than anyone else." Related by Bukhari and Muslim.
[89] Qur'an 2: 280.

like Allah to save him from the hardships of the Day of Resurrection, he should give more time to his debtor who is short of money, or remit his debt altogether."[90]

Nevertheless, Islam recognizes insolvency and once a competent court In his interpretation of this verse, Al-Qurtubi (2006/1427: 417) in his compedium of legal rulings of Qur'an explains the need for the judge to seize the property of a person who is insolvent except for his personal effects which are of utmost necessity such as his old clothes and books if he is scholar. This is further justified by a prophetic saying which provides: "If a man finds his very things with a bankrupt, he has more right to take them back than anyone else."[91]

Though there are different of opinions among the Muslim jurists on some of the issues, the general Sharī'ah principles on bankruptcy are summarized thus:

1. A debtor may be deemed bankrupt if he has no wealth or he has wealth but it will not cover the debt that is currently due. With regard to debts that are not yet due, the one who owes them cannot be deemed bankrupt.
2. The bankrupt individual may have his assets frozen if his creditors or some of them request that, so that he will not harm them by that.
3. If his assets are frozen, then any transaction he does, whether buying or selling, establishing a *waqf* or giving a gift, is not valid.
4. The ruler or *qādi* (judge) may sell his property in order to pay off his debts and leave him nothing except what is necessary for him, such as his dwelling, his books, his clothing, the tools of his trade, and the capital of his business; he may sell everything apart from that (Al-Munajjid, 2013).

It may not be necessary at this point to go into the details of Sharī'ah rules on insolvency. These have been comprehensively examined recently by Manṣ ūr (2012) with particular reference to insolvency of corporate bodies, Kilborn (2011b) who gives a comprehensive foundation on Islamic bankruptcy law, and Hamoudi (2011) who berated the attitude of Muslim countries in neglecting fine principles of Islamic bankruptcy law, and Awad & Michael (2010) who examined the Islamic law of bankruptcy as understood in the Sunni jurisprudence.

Transposing Sharī'ah Rules from Defaulting Individuals to Corporate Bodies

There is always the argument that corporate bodies are not recognized under the classical *fiqh* and thus such traditional understanding may impact the applicable rules to modern financial institutions with distinct legal personality. The emergence of the joint-stock limited-liability corporations in the Western world transformed the way people do business since such corporations had distinct personality from their owners. Hence, corporate bodies could then become debtors or creditors and indeed they could also become bankrupt. Though the notion of corporate personality has been a subject of debate among modern Sharī'ah scholars, the predominant view which is more pragmatic in the light of modern realities is that even though there is no direct reference to the corporate personality identity of a business outfit, it does not contradict any Sharī'ah principles; and as such, it is part of the Sharī'ah. More so, there are traces of principles expounded in the locus classicus of *Salomon v. A Salomon & Co. Ltd* [1897] AC 22.[92] For instance, once a *waqf* deed is created, it is dedicated to God and it immediately acquires a distinct status different from that of the founder (*wāqif*), beneficiaries, or the trustee. According to Muhammad Taqi Usmani:

> The Waqf is a legal and religious institution wherein a person dedicates some of his properties for a religious or a charitable purpose. The properties, after being declared as Waqf, no longer remain in the ownership of the donor. The beneficiaries of a Waqf can benefit from the corpus or the proceeds of the dedicated property, but they are not its owners. Its ownership vests in Allah Almighty alone… It seems that the Muslim jurists have treated the Waqf as a separate legal entity and have ascribed to it some characteristics similar to those of a natural person (Usmani, 1999).

[90] Related by Muslim.
[91] Related by Muslim.
[92] The position of the House of Lords was highlighted by Lord Macnagthen where he emphasized: "The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act." See *Salomon v. A Salomon & Co. Ltd* [1897] AC 51.

Usmani (1999) also supports his argument with some other renowned Islamic institutions such as *bayt al-māl* (public treasury),[93] inheritance under debt,[94] and joint stock partnership.[95] Meanwhile, it goes without saying that this recognition of traces of the natural person character of some Islamic institutions has been criticized by some scholars,[96] it is widely acknowledged that Islamic legal principles, particularly those relating to *fiqh al-mu'āmalāt* are flexible, as they are meant to reflect changing circumstances through *ijtihād*. Therefore, once it is established that there are similar institutions that had some form of independent status of legal personality as described above, this forms the basis of a new understanding of partnerships as having a separate corporate personalities.

It therefore flows from the above argument that the rules applicable to personal bankruptcy may be transposed or extended to corporate bankruptcy. This has to be clarified in order to move on to the next stage of the discourse, i.e. coming up with modern bankruptcy laws that are Sharī'ah-compliant and conventionally viable. Awad & Michael (2010: 985) agree with this position where they argue that:

> …there is no distinction in classical Islamic bankruptcy law between personal and commercial bankruptcies. This is entirely consistent with the related elements of a continuing duty to pay one's debts and the lack of the development of limited liability, entity-shielded, business vehicles, such as the corporation. As a result, the liabilities of the business enterprise would also be the obligations of the individual owner, or the partners in the partnership.

This makes a case for the application of Sharī'ah rules on bankruptcy in *fiqh* to modern corporate entities, particularly the Sharī'ah-complaint companies or Islamic financial institutions.

National and Cross-Border Bankruptcy & Insolvency Legislations

Most of the GCC countries do not have adequate bankruptcy laws even though some Islamic financial transactions and indeed institutions are vulnerable to financial distress. These uncertainties have further complicated issues involving sukuk defaults. It is unfortunate that the skyrocketing interest in developing the Islamic finance industry has not have any meaningful impact on bankruptcy laws of most Muslim countries. And insolvency is a cardinal aspect of financing regimes. Hamoudi (2011) has earlier made this concern which, up till now, has not been given the much needed attention by regulatory authorities in jurisdictions operating Islamic financial services:

> The interest in reforming bankruptcy laws is in fact astonishingly low, and bankruptcy is among the broad gamut of once Islamic legal regimes that have been, as a general matter, "totally replaced" by transplanted counterparts. To take one salient example, Qatar, which has begun a serious Islamization of its finance sector through issuing bank directives designed to expand Islamic banking within the country, initiated a bankruptcy regime in a 2006 law that bears all the hallmarks of a Western transplant (Hamoudi, 2011: 509).

Apart from Qatar, other Muslim countries with good regulatory frameworks for Islamic finance such as Malaysia, Saudi Arabia and Indonesia have similar experiences. Their bankruptcy laws are western transplants neglecting the fine Islamic principles that could add value to their laws. One is therefore not surprised why Hamoudi (2011) is flaggabasted about the conspicous irrelevance of Islamic bankruptcy in the modenr Muslim world.

There is no doubt that legislation or simply put, law plays a significant role in enahncing the original value proposition of Islamic financial intermediation (Oseni, et al. 2012). Islamic principles of bankruptcy cannot be relevant in the modern era without some sort of codification. While the bankruptcy regimes of Muslim countries have preferred the legal transplant approach from western laws, it is time for experts to come up with Islamic bankruptcy rules for the modern Islamic finance industry. It is doubtful whether the new AAOIFI Sharī'ah Standard No. 43 on Bankruptcy will have any impact on existing laws in Muslim countries.

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[93] He describes the exchequer of an Islamic state as having a separate juridical personality thus: "Being public property, all the citizens of an Islamic state have some beneficial right over the Baitul-mal, yet, nobody can claim to be its owner. Still, the Baitul-mal has some rights and obligations" (Usmani: 1999: 156).

[94] He describes this as: "the property left by a deceased person whose liabilities exceed the value of all the property left by him… According to the jurists, this property is neither owned by the deceased, because he is no more alive, nor is it owned by his heirs, for the debts on the deceased have a preferential right over the property as compared to the rights of the heirs. It is not even owned by the creditors, because the settlement has not yet taken place" (Usmani, 1999: 157).

[95] A similar juridical personality is seen in the Shafi'i understanding of a joint stock business, which Usmani (1999) describes thus: "According to a settled principle of Shafi'i School, if more than one person run their business in partner-ship, where their assets are mixed with each other, the zakah will be levied on each of them individually, but it will be payable on their joint-stock as a whole, so much so that even if one of them does not own the amount of the nisab, but the combined value of the total assets exceeds the prescribed limit of the nisab, zakah will be payable on the whole joint-stock including the share of the former, and thus the person whose share is less than the nisab shall also contribute to the levy in proportion to his ownership in the total assets, whereas he was not subject to the levy of zakah, had it been levied on each person in his individual capacity" (Usmani, 1999: 156-7).

[96] See the criticisms of Usmani's argument in Mujlisul-Ulama of South Africa (2004).

Cross-border bankruptcy cases

Any Islamic bankruptcy law must take into consideration cross-border bankruptcy cases with the increasing prominence of sukuk transactions which are susceptible to defaults. Hence, apart from the enabling legislation, cross-border bankruptcy rules need to be issued. It is interesting to observe that the United Nations Commission on International Trade Law (UNCITRAL) issued its Model Law on Cross-Border Insolvency on 30 May 1997 (UNCITRAL, 1997). Other related instruments issued by UNCITRAL are:

(a) UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation, 2009
(b) UNCITRAL Model Law on Cross-Border Insolvency: the Judicial Perspective, 2011
(c) UNCITRAL Legislative Guide on Insolvency Law, Part three, 2010

About 20 jurisidctions have adopted the Model Law and none of them is part of the Muslim world.[97] The reason for this is obvious. As earlier observed, most Muslim countries, if not all, have patterned their bankruptcy laws after the French bankrutpcy law. Despite the fact that a new French Bankruptcy Law (*Ordonnance* 2008-1345 of December 18, 2008), and the corresponding implementing regulation (*décret* 2009-160 of February 12, 2009) came into force on 15 February 2009, many of the Muslim countries that have patterned their laws after the defunct law have not amended their bankruptcy laws even though the French bankruptcy law has undergone several amendments. The new French bankruptcy law was enacted to facilitate pre-insolvency restructuring ("*procédure de sauvegarde*") which represents a form of dispute management among the parties. Undoubtedly, this form of restructuring is previously unknown to the French law but it has been the bedrock of the Islamic bankruptcy law as established in the prophetic precedent.

The AAOIFI Standard on Bankruptcy (Sharīʻah Standard No. 43)

The objective of this Sharīʻah standard is to introduce the Islamic legal principles relating to bankruptcy and their application to the business of modern Islamic financial institutions, as well as the companies or individuals that deal with such financial institutions. It is interesting to note the difference bewteen *iflās* and *taflīs* given in Article 2 of the AAOIFI standard. It defines *iflās* as a situation where the current debts of the debtor are more than his assets. On the other hand, *taflīs* as the ruling of a judge with regards the bankruptcy of the debtor preventing him from disposing his assets. Through such ruling or judgment of the court, the bankrupt is prevented from managing his assets. This distinction, with particular reference to the former, represents the reference made earlier to prophetic precedents. In this case, the debtor may be an individual or a corporate body, which also includes an Islamic financial institution.

Article 3 provides for the applicable Sharīʻah rules in bankruptcy issues. It is incumbent upon the debtor to refrain from any action that is detrimental to the creditor even if he has not been declared bankrupt by a competent court. The competent authorities saddled with the responsibility of bankruptcy proceedings must endeavor to establish that the debts of the debtor are more than his assets before placing a financial interdiction on his dispositions. Generally, the standard provides for the scope of the standard on bankruptcy (Art. 1), the definition of insolvency and bankruptcy in Islamic law (Art. 2), the Sharīʻah principles on insolvency (Art. 3), different phases relating to insolvency (Art. 4), effects of bankruptcy (Art. 5), right of recovery of a sold item from one who has been declared bankrupt (Art. 6), sale of the property of the bankrupt and what may be left for him (Art. 7), distribution of the assets of the bankrupt among the creditors (Art. 8), exclusive rules applicable to Islamic financial institutions (Art. 9), and discharge of a bankrupt (Art. 10).

Being standards that are not binding in a way conventions are binding, it is left for the Islamic financial institutions that are members of AAOIFI to implement them (Colón, 2011).in the meantime, it may interest practitioners to see how the new AAOIFI standard will work in light of existing legislations in Muslim countries. Nevertheless, one must not shy away from the fact that these rules cannot be implemented by those financial institutions. Issues relating to insolvency and bankruptcy fall under the powers of the state and competent authorities. Hence, the need to come up with model Islamic bankruptcy law that would be used to benchmark related practices in the Muslim world. The AAOIFI standard may form the basis of a more pragmatic and systematized model Islamic bankruptcy law for the Muslim world.

For such standard model legislation on Islamic bankruptcy, other areas not covered in the AAOIFI standard such as cross-border insolvency, which is very relevant in the modern Islamic finance industry with the proliferation of cross-border *sukuk* transactions, and debt restructuring through conciliation or arbitration involving amiable composition should be emphasized. Other aspects of modern bankruptcy laws, whether from the UNCITRAL Model

[97] The countries that have enacted legislations based on the Model Law on Cross-Border Insolvency and the year of their adoption are: Australia (2008), Canada (2005), Colombia (2006), Eritrea (1998), Greece (2010), Japan (2000), Mauritius (2009), Mexico (2000), Montenegro (2002), New Zealand (2006), Poland (2003), Republic of Korea (2006), Romania (2002), Serbia (2004), Slovenia (2007), South Africa (2000), Uganda (2011), UK – British Virgin Islands (2003), Great Britain (2006), United States of America (2005).

Law or the French bankruptcy law, that do not contradict fundamental principles of Sharīʻah should be taken into consideration to promote global integration.

Debt restructuring, Dispute management and defaults in Islamic financial Transactions

While issues relating to insolvency are recognized in Islamic law, emphasis is placed on debt restructuring and amicable dispute management that serves the purpose of all stakeholders. The desirability of conciliation and forbearance is emphasized in Qur'an 2: 280 (Warde, 2011). This basis of debt restructuring established in the Qur'an is further explained in a number of prophetic precedents. 'Abdullah b. Ka'b b. Malik once narrated that Ka'b demanded his debt back from Ibn Abi Hadrad in the Mosque and their voices grew louder till Allah's Apostle heard them while he was in his house. He came out to them raising the curtain of his room and addressed Ka'b, "O Ka'b!" Ka'b replied, "Labaik, O Allah's Apostle." (He said to him), "Reduce your debt to one half," gesturing with his hand. Kab said, "I have done so, O Allah's Apostle!" On that the Prophet said to Ibn Abi Hadrad, "Get up and repay the debt, to him."[98] The Prophet served as the judge during the early period of Islam and had cause to settle a number of disputes in a manner acceptable to all the parties. He encouraged the creditor to reduce the amount of debt and the debtor to pay off the debt as soon as possible, thereby avoiding a situation where the latter will be declared bankrupt. As Warde (2011) rightly posited, "[t]he judge (*qadi*) was the central figure in finding an appropriate resolution to the cases brought before him. What resulted was an ad hoc attempt at compromise as opposed to systematic receivership. Assuming good faith, both sides were expected to make concessions. Typically there would be a reduction of debt and a change in terms based on the debtor's ability to pay". It therefore follows from the above discussion that there cannot be debt restructuring without appropriate steps toward dispute management among the stakeholders involved in a particular transaction.

For disputes involving insolvency, it thus appears a number of amicable dispute resolution processes are applicable (Oseni, Ansari, & Kadouf, 2012). Notable among these processes are compromise of action, conciliation, arbitration, and litigation. That is, any case involving insolvency should begin with compromise of action and if not resolved amicable through it, it may proceed for conciliation and arbitration, and ultimately end in litigation. Compromise of action is meant to create an avenue for the parties to discuss debt restructuring and make such compromise or any other arrangement they deem expedient with the creditors. While the compromise of action procedure does not involve a third party neutral who is empowered to make a binding ruling, conciliation and arbitration may involve such a third party whose decision may be binding on the parties. But any settlement agreement that emanates from the compromise of action proceedings which is duly signed by the parties should be enforceable by the courts.

While the East Cameron case involved a junk *sukuk* issuance which ended up in the U.S. courts, the Nakheel debacle was properly managed through appropriate steps toward debt restructuring with the creditors. After reaching a compromise with the trade creditors, it completed the $10.9 billion debt restructuring in the first half of 2011. Recently, as part of its restructuring plan, it issued $32.94 million *sukuk* on 7 January 2013 which represents the third tranche in the restructuring process.

In 2009, the Investment Dar also defaulted on a $100 million *sukuk* and it was restructured in 2011. Part of the arrangement was to convert part of the claims of the creditors into equity in the company. In a similar vein, the near-default Dana Gas *sukuk* issue is being resolved through compromise of action. Dana has proposed a $920 million debt restructuring deal where it offered bondholders $70 million in cash while the remaining $850 million debt will be refinanced. At present, the shareholders are still considering this offer but there are indications that some of them will agree with the proposed plan.

Table 1. Remedial Measures for *Sukuk* Defaults and Near Defaults

Name of Sukuk	**Immediate Cause of Default or Near-default**	**Exit Strategy / Remedial Measure**	**Year of Default**
The Investment Dar	Default on a $100 million debt repayment	Debt restructuring to revive the *sukuk* sales	2009
Golden Belt 1 (Saad Group)	Default in repayment of $650 million to Citicorp Trustee Co. Ltd.	Dissolution of the Trust	2009

[98] Vol. 3, Book 41, Hadith No. 600.

East Cameron Partners	Filing of one of the parties (East Cameron Partners) for bankruptcy	Bankruptcy proceedings	2008
Nakheel	Delay in repayments of $4 billion sukuk	Default narrowly averted with the rescue of Abu Dhabi	2009
IIG Funding Limited	Inability to make periodic distribution to sukuk holders	Looming debt restructuring plan	2012
Dana Gas	Inability to repay outstanding $920 million of the sukuk, issued in 2007, on time and in full	Presently seeking consensual deal on sukuk by weighing options of repayment	2012

Source: (Oseni, 2012)

What can be gleaned from Table 1 above is the preference of stakeholders for remedial measures as exit strategies for the sukuk debacle. Apart from the extreme situation where a party has to commence bankruptcy proceedings, it appears parties prefer debt restructuring which agrees with the Qur'anic principles of forbearance and forgiveness in issues relating to debt. Be that as it may, a clear legal framework is necessary for debt restructuring in cases of sukuk defaults. The proposed Islamic bankruptcy law should be comprehensive enough to accommodate pre-default issues that may require debt restructuring. A looming default should ordinarily trigger the process of debt restructuring. Managing the dispute at its early stage will help prevent an escalated dispute that may end up in bankruptcy proceedings.

Conclusion and Recommendations

This short paper has attempted to highlight some current trends in insolvency and debt restructuring in the Islamic finance industry with a view to proposing future directions for the industry. This is necessary to ensure the Sharī'ah compliance of the process as well as coming up with a conventionally viable Islamic bankruptcy law. It is needless to say that most of the Muslim countries have been complacent about the need to ensure that the laws regulating insolvency and bankruptcy issues is Sharī'ah compliant. While significant strides have been recorded in the regulation of Islamic finance industry, there has not been much development in the Islamic insolvency law.

One may conclude by re-echoing McMillen (2012)'s concerns on the need for fundamental research and indeed discussions on some relevant issues with a view to understanding the Sharī'ah position on some contemporary practices.

> If, in line with international trends, the system will incorporate reorganization concepts and principles, what is the *Sharī□ ah*basis for this regime? Even the fundamental questions are daunting. For example, consideration will need to be given to debt rescheduling concepts, debt forgiveness concepts, delayed debt payment concepts, equity conversion concepts, asset sale concepts, and differential equity conceptions. There will have to be consideration of whether voluntary bankruptcies can and will be permissible. And after agreement is reached on the basic nature and parameters of the system, the long road of discovery and elucidation of specific *Sharī□ ah*principles will have to be addressed. That undertaking will wind through a great deal of new territory, from the *Sharī□ ah* perspective, and will entail a comparative laws analyses (*sic*), and a systemic comparison, unlike any in history (McMillen, 2012: 29).

At this juncture, it is pertinent to emphasize that the process of coming up with a model law starts from a joint deliberation among Sharī'ah scholars, economists, financial experts, lawyers and even the consumers of Islamic finance products. Perhaps, the process can start from the one-day workshop to come up with the major highlights of a modern Islamic bankruptcy law. Subsequently, a committee comprising experts from all the groups concerned should be set up to come up with a draft which should, as a matter of necessity, be subject to further deliberations. Therefore, rather than waiting for the OIC Islamic Fiqh Academy to come up with a model law, the initial draft may be prepared and forwarded to it for ratification.

Against the above backdrop, the following recommendations should be taken into consideration while formulating the fine principles of a model Islamic bankruptcy law:

1. Identifying the unique Islamic principles on financial distress, insolvency and debt restructuring. These may form the subject of a preliminary discussion from which a skeletal draft may emerge as a working outline for the special committee on the model Islamic bankruptcy law to be set up.

2. Coming up with model rules or laws on bankruptcy and debt restructuring that can be domesticated in Muslim countries which are specifically applicable in the Islamic finance industry. Such a model law should consist of both the enabling laws and subsidiary legislations, i.e. both the substantive and procedural aspects.

3. The proposed Islamic bankruptcy law should be developed at the level of OIC for wider acceptance among member countries. The International Islamic Fiqh Academy (IIFA) of the OIC should constitute a high-powered committee comprising of leading experts in bankruptcy law in the modern world, leading Muslim lawyers from different member countries, representatives of IIFA, academicians, economists and financial experts, and some notable Sharīʻah scholars in the Islamic finance industry. This committee should be saddled with the responsibility of coming up with a model Islamic bankruptcy law to be proposed to the OIC member countries. In the interim, such committee may only need to ratify a draft law if such has been prepared by a team of experts.

4. Structuring sukuk according to Islamic rules with specific reference to insolvency rules in Islamic law. The proposed Islamic bankruptcy law should be able to take case of issues of sukuk defaults. Since sukuk largely involve debts, insolvency issues should naturally be anticipated; hence, the need to specifically provide for sukuk transactions, particularly cases involving cross-border bankruptcy and insolvency cases.

5. Emphasizing an outcome-oriented and conciliatory approach in managing bankruptcy issues in the Islamic finance industry. This should form the bedrock of dispute management in cases involving insolvency.

6. Setting up Sharīʻah-complaint tribunals for the resolution of bankruptcy cases. Specialized arbitration tribunals may be utilized. This should be provided for under the model Islamic bankruptcy law.

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Rodney WILSON, *Emeritus Professor,* Durham University, UK and INCEIF, Kuala Lumpur

INSOLVENCY & DEBT RESTRUCTURING IN ISLAMIC FINANCE

Islamic teaching on debtors in difficulty

The teaching in the Holy Quran on debt is clear as it states that when a debtor is in difficulty they should be given time to repay. (Sura 2:280). Indeed if the debt is forgiven as a charitable act, this will be best for the lender.

Islamic banks are not charities however, but commercial institutions with shareholders who are seeking dividends and capital gains, and depositors, including those with investment accounts, who are expecting profit sharing pay-outs. There is a conflict of interest between those being financed and an Islamic bank's owners and depositors. Debt forgiveness on a large scale will result in declining shareholder value and zero profits for investment account holders. Regulators will also be concerned with excessive debt forgiveness, as if the bank fails, in most jurisdictions governments will be obliged to bail out the bank using taxpayers' money.

How can Islamic banks reconcile such conflicts of interest with the teaching of the Holy Quran?

Firstly Islamic banks can take a moral position and distinguish between clients who default because of genuine difficulties, such as ill health, and unscrupulous defaulters. The latter may give lower priority to settling their debts with Islamic banks than those with conventional lenders, as Islamic banks cannot impose additional charges and therefore may be viewed as a "soft touch".

Moral hazard is a significant challenge for Islamic banks. Nevertheless by restricting re-scheduling and debt forgiveness to those in greatest genuine need, this ensures help is concentrated, whereas if all debtors are aided, help will be at best partial given limited resources. Failure to meet repayments commitments due to poor business decision making would not qualify for debt forgiveness, although some rescheduling may be permitted.

Second Islamic banks can offer clients in financial difficulty *qard hasan* loans, the only type of loan permitted under *Shari'ah* as it involves no interest charges. The purpose of such loans in the case of potential payments failure is to ensure that repayments can be made without delay on *murabaha*, *ijara, istisna* and other forms of Islamic financing. The *qard hasan* will not be paid into the client's current account, but rather into the account used to settle the financing contract.

The new financing can be classified as hypothecated. Hence there is no possibility of the client using the *qard hasan* for purposes not approved by the bank. An arrangement fee can be charged for the *qard hasan* plus a management charge for the duration of the contract. The bank should not profit directly from the financing, but it is legitimate for charges to be levied to cover set-up and monitoring costs. Needless to say *qard hasan* should only be offered to those who can in time meet their financial obligations; otherwise the bank would be giving away good money after bad. *Qard hasan* is a loan contract, and the loan must be repaid; it is not a gift.

Poor risk management

Where repayments defaults occur it should not be assumed that the debtor bears full responsibility as is too often the case in conventional banking where risk is treated in an asymmetrical manner. Payments failures often reflect poor risk appraisal by lenders, or even worse, miss-selling of financial products which are inappropriate for the client's requirements. In other words the bank itself bears some of the responsibility for the repayments failure, and not solely the client.

Islamic finance involves risk sharing and hence the recognition of risk management responsibilities. When clients default, the banks are partly to blame, as the key skill in banking is risk appraisal, and payments failure provide evidence of less than adequate appraisal.

Systems failure

Systems can also be at fault. Requiring post-dated cheques as collateral for financing, as has been the practice in the UAE and other GCC countries, is a dubious practice. When cheques are not honoured the debtors can face prison sentences, but this makes little sense, as imprisonment is costly for the state, and those in prison cannot be engaged in gainful employment that would enable them to repay their debts.

However it is not only in the GCC where systems are inadequate. The large number of home re-possessions in the United States and to a lesser extent other western countries as a result of the sub-prime crisis was at best a sign of risk appraisal failure, and at worst of deliberately signing up clients for mortgages who had no realistic possibility of repaying. The bank employees were paid incentive bonuses for each client signed up, regardless of whether they remained in good standing: a system that encouraged and rewarded irresponsibility.

Conclusions

Islamic banking principles deal more justly with debt and insolvency issues than their conventional equivalents. A moral appraisal of the causes of defaults, recognition of joint responsibility for payments failures and the use of instruments such as *qard hasan* all have a part to play. Practices may not always live up to the principles, but the way ahead is clear for Islamic banking if it is to realise its potential under conditions of stress.

Luqman Zakariyah, *Visiting Fellow*, Islamic Legal Studies Program, Harvard Law School, Cambridge, Massachusetts, USA

INSOLVENCY & DEBT RESTRUCTURING IN ISLAMIC FINANCE

First of all, I thank Professor Nazim Ali for dragging me to the discussion on the forthcoming Harvard LSE workshop. To him I am very grateful. Being a newcomer to this forum, I would like to focus on the first sub theme for this workshop which is “defaulting individual” from there; perhaps, we can drawn analogy to delve with other subs.

Debt is inevitably detested rights of human. All humans are indebted in one way or other. We are indebted to Allah for His countless bounties on us as we are also indebted to those who have in one way or others helped or assisted us in various ways in our lives. Most of these debts, especially the ones we owe our Lord can never be restructured or eradicated.

Temporal debt (material ones) sometimes may not be settled till one passed away. It is reported by that the prophet died and his garment was mortgaged with a Jew. (al-Bukari hadith 2916). If this is true, it shows significantly that even the bellowed one to God had never had sufficient means to cater for his need till he died. When one juxtaposes the occurrence with the other traditions that detest debts and seek from Muslims to seek refuge from debt, (al-Asqalani Bulugh al-Maram, Hadith no 1573), one may think that there is a contradiction. However, looking vividly into the texts suggest that the former shows “inevitability of having debt and the latter suggests indulging in debt. This interpretation fits well into the idea of debt restructuring in Islamic finance.

At this junction, it is worth examining what is inevitable debt and how the rights of debtor and creditor can be protected from Islamic point of view. Man is created to striving for his endless means according to a poet.
“naruh wanaghdu li hajatina # wa hajat man asha lantaqadi”
“We strive day and night to get our needs # the needs of a living soul are endless”

Islam has taken a balance judgment on dealing with humans’ rights especially in property ownership. In business, different terminologies have been used by Muslim jurists to adjudicate in cases involve humans rights in business. Sometimes, the word yajuz (allowed) laa yajuz (not allowed) are used to signify that a particular action is moral or immoral. Thus, a Muslim will have to take decision on whether breaching immoral or act morally at a particular time is necessity or not. This aspect of Islamic law can be called “moral obligation”.

For a creditor to have mercy on and to forgive a debtor is a matter of moral obligation which otherwise called “diyanatan” (something do for extral rewards from God). This Quran is clear in encouraging a creditor to “And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease; and that ye remit the debt as almsgiving would be better for you if ye did not know” (280).

One may argue that Islamic banks are not charities and thus, forgiving debt will cost huge loss to the business. This is right and Islam does not oblige the creditor to do so. However, how could such Islamic industry cater for the well being of its members who are in difficulties for paying back their debts? I think the issue should be looked into beyond microscopic level to macroscopic one.
Two practical suggestions will be made here:

1. The banks need to thoroughly scrutiny the application of a debt seeker to know whether the need is necessity (daruriyya), complement (hajiya) or luxury (tahsiniyya). This will give chance to advise on the possibility of the banks to give out loan on qard hasan. If such applicant defaults there will be a very strong case to forgive or give more time to pay back. This indeed with harmonizes the legalistic level of Islamic finance law and its moralistic dimension.
2. The banks who profits on their products may not be completely charities but, they can charitable obligation for which separate outlet of the business can cater. The profit that emerge from their business to be used to create charity outlet for anyone who is in debt and cannot pay back.

In my subsequent comment, I will address the issue of Defaulting Corporate transactions (insolvent borrowers: *sukuk*)

Chapter 10 - Restructuring

Insolvency and Restructuring Manual

Status: Law stated as at 30-Apr-2009

Jurisdiction: United Kingdom

This chapter is from *Insolvency and Restructuring Manual* (Bloomsbury Professional), which is a comprehensive guide to corporate insolvency and restructuring. It is intended to provide an introduction to the subject and to serve as an aide memoire for more experienced practitioners. The book takes the reader through the various formal insolvency processes and examines the differences between them. It reviews and explains a wide range of associated topics, including antecedent transactions, the position of directors, the rights of creditors and cross-border issues. It also deals with the wider issues involved in the restructuring of a troubled company's debts.

Chapter 10 Restructuring

Table of Contents

10.1 INTRODUCTION

Chapter 1 gave a brief overview of the considerations involved in a restructuring. This chapter considers the thinking involved in a restructuring more generally, and looks in particular at the following stages which might typically be involved in a successful restructuring process:

identifying the problem and the relevant stakeholders;

creating a stable environment;

information gathering;

assessing the restructuring options and implementing a solution.

For simplicity, this chapter takes as its model a restructuring of a group of English-registered companies with a structure which might typically exist after an acquisition financed with a mixture of debt and investment from a single major shareholder. A simple example of such a structure is shown in Table 10.1.

In practice, the group structure may differ from this. It may also be that, for business, tax or other reasons, some of the companies in the group are overseas entities. Where one or more of the companies in the group is listed, or the debt itself is listed (eg following a securitisation), then this will create additional issues which are largely beyond the scope of this book. Nonetheless, much of the content of this chapter will still be generally applicable.

10.2 IDENTIFYING THE PROBLEM

10.2.1 What is the problem?

For a successful restructuring to be achieved, the company, or group, must have a viable underlying business. In many cases it may not become clear whether this is the case until further work has been carried out. However, once the fundamental problem, or problems, the group is facing have been identified, the relevant stakeholders will be able to make a commercial judgement as to whether it is even worth carrying out further work.

Groups encounter financial difficulties for a variety of reasons:

the state of the economy generally;

problems exist in the group's industry sector generally; and/or

problems exist which are specific to the group.

Table 10.1 – Typical post-acquisition group structure

[Table not included]

Clearly, if one or both of the first factors are also present, these may exacerbate any problems the group already has. However, groups with viable underlying businesses may still encounter difficulties even in a benign economy where their competitors are thriving.

Sources of difficulty which may not adversely affect the long-term viability of the business may include:

an over-ambitious acquisition strategy;

flaws in the business model;

an underperforming non-core business draining the core business;

loss of a major customer or supplier; and/or

increased cost of a defined benefit pension scheme, labour, utilities, or other key purchases.

It may be clear that a simple solution which does not require a fuller restructuring of debt or equity is available – see Section 10.2.3. However, more significant action is likely to be needed if the underlying problem means that in the medium to long term the group can no longer afford the cost of servicing its existing interest payments and/or principal repayments to its financial creditors.

10.2.2 What is the 'trigger point'?

There will usually be some clear point in time before which action needs to be taken. Such 'trigger points' might typically include:

the testing date for a financial covenant in the group's banking facilities;

the date on which the group's annual accounts needed to be signed off by the auditors;

the date on which the group's banking facilities are due to be repaid;

the date by which a regulatory authority, such as the FSA, is threatening to withdraw a licence or consent which the group needs to continue to trade unless action has been taken;

the date on which the operating subsidiaries in the group are forecast no longer to have sufficient cash to operate.

The existence of such a trigger point can be a virtue on one sense, in that it may concentrate stakeholders' minds on the need to complete the whole restructuring by the date in question. However, if this cannot be achieved, interim solutions may need to be found.

10.2.3 Is a simple solution available?

If it is immediately clear that the underlying problem derives from a one-off event or is otherwise not a serious one, it may not be necessary to carry out a more fundamental restructuring of the group's debt or equity structure. Examples of simple solutions include:

replacing of underperforming senior management;

resetting of financial covenants (or waiving of a breach deriving from a one-off problem);

a minor change in the dates for the payment of debt and/or interest by the existing lenders under a banking facility;

an equity injection (ie a cash subscription for further shares) by a sole, or majority, shareholder, or a rescue rights issue to a larger group of existing shareholders, to provide the group with the cash it needs to cure a financial covenant breach or cash-flow problem; and/or

raising cash by other means, for example by a sale of non-core assets or parts of the business or a sale and leaseback of freehold premises.

Groups and their stakeholders will tend to consider such options prior to deciding that more significant action is needed. However, in some cases, it may transpire that what was thought to have been a simple but permanent solution was only an interim solution.

10.3 WHO ARE THE KEY STAKEHOLDERS?

For a successful restructuring to be achieved, a sufficient number of the key stakeholders whose interests will be affected by the restructuring must support the process. These key stakeholders might include:

10.3.1 Shareholders

Investor shareholders are likely to have considerably more day-to-day involvement with the business itself than the financial creditors. Their appointees may well sit as non-executive directors on the board of one or more of the group companies and provide considerable expertise. The shareholders are likely also to have strong links with the rest of the management, although it is also they who have the power to remove underperforming directors.

If the group is already insolvent on a balance sheet basis, its shares will retain no present value. Where creditors are asked to compromise their claims, they are likely therefore to expect shareholders also to make some new investment in any restructuring, or otherwise relinquish their existing shareholder rights.

10.3.2 Financial creditors

Some groups may have only a single lender. However, larger, more sophisticated groups are likely to have several tiers of debt consisting (in descending order of priority) of senior, second lien, mezzanine, and subordinated debt.

If senior, second lien or mezzanine loans have been syndicated, there may be a number of different lenders in each tier. Some of the tiers of debt may in turn be subdivided into more than one sub-tier. The subordinated debt may include debt due to shareholders, outstanding consideration due to the seller of the business from the existing owners and/or debt due to past or present management and will typically be recorded in the form of loan notes. If the company has issued bonds, these will form a further tier of debt.

The group of financial creditors who are likely to prove most active in any restructuring are those who would expect only to be partially repaid on a formal insolvency of the group. Colloquially, the value 'breaks' in their tier of debt. Financial creditors whose debt still sits above the value break can expect to be repaid in full, whereas financial creditors sitting below the value break would be repaid nothing and might therefore be less engaged; but their agreement may still be needed to achieve a consensual restructuring. Financial creditors whose debt sits just below the value break, are also likely to be fairly active, and are likely to scrutinise any valuations carefully. In addition, financial creditors who hold debt below the value break may also hold debt at a higher level, and try to use this as leverage.

The picture will be complicated further if, since the debt was originally lent, all or part or it has been sold to other parties. Players in the distressed debt market may have bought debt, or acquired sub-participations in the debt, at a substantial discount. These players may well have a very different agenda from the original financial creditors. They could still stand to make a positive return on the investment if the business is quickly broken up or sold. Alternatively, their primary objective may always have been a restructuring which converts that debt to voting shares, giving them control of the group – a so-called 'loan to own' strategy.

The first stage of a restructuring will often therefore require the group to identify which financial creditors now hold all of its debt.

The rights of the financial creditors vis-à-vis each other will be important and will be set out in various documents, which the relevant stakeholders will also need to review. For example:

> A deed or priority, or intercreditor agreement, will set out the priority ranking of the various creditors, limit the rights of lower ranking creditors to receive payments and/or to take their own enforcement actions, and stipulate what further actions the higher ranking creditors can take without the consent of the lower ranking creditors. It may also give lower ranking creditors the right to buy out higher ranking creditors at par.
>
> Individual facility agreements will stipulate how decisions are taken among the various lenders under that facility. Many decisions, for example to waive breach of covenants, can be taken if a stipulated majority of those lenders are in favour, but a decision to reduce the total debt due or to extend a repayment date is likely to require the consent of all of those lenders.

10.3.3 Other major creditors

If one of the difficulties of the group is that it has an underfunded defined benefits pension scheme, it may be necessary to restructure this either as an exercise in itself or as part of a wider restructuring. Whilst the debt due to the pension scheme may be unsecured in the event of a formal insolvency (see Chapter 9), the trustees will be in a far better negotiating position than other unsecured creditors due to the special powers of the Pensions Regulator ('TPR'). Pensions issues are discussed further in Section 10.8.

The group may also be paying excessive rents on business premises, particularly where the underlying problem was an over-ambitious acquisition or expansion strategy, in which case the debts due to some of its landlords may need to be addressed.

However, it is unlikely that most consensual restructurings will be carried out in a way which affects the trade creditors, employees or most of the other operational creditors of the group, for a number of reasons:

> the process creates uncertainty and risks the ability of the business continuing as a going concern;
>
> key suppliers are likely to adopt ransom positions and refuse to trade further with the business, or supply it on less favourable terms going forwards as the cost of their consent;

a far larger number of parties might need to be involved in the restructuring process, many with very small claims, which they might be reluctant to compromise consensually; and

it would be virtually impossible to conduct such wide negotiations confidentially.

Indeed, even if a formal insolvency process is used as a restructuring tool this will frequently still provide for trade creditors or employees to be paid in full.

10.3.4 Management

The other stakeholders are likely to wish to ensure that existing management are retained and incentivised as part of the restructuring process. This is because:

although in some case the problems of the business lie with existing management, management will often be key to the value of the business going forward;

the information-gathering exercise required as a precursor to the restructuring will be far more difficult without their help.

Management are likely to prefer a restructuring to an unplanned formal insolvency for a number of reasons. In the latter case executive directors could lose their jobs and all directors who hold equity or share options would lose these. Formal insolvency may lead to disqualification proceedings against the directors, and on a liquidation personal liability is a possibility. However, management will still remain wary of the risk that, by continuing to trade, they may increase their exposure to disqualification or personal liability should the restructuring fail and formal insolvency still result.

Non-executive directors may also have different motivations from executive directors. The group will not be their only source of income, and they are also likely to have less emotional commitment to the survival of the group. They may be more concerned that if they remain a director of a group which fails, this could adversely affect their own reputations.

In addition to creating stability generally in the other ways described in this chapter, the stakeholders may therefore need to address management's concerns:

by addressing management's own incentivisation packages early;

by creating a stable financial environment, as outlined in Section 10.4; and

by giving comfort to the existing directors that they are not being left to take the risk alone. In this respect, the stakeholders may be inclined anyway to supplement the existing board by appointing one or more further directors with specialist turnaround expertise.

10.4 CREATING A STABLE FINANCIAL ENVIRONMENT

10.4.1 What principles apply here?

In the 1970s, the Bank of England developed a set of general principles to govern how a group's financial creditors should respond when they become aware that the group is facing serious financial difficulties. These principles became known as the London Approach.

The aim was to give the troubled group a breathing space whilst information was gathered to determine whether it could survive, and for proposals then to be put together. During this time, the group is likely to need continued access to its lending facilities and possibly new money. However, in return for not withdrawing facilities or enforcing, creditors need to know that their own positions will not deteriorate absolutely or relative to each other. The basic premise was that by acting collectively, the financial creditors ought to ensure a higher return for all of them than they would receive on a formal insolvency.

In 2000, INSOL International (the International Federation of Insolvency Professionals) published the INSOL Global Principles for Multi-Creditor Workouts (the 'INSOL Principles'). These were intended to be a statement of best practice to be followed in multi-creditor restructurings. Broadly speaking, the principles involved reflect the London Approach, but they were designed to be equally applicable in a variety of different jurisdictions. The INSOL Principles are set out in Table 10.2.

Neither the London Approach nor the INSOL Principles have any statutory force. Due partly to the fact that it has become commonplace for a group's finance debt to be held by an increasing number of entities, often with a variety of agendas, they are by no means universally applied. Indeed, their strict application is probably becoming increasingly less common given the number of aggressive distressed debt investors now operating in the market. However, the underlying principles involved are still a useful starting point for moving towards a restructuring which is designed to enable the survival of the group.

Table 10.2 – The INSOL principles

First Principle: Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to co-operate with each other to give sufficient (though limited) time (a standstill period) to the debtor for information about the debtor to be obtained and evaluated and for proposals for resolving the debtor's financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.

Second Principle: During the standstill period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor but they are entitled to expect that during the standstill period their position relative to other creditors and each other will not be prejudiced.

Third Principle: During the standstill period, the debtor should not take any action which might adversely affect the prospective return to the relevant creditors (either collectively or individually) as compared with the position at the standstill commencement date.

Fourth Principle: The interests of relevant creditors are best served by co-ordinating their responses to a debtor in financial difficulty. Such co-ordination will be facilitated by the selection of one or more representative co-ordination committees and by the appointment of professional advisers to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.

Fifth Principle: During the standstill period, the debtor should provide, and allow relevant creditors and/or their professional advisers reasonable and timely access to, all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors.

Sixth Principle: Proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill should reflect applicable law and the relative positions of relevant creditors at the standstill commencement date.

Seventh Principle: Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should, unless already publicly available, be treated as confidential.

Eighth Principle: If additional funding is provided during the standstill period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

10.4.2 The co-ordinator

The co-ordinator is appointed by the group's lenders and the group itself, and will normally be the bank with the largest exposure. They will play the role of 'lead bank' in the restructuring. The scope of the co-ordinator's role is often set out in a specific co-ordination agreement. This role is likely to include:

- collating and disseminating the financial and other information provided by the group, and by the investigating accountants (see Section 10.5);

providing feedback to the group on any information provided by it, and on any presentations given by the group to its lenders;

liaising between the group and any facility agents, or possibly the individual lenders, with regard to the any standstill arrangement and any requests for new money by the group; and

liaising between the group and the other lenders in relation to any restructuring proposals put forward.

Although it may be responsible for obtaining legal and financial advice, the co-ordinator's own role is therefore administrative, not advisory, and it will ensure that the co-ordination agreement places clear limits on its responsibilities. A co-ordinator may nonetheless in practice provide much of the driving force needed to achieve the restructuring.

Any co-ordination agreement will also deal with the co-ordinator's fees and other expenses. Since these are likely to be borne by the group itself, it will usually take a particular interest in the extent of the co-ordinator's role and its ability to engage advisers.

It is possible that a 'steering committee' may be formed containing a number of the larger lenders and/or representatives of different lender groups. Such a committee will either play the role of co-ordinator, or form an intermediate point of liaison between the co-ordinator and the lenders generally.

Often the co-ordinator will itself already have another role as agent or as security trustee under the finance documents. It will also, of course, be a lender in its own right. These other roles will carry different responsibilities from, and be separate from its role as co-ordinator. The bank concerned may need to clarify on occasions which role it is acting, particularly when it receives information.

10.4.3 The need for advisers

The group is likely to need the following advisers during a restructuring process:

Accountancy advisers. The group's auditors will already know the group and will play an important part in helping to provide the financial information the stakeholders will need.

Legal advisers. Whilst the group will already have existing legal advisers, the directors will need advice as to their responsibilities and duties as directors. If the existing legal advisers also act for a major shareholder, they and the directors will need to consider whether this creates a conflict of interest requiring a different legal adviser now needs to be retained to advise the board.

Financial advisers. These will generally be bankers or accountants by training, and are likely to play a lead role in liaising with the other stakeholders and developing the restructuring proposal. A financial adviser will often also have worked in the past with many of the key individuals within the lenders' and advisers' organisations on similar restructurings. Their appointment should therefore assist in making these stakeholders feel more comfortable, and in making initial discussions more productive.

PR advisers. Public relations issues will grow increasingly important in maintaining stability, as rumours will almost inevitably spread in the outside world that the group is in difficulty. (These rumours may indeed sometimes originate from minority stakeholders who have their own agendas to pursue.)

The group is likely to be actively encouraged by its various stakeholders to ensure it has the right advisers in place at an early stage in the process. The stakeholders will also wish to appoint other advisers. These may include legal advisers to the co-ordinator, and investigating accountants and valuers (see Section 10.5). The facility agreement may already provide that the cost of some of these advisers is to be borne by the group itself. Even where it does not, the lenders may consider that they are in a position to negotiate a requirement to this effect.

It is common for a group initially to resist appointing additional advisers itself, and particularly to question the need for the lenders to appoint further advisers, given the cost involved. The lenders will see this differently. If there is currently doubt as to whether they will be paid in full, they will consider that the group is spending their money, rather than its own or its shareholders' money on the costs of the advice.

10.4.4 Standstill agreement

10.4.4.1 Is a standstill agreement necessary?

Even if a group of lenders who would be entitled to enforce have already concluded that it is not presently in their interests to do so, both the group and individual stakeholders may press for a formal agreement. A standstill agreement not only governs the company's relationship with its lenders, but also those lenders' relationships with each other. The standstill gives a feeling of stability both internally and externally. Indeed, the group may specially need to be able to show an external regulator such as the FSA or TPR that a standstill is in place.

10.4.4.2 What are the typical terms of a standstill agreement?

The standstill will typically contain provisions dealing with the following:

- suspension of the lenders' rights to accelerate facilities or enforce guarantees or security, notwithstanding a stipulated list of events of default which have occurred (or may occur);

- agreement by the lenders to allow the group to continue to use its existing facilities, notwithstanding a stipulated list of defaults;

- agreement by the lenders not to improve their positions vis-à-vis each other, for example, by setting off cash balances;

- agreement by the lenders to share any losses in an agreed manner. Such provisions may be needed if, for example, some lenders are continuing to make revolving or ancillary facilities available to the group. They are likely to provide for balancing payments at the end of the standstill by better-off lender to worse off lenders;

- agreement by the lenders not to trade their debt. The restructuring may be set back if new stakeholders with different agendas became involved part-way through;

- agreement by the group to provide more detailed and/or more frequent financial information (which will be relevant to the information-gathering process discussed in Section 10.5);

- agreement by the group not to take various actions which might affect the prospective returns to lenders. For example, tighter controls may be imposed on the group's ability to make disposals or to pay out any money to lower ranking stakeholders in the ordinary course. If cash flow permits, the lenders might also seek to reduce their exposure by requiring surplus cash to be used to pay down their existing facilities or placed in a blocked account for lenders to decide whether to release back if needed for cash flow or apply in prepayment; and

- terms permitting any new funding to be on a super-priority basis. If this cannot be dealt with by amendment to the existing intercreditor agreement due to the resistance of other stakeholders, it may need to be dealt with by a more limited priority agreement.

Commonly the standstill will terminate at the end of a specified period, or on earlier notice (the period of which needs to be agreed) if a stipulated majority of the creditors so require, although if the company needs the standstill to give comfort to some third party this may not be appropriate. It is likely also to terminate if an event of default other than one of those on the stipulated list occurs.

10.4.4.3 Who needs to be a party?

The group will wish any group of lenders who would immediately be entitled to enforce to be parties to the standstill agreement.

Mezzanine lenders are likely to be prevented from taking immediate enforcement action for stipulated periods of time by standstill provisions in an existing intercreditor agreement. They will nonetheless often still sign up to the formal standstill arrangements, and may need to do so, for example, if there would otherwise be a 'notifiable event' (see Section 10.8). They will wish to be clear as to whether the standstill under the standstill agreement runs concurrently or consecutively with those in the intercreditor agreement.

Other financial creditors, such as bondholders, will usually not have the ability to enforce unless there is a payment or insolvency default. They will typically not therefore join as a party to the standstill agreement.

10.4.5 Cash-flow issues

For any restructuring to succeed, the group must continue to have enough working capital to satisfy its day-to-day needs. Clearly these needs are likely to increase as a result of the costs of the restructuring itself.

10.4.5.1 Drawdown on existing facilities

Tactically, a group which has not yet breached the financial covenants under its banking facilities but which anticipates a breach, may try to place itself in a stronger position by drawing down any unused part of its banking facilities immediately to stockpile cash. It is possible that an agent or lender may still try to oppose this, if it considers that some other breach has already occurred. Possible additional events of default which will apply here are:

> Material adverse change ('MAC'). Whether this is applicable may depend on the exact wording of the clause, particularly the degree of discretion given to the agent or lender as to what constitutes a MAC.
>
> Insolvency. However, it is likely to be insufficient that the group is balance sheet or even cash-flow insolvent on paper, so long as it has not been deemed unable to pay its debts (see Chapter 1).
>
> Insolvency proceedings. If the group has already approached the lenders to discuss a restructuring at this stage, it may be in breach here through having taken a step in relation to a compromise or arrangement with its creditors.

Otherwise, the group's ability to continue to drawdown on facilities will be a negotiating point in any standstill agreement.

10.4.5.2 New money

The senior lenders, or some of them, have historically been the natural source of new money requiring the group to take ir over during the restructuring. However, new money may often also come from other lenders whose existing debts are lower ranking, or possibly from shareholders. Outside investors who have no existing interest in a group may also be willing to provide new money. Regardless of the status of any existing money owed to the new money provider, however, any new money would normally be given priority status. (Despite this, the return on any new money is often set at a higher level than that on the highest ranking of the existing facilities.)

A new money request can prove a contentious issue. Whilst they recognise that the aim is to buy further time to find a solution which will protect their existing investment, lenders will still wish to assess at the point of the request how likely it is that both the new money and their existing exposures are to be repaid. Stakeholders will generally ask the company to consider other cash-flow management techniques to reduce the new money needs (see Section 10.4.5.3).

The group needs to assess the amount of new money it requests carefully. Lenders are unlikely to look favourably on a group which makes repeated requests for new money because its first request was for too low an amount. The lenders will start to lose faith in the systems used by the group in analysing its requirements, and may question the viability of any restructuring proposal put together using the same systems.

10.4.5.3 Cash-flow management

In addition to, or instead of, asking for new money the group may also ask existing lenders temporarily to postpone payments of principal and/or interest under a banking facility. Again, lenders will generally ask the company to consider other cash-flow management techniques before, or as a condition of, acceding to such a request. Table 10.3 lists some of the cash-flow management techniques commonly used. Whether any of these techniques are likely to be practicable – and if so which – will depend on the time which is likely to elapse before the restructuring is finalised.

Table 10.3 – Methods employed in managing cash (in addition to speaking to existing/new lenders)

Action	*Relevant considerations*
Identify and dispose of surplus premises or business assets.	Secured lenders will regard these assets as part of their secu wish to see these payments used to reduce overall debt inst
Ensure that older/surplus stock is realised, and/or that unbilled work-in-progress is invoiced, promptly.	It may be desirable to sell older/surplus stock at a significa cash needs are paramount.
Recover outstanding debts efficiently, for example: • improve collection procedures for 'good' debts; and • reach compromises with debtors who are disputing their liability to pay.	Where the company has an invoice-discounting facility, how be limited scope for it to benefit from these steps. It may be desirable to compromise disputes over large sums this is on worse terms than the company could obtain given
Reduce surplus expenditure, for example: • put a hold on any non-essential capital expenditure; • reduce employment costs, eg by limiting discretionary bonuses and other non-essential benefits, stopping planned salary increases or promotions, and reducing over-staffing; • reduce costs by renegotiating with suppliers or changing supplier; • eliminate surplus overheads such as subscriptions, entertainment, advertising, training, travel, etc. Ensure that strict internal controls are placed on purchasing generally.	Obtain employment law advice before reducing over-staffin handled badly, this approach could lead to additional emplo against the company. Consider also the effect on workforce A redundancy programme will still result in a significant or cost. Reducing overheads will need to be part of a strategy – a pr decrease in some capital or other expenditure will eventuall business.
Extend creditor payment dates (and/or reduce sums due), for example: • agree with HMRC to defer tax payments; • agree with landlords to pay rent monthly rather than quarterly or to reduce the rent temporarily; or • agree with suppliers to extend payment dates.	It is better to reach agreements with creditors rather than ju payment. Directors who delay payments to HMRC in partic disqualification. It is also important not to misrepresent or information in reaching agreements with creditors. HMRC have a dedicated Business Payments Support Servic such requests (see http://www.hmrc.gov.uk/pbr2008/busine They are supportive where appropriate but must be convinc company will meet rescheduled payments.

10.5 INFORMATION GATHERING

10.5.1 What information is needed?

From a financial perspective, there are three main elements to the information-gathering process:

The business plan. This will indicate the level of debt which the group can continue to service going forward and enable financial creditors to understand the projected return on any equity instruments that they may receive in connection with the restructuring.

Financial due diligence. Further investigation into the group's financial affairs will enable the business plan to be tested, and if necessary, amended.

Valuations. These will indicate the total amount likely to be achieved on a sale of the group's business (or, if relevant, its assets).

The information revealed will determine the strength of the respective stakeholders' positions in the course of any further restructuring negotiations. Conversely, it may lead stakeholders to conclude that a restructuring would not be achievable.

10.5.2 Independent reporting accountants

The group itself will normally provide regular information to its lenders. However, the lenders will generally wish to engage independent reporting accountants of their own. The role of the reporting accountants may include the following:

to review and verify the cash flow projections and other financial information provided by the group;

- to assess the adequacy of the business plan and systems used by management;
- to assess the performance of the group by comparison within other companies operating with a similar industry sector;
- to review the restructuring proposals put forward by the group; and
- to identify and review any alternatives which exist, including formal insolvency, and calculate the likely returns to the senior lenders in such scenarios. Sometimes this will include a fuller contingency planning exercise.

The identity and scope of work of the independent reporting accountants often proves contentious. This will be partly on the costs grounds already identified in Section 10.4.3. Management may feel they are in practice assessing the adequacy of the management team themselves. Sometimes management are also nervous that the independent reporting accountants might be inclined to recommend formal insolvency if this could lead to a greater fee income for their own firm, and if so this concern needs to be identified and addressed.

10.6 LOOKING AT THE RESTRUCTURING OPTIONS AND IMPLEMENTING A SOLUTION

10.6.1 What are the possible consensual options?

There are a number of possible consensual options, ie options which will require the consent of all affected stakeholders. Examples of these include the following.

10.6.1.1 Amendment and restatement

This will involve a change in the terms of the lending facilities and/or bonds. It may involve, for example a rescheduling of payments of principal or interest to give the group longer to pay and/or an increase in the facility limits (or an adaptation of the facilities to incorporate some additional source of finance such as an asset-based facility using the group's receivables).

The lenders concerned will, however, wish to see their positions improved in some other way in return for their agreement. Possibilities include:

- a further injection of equity;
- tighter financial and/or operational covenants;
- more onerous continuing financial information obligations;
- a higher interest rate;
- guarantees from additional subsidiaries and/or new security (although s 245 IA 1986 and possibly s 239 IA 1986 will be a factor here if the group is receiving no new monies – see Chapter 5);
- an asset disposal programme and/or a cash sweep mechanism, where proceeds or other surplus monies are used to pay down the debt; and/or
- greater freedom to trade their debt, for example, by removing any group consent rights; and/or
- increased fees.

10.6.1.2 Refinancing

This will involve the advance of fresh monies to repay existing debt. A refinancing will typically involve an incoming lender or group of lenders replacing the existing lenders. Provided the refinancier is satisfied that sufficient security is available, for example because it evaluates the assets of the group in a different way from the existing lenders, it may be possible for the group to increase its overall facilities on a refinancing. However, the terms of the refinanced debt may well be less favourable to the group. The possibilities set out in Section 10.6.1.1 will also be relevant here.

10.6.1.3 Reduction of debt

An outright release of debt is generally an unattractive restructuring tool from a tax perspective, as the debt released can be credited to the debtor as an income receipt with the result that charge to tax could arise (in the absence of any losses or other reliefs to shelter the charge). However, under ss 322, 358 and 359 Corporation Tax Act 2009 ('CTA 2009') there are certain circumstances where a tax charge will not arise, for example:

Where the debt is released in consideration of the issue of ordinary shares in the debtor. 'Ordinary shares' may include preference shares provided they carry a right to dividends which are not at a fixed rate. This can make a debt to equity swap the more attractive option for reducing debt, and this is discussed further in Section 10.7.

Where the debt is released as part of a statutory insolvency arrangement. Such an arrangement may include a CVA or Scheme of Arrangement.

Where the debtor meets one of a number of 'insolvency conditions'. The insolvency conditions include situations where the debtor is in insolvent liquidation, administration or administrative receivership, where a provisional liquidator has been appointed in relation to the debtor under s 135 IA 1986 or where the debtor is in an equivalent situation outside the UK.

Where the debtor and creditor are 'connected' within the meaning of s 348 CTA 2009. This requires that one has control of the other or that both are under common control at some point during the accounting period in question. This seems comparatively unlikely so far as most lenders are concerned unless they have taken shares in an earlier restructuring.

10.6.2 What is the alternative?

The stakeholders are unlikely to agree upon a consensual solution unless each of the stakeholders involved perceives that it would be placed in a worse position under any likely alternative. The group, and any stakeholders who actively wish to pursue the restructuring are therefore likely to need to convince the remaining stakeholders that a less attractive alternative exists and will be implemented should all stakeholders not achieve a consensual restructuring.

10.6.2.1 Alternatives to a restructuring

Possible alternative scenarios are:

An 'unplanned' formal insolvency. This is a formal insolvency process into which the group is effectively forced because a trigger points occurs, and either a creditor takes enforcement action or the boards of directors of the various group companies conclude the group has no reasonable prospect of avoiding insolvent liquidation and initiate the process themselves. The term 'unplanned' here is used to distinguish such a process from a 'planned' formal insolvency used as a restructuring tool (see below). Crucially, an unplanned process may well involve the formal insolvency of operating subsidiaries as well as holding companies within the group, and will almost certainly have a negative impact on realisations.

A solvent sale of the business or assets. This is likely to generate a higher price than a sale out of formal insolvency. However, it is still likely to be perceived by potential buyers as a forced sale to some extent, which will adversely affect the level of any offers. The directors may also find it unattractive because it exposes them rather than an insolvency officeholder to claiming that the sale was at an undervalue, although if the group has exposed the business and assets properly to the market prior to any sales the risks should not be great.

Maintaining the status quo. So long as an interim solution can be found every time a trigger point occurs, then there will be no need to carry out any wider restructuring. In many cases, interim solutions are found and the only real driver for a restructuring is ultimately that the group is about to run out of cash. However, maintaining the status quo will be unattractive to financial creditors who have bought debt at a discount with a view to making a return. Where interest payments to mezzanine lenders or dividend payments to shareholders are blocked as a result of a default, they may also wish to see a speedier resolution. It is also likely to be unattractive to management, who will want the group's difficulties resolved so that they can focus once again on running and growing the business. (They may also want to ensure that any shares they hold retain value or are replaced with an incentive package which gives them an equivalent return.)

10.6.2.2 Non-consensual restructuring

Various of the formal processes described in this book may still serve as mechanisms for achieving a non-consensual restructuring, where not all stakeholders are prepared to agree terms. For example:

A **pre-packaged** administration or receivership can be used to circumvent the claims of dissenting shareholders or lower ranking creditors by transferring assets to a new company buyer whose debt and equity structure reflect the desired outcome. Pre-packs have already been discussed generally in Chapter 4, but the use of a pre-pack as a restructuring tool is discussed further in Section 10.7.

A **Scheme of Arrangement** can be used to bind, or 'cram down', a minority of dissenting creditors and/or shareholders within a class.. The use of Schemes was discussed generally in Chapter 7.

A **CVA** can similarly be used to cram down a minority of dissenting unsecured creditors. Unlike a scheme of arrangement, there is no need to divide creditors into separate classes. However, its usefulness is limited by the fact that it can neither bind a secured creditor (without their consent), nor affect a shareholder's rights. The use of CVAs was discussed generally in Chapter 7.

A summary of the advantages and disadvantages of these respective processes as restructuring tools is set out in Table 10.4. Normally the costs and other disadvantages will be such that a consensual restructuring is more attractive if it can be achieved. Clearly these non-consensual routes also still require a sufficient number of the stakeholders affected to support the process – they can only be used to overcome the resistance of minority stakeholders, or stakeholders who would otherwise expect to receive nothing on a formal insolvency.

10.6.3 The restructuring agreement

In a complex restructuring it is common to use a restructuring agreement signed by the key stakeholders to create a framework for the entire restructuring. This will typically stipulate when the various other documentation required to implement the restructuring becomes effective, and may itself implement various of the steps once other conditions precedent have been satisfied.

10.7 PARTICULAR TYPES OF RESTRUCTURING

10.7.1 The debt to equity swap

A debt to equity swap will involve shares being issued to creditors in return for the release of all or part of their debt. The main issues are likely to be:

The amount of debt which should be converted. This will depend significantly on the amount of debt which the group will be able to continue to service going forward. The lender in whose tranche of debt the value breaks would normally expect to receive the largest share of any equity. Clearly, however, this lender is unlikely to agree to convert its own debt into equity unless most or all of the debt which ranks behind it is also converted.

Table 10.4 – Non-consensual restructuring processes

	Advantages	*Disadvantages*
Pre-packaged administration	• Can circumvent creditors and shareholders who would receive nothing on a formal insolvency • A share transfer at holding company level avoids any disruption at an operating company level. Process can be completed before it becomes public • Relatively quick, certain outcome driven by creditors that have a real economic interest in the group • It is the administrator who bears the risk of challenge by any disenfranchised creditors	• The additional fees of the administrator, the va administrator's other advisers can be substanti • Valuations are critical, and the most time-cons administrator might also require a marketing e • If guarantees and security cannot be released o may also need an administration of operating s well, which is considerably more disruptive • Disenfranchised stakeholders recognise that pr administrations carry a degree of stigma, so m retrospective PR campaign
Scheme of Arrangement	• Binds all stakeholders in those classes which approve the Scheme, apathetic as well as recalcitrant minority stakeholders • Can be used in association with an asset transfer to circumvent classes of creditors and shareholders who would receive nothing on a formal insolvency (although those stakeholders could later challenge on value) • Flexible enough to restructure shareholdings as well as debt • Can bind secured as well as unsecured creditors • Outcome is certain once the final hearing has occurred	• Multiple classes are likely to be involved and c composition can be complicated • Requires support of both 75% in value *and* a n number of *each class affected* • Court hearings and meetings make this a publi • Court hearings and meetings take time and lea certainty of outcome until the final court hearin • A Scheme may still be needed for every comp given a guarantee to the creditors concerned
CVA	• Can bind all unsecured creditors – no need to divide into separate classes • Likely to be cheaper than either a Scheme or a pre-pack • Onus is on creditors who have been unfairly prejudiced to bring a challenge	• Cannot be used to bind secured (or preferentia without their consent • Cannot be used to bind shareholders without t • Meetings make this a public process

Into what the debt will be converted. As an alternative to shares, the lenders may be issued warrants or granted share options.

The class of shares into which the debt should be converted. The lenders may be content to take non-voting preference shares which give them priority rights to a dividend. It is possible to provide for returns to the shareholders to increase as the group's fortunes improve. However, the shareholders are still likely to want the shares to carry certain blocking rights and other rights such as the right to appoint a board observer or director. The terms of any non-voting shares may also provide for their conversion to voting shares in the event that the group fails to perform as projected. In addition, lenders who have acquired debt as part of a wider strategy may specifically be seeking voting shares.

Which stakeholders should control the group following the debt to equity swap and how the equity is allocated between lenders which hold debt sitting in different tranches. The original controlling shareholders will wish to retain control if they still see long-term value in the group, but if the lenders are interested in taking voting shares, they are likely to resist this unless the shareholders are prepared to invest more capital of their own into the group.

Table 10.5 shows the debt to equity swap which might emerge where a group originally has £110m of bank debt, but the business plan has shown that the group can only continue to support £60m of bank debt.

Mechanistically, the debt will need to be owed by the company which is to issue the shares before it can be converted. In the example shown in Table 10.5, the debt is initially owed by Holdco 2. If Holdco 1 has given a guarantee, it may be possible for Holdco 1 to become the debtor by the relevant lenders calling on the guarantee, otherwise the debt will need to be novated to Holdco 1.

In practice, tax considerations may result a more complicated swap.

10.7.2 Pre-packaged administration or receivership

10.7.2.1 Pre-packaged sale of shares

Where the only creditors to be affected by the restructuring are financial creditors of a holding company, as in the structure illustrated in Table 10.1, it is possible to achieve the restructuring by appointing an administrator or receiver to sell the shares in, rather than the assets of, the operating subsidiaries. This avoids the disadvantages described in Section 10.7.2.3. Indeed, the trade and other creditors of the operating subsidiaries need not be affected at all.

Table 10.6 shows how a pre-pack could be used to reduce a group's debt burden in a similar manner to that achieved by the debt to equity swap illustrated in Table 10.5, where a consensus has not been reached with the lower ranking stakeholders. Administration is the process used in this example.

Holdco 2 is placed into administration, and the administrator sells the shares of Target and its operational subsidiaries to a new company, 'Newco'. By way of consideration, Newco takes on the obligations to pay the senior debt in place of Holdco 2. The mezzanine lenders and any lower ranking creditors of Holdco 1 or Holdco 2 are left as creditors of assetless companies. Provided the amount of debt assumed by Newco comfortably exceeds the value of Target it will be difficult for this arrangement to be challenged – had a third party buyer paid Holdco 2 a cash sum equal to the value of the shares, this would have been paid to the senior lenders in any event as the holder of the first ranking fixed charge over the shares. The excess part of the debt assumed by Newco will then be converted into shares held by the senior lenders.

Table 10.5 – Debt to equity swap

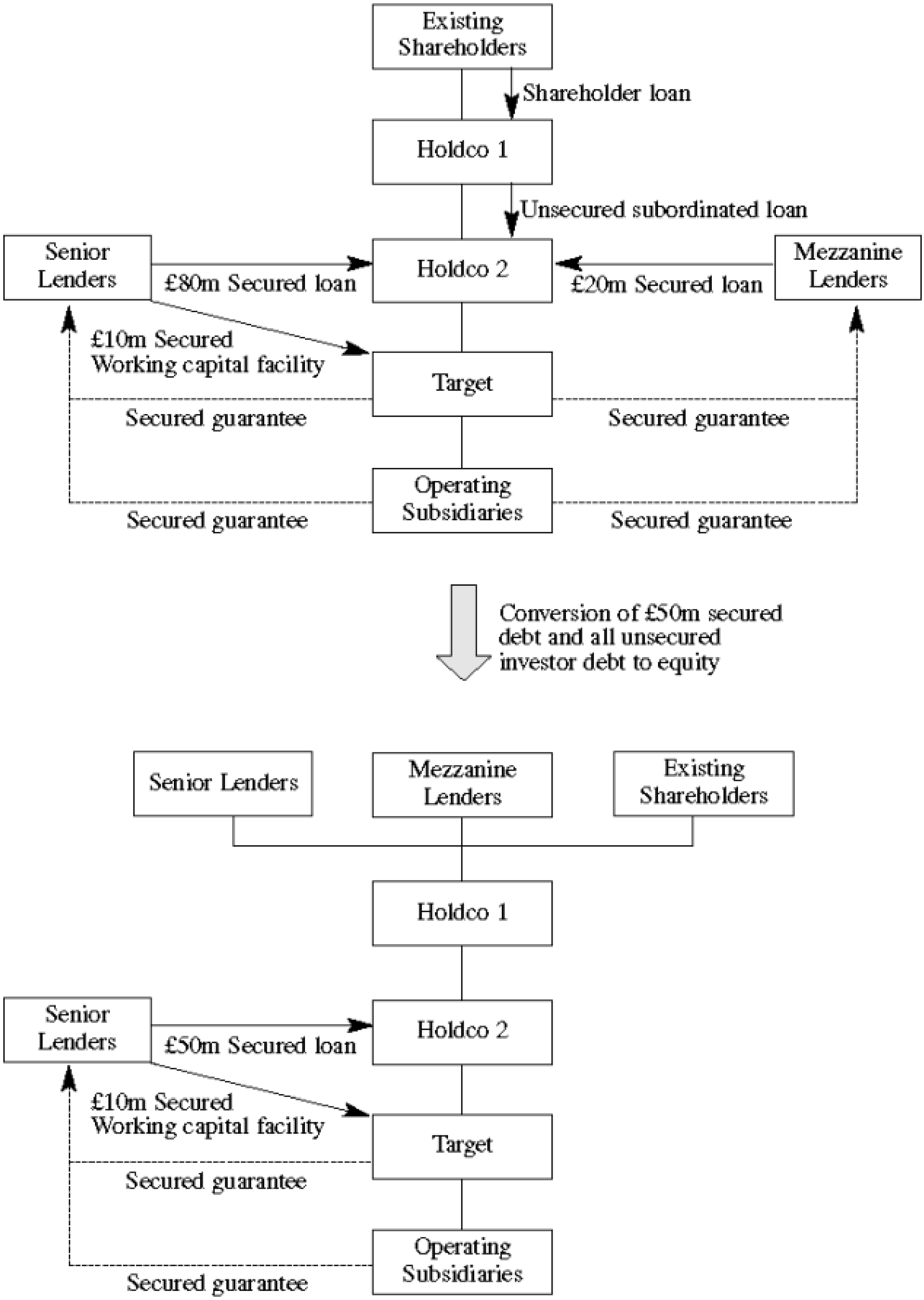
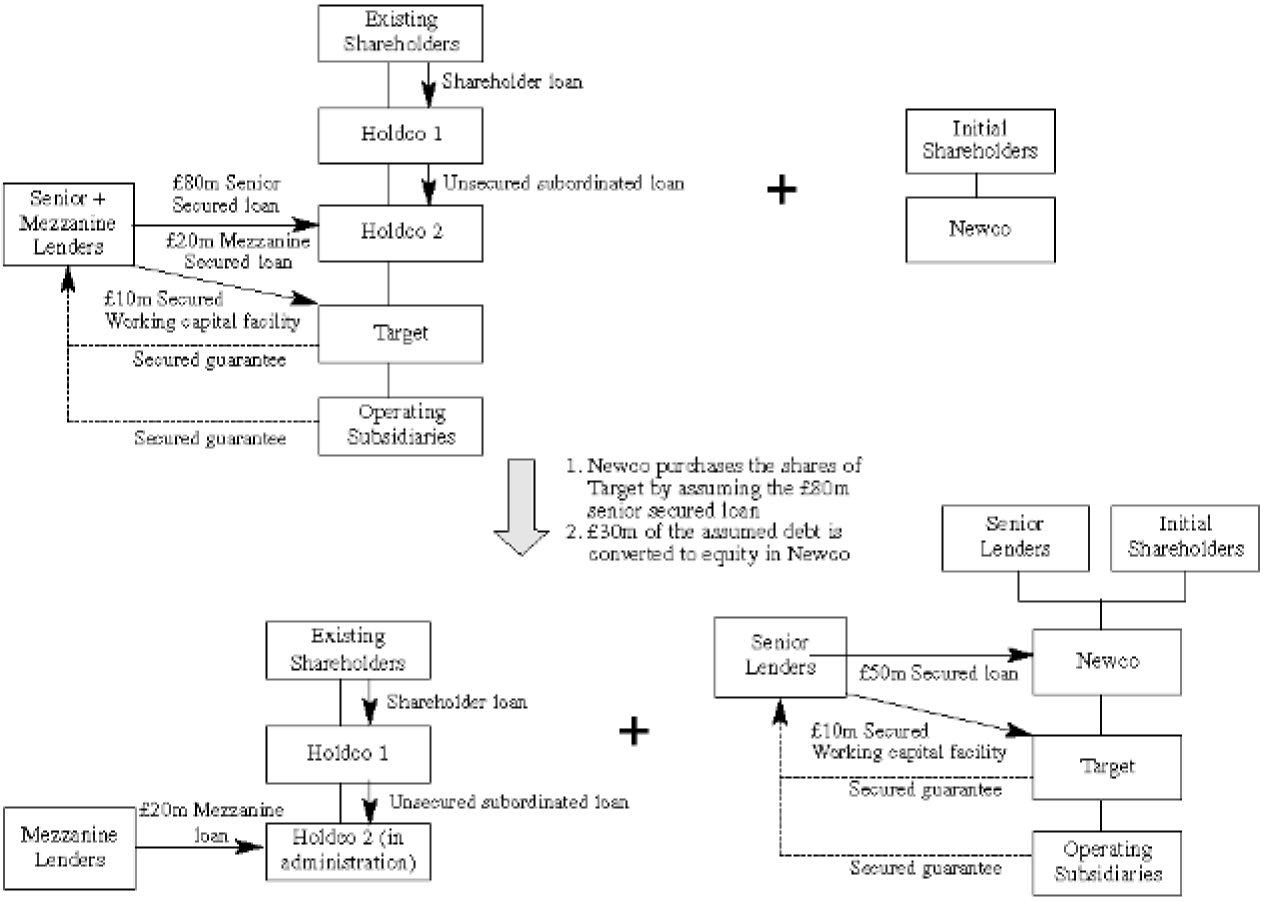


Table 10.6 – Pre-packaged administration sale



If the mezzanine lenders hold security over the shares of Target, and guarantees and security from Target and its operating subsidiaries, however, the pre-pack can only be implemented if there is a way of releasing these on the sale. As seen in Chapter 4, an administrator is able to sell assets free of any floating charge security, but not of fixed charge security without a court order. Moreover, he will have no statutory power to release the guarantees and security given by Target and its subsidiaries. Ideally the intercreditor agreement will give the senior security holder or any administrator or receiver they appoint the power to grant all of the necessary releases, but this will need to be checked in each case.

10.7.2.2 Other considerations on a share sale

In practice, a pre-pack is still likely to require more than just a share sale, as the holding companies are likely to hold other assets and to perform groupwide functions. For example:

> Target and/or the operating companies may well owe intragroup debts to the holding companies. Unless the benefit of these debts is sold to Newco, or they are otherwise dealt with, they would remain assets of the holding companies which the administrator, or any subsequent liquidator of these holding companies would have to seek to recover from the debtor concerned. For this reason, an analysis, and possibly a rationalisation, of the group's internal debts is always an important part of the planning process;
>
> groupwide insurance policies, for example D&O insurance, are often in the name of the holding companies; and
>
> whilst most group employees are likely to be employed by the operating subsidiaries, the senior employees will most likely be employed by the holding companies.

10.7.2.3 Pre-packaged sale of a business

It may be necessary to place one of more of the operating subsidiaries into administration, and for the administrator to sell their businesses to Newco if:

the intercreditor agreement fails to give the administrator the ability to release the guarantee or security given by the operating subsidiaries on a share sale; or

the aim is to restructure some of the debts of the operating subsidiaries themselves, for example, their obligation to their landlords.

However, this route is less attractive than a share sale for a number of reasons:

A prepack involving the formal insolvency of an operating subsidiary will require a more extensive public relations exercise, and this may be particularly difficult where the companies concerned operate in the financial, or another regulated, sector.

The business sale will require various third parties, such as lessors, landlords and the counterparties to those companies' other contracts to agree to the transfer of those subsidiaries' rights and obligations to the buyer.

The directors of the operating subsidiaries may regard a pre-pack of a trading company as less appealing, since they will need to be more conscious of protecting creditors' positions in the period prior to the formal insolvency.

10.8 PENSIONS ISSUES

10.8.1 Why are pensions a particular issue?

The position of a pension scheme on a formal insolvency was discussed in Chapter 9.

TPR is likely to play a role in any restructuring where there is a defined benefit pension scheme which has a deficit when calculated on the full buy-out basis. The aims of TPR include protecting the benefits of pension scheme members and reducing the risk of situations arising that may lead to compensation being payable from the Pension Protection Fund ('PPF').

To help TPR achieve its aims, it has been given the power to make third parties liable for the pensions deficit in certain circumstances through financial support directions ('FSDs') and contribution notices. These are intended to prevent stakeholders abusing the PPF by structuring a group, or carrying out a transaction, in a way which leaves the pensions liability with an underfunded company whilst funds exist elsewhere. They are therefore often referred to as the 'moral hazard' provisions and are described further in Section 10.8.2.

Employers and trustees are also required to inform TPR of any 'notifiable event' in relation to a pension scheme. This is designed to give TPR advance warning of difficulties which exist to allow it to assist or intervene before a claim for compensation from the PPF becomes necessary. Table 10.7 sets out those events which are notifiable if they occur in relation to the employer (as amended with effect from 6 April 2009).

Table 10.7 – Notifiable events in relation to an employer

(a) any decision by the employer to take action which will, or is intended to, result in a debt which is or may become due to the scheme not being paid in full;

(b) a decision by the employer to cease to carry on business in the UK;

(c) receipt by the employer of advice that it is trading wrongfully within the meaning of s 214 IA 1986, or circumstances being reached in which a director or former director of the company knows that there is no reasonable prospect that the company will avoid going into insolvent liquidation;

(d) any breach by the employer of a covenant in an agreement between the employer and a bank or other institution providing banking services, other than where the bank or other institution agrees with the employer not to enforce the covenant;

(e) where the employer is a company, a decision by a controlling company to relinquish control of the employer company;

(f) the conviction of an individual for an offence involving dishonesty if the offence was committed while the individual was a director or partner of the employer.

10.8.2 The moral hazard provisions

10.8.2.1 What is a financial support direction?

Under s 43 Pensions Act 2004, TPR may, if it considers it **reasonable** to do so, direct a person who is associated with or connected to an 'employer' to put financial support in place to meet the employer's pension liabilities. This can apply where the employer is or was in the previous 12 months (or, from April 2010, 24 months) a **service company** (ie its turnover is solely or principally derived from amounts charged for providing employees to other members of the group) or **insufficiently resourced** (ie the value of its resources is less than 50% of the estimated scheme deficit, calculated on the full buy-out basis and other members of the group have together sufficient resources to make up the shortfall). The terms 'associated' or 'connected' bear the meaning given to them by IA 1986, as discussed in Chapter 5. References to 'group' here are references to entities that are associated or connected with the employer.

10.8.2.2 What is a contribution notice?

Under s 38 Pensions Act 2004, TPR may also, if it considers it **reasonable** to do so, require an associated or connected person to contribute all or part of the pension scheme deficit. This can apply if the person in question was a party to **an act or deliberate failure to act**, one of the main purposes of which was (in TPR's opinion) to prevent the recovery of all or part of the deficit or to prevent such a debt becoming due, to compromise or otherwise settle such a debt, or to reduce the amount of a debt which would otherwise have become due. TPR is entitled to look back at acts or failures which occurred at any time in the **six-year period** prior to the notice (provided they occurred on or after 27 April 2004).

A contribution notice may also be issued where a person has failed to comply with a financial support direction (s 47 Pensions Act 2004).

10.8.2.3 When is it reasonable for TPR to act in this way?

There are certain matters which TPR must consider when deciding whether it would be reasonable to issue a financial support direction ('FSD') or a contribution notice (ss 43(7) and 38(7) of the Pensions Act 2004):

> In both cases, these include the person's **financial resources**, any connection or involvement they had or have with the pension scheme, the relationship they have or had with the employer, including whether they have **'control'** and the **value of any benefits** received directly or indirectly by the other person from the employer.
>
> In the case of a contribution notice, these will also include that other person's **degree of involvement** and the **purposes** of the act or failure to act (including whether the purpose was to prevent or limit loss of employment), whether the act or failure to act involved a notifiable event (see Table 10.7) that was not notified and the likelihood of other creditors being paid.

In 2008, TPR considered it reasonable to issue its first ever FSD to Sea Containers Limited ('SCL'), the Bermudan parent of an English service company. The latter was the principal employer of two final salary pension schemes with significant deficits. In assessing the benefits received by SCL here, it was noted that not only had SCL received services from the employer for which it did not have to pay within normal commercial timescales, but it could also maintain a European trading presence through the employer while itself enjoying a favourable tax regime in Bermuda. The fact that SCL had just entered into formal insolvency in the USA did not prevent the FSD being made.

10.8.2.4 What amendments are proposed?

At the time of writing, certain changes to the moral hazard provisions have been provided for in the Pensions Act 2008 and, while not yet in force, are proposed to have retrospective effect. Briefly, these are:

> TPR will be able to issue contribution notices where the act or failure to act was **materially detrimental** to the likelihood of members' benefits being paid, regardless of whether or not this was its intended purpose.
>
> A statutory defence will be available if the party can show that he gave reasonable consideration to any potential detrimental impact and acted appropriately before the detrimental act or failure to act.
>
> TPR will be able to issue contribution notices in respect of a **series** of acts or failures to act.

TPR will be able to issue a contribution notice even where the pension liabilities have been transferred to another pension scheme and the persons to be made liable are associated or connected only with the employers sponsoring the original scheme and not the new scheme.

TPR is required to publish a Code of Practice in relation to these new powers.

10.8.3 The clearance procedure

10.8.3.1 What is 'clearance'?

Clearly, there will be various associated or connected persons who are at least potentially at risk of receiving an FSD or a contribution notice. These might include other group companies or shareholders (including potentially lenders who have converted their debt to voting shares in a debt to equity swap). To limit uncertainty, there is a formal procedure whereby parties involved in a restructuring can apply to TPR for confirmation that it will not impose a liability on them in this way. This confirmation is known as a clearance statement and made pursuant to ss 42 and 46 Pensions Act 2004.

TPR encourages groups to apply whenever a transaction is detrimental to the pension scheme either because it will reduce the employer's ability to fund the scheme or because it will reduce the pension scheme's recoveries on insolvency. TPR expects applicants to 'mitigate' any detriment as a condition of any clearance statement.

In practice, the group and the trustees will negotiate terms between them, and the application for clearance will present the jointly agreed terms to TPR. In this process, TPR expects the trustees to behave as would any other unsecured creditor in their position. Because of the requirements for 'mitigation' and for agreement with the trustees, the application may become time-consuming and costly, and this will be a factor in deciding whether to make an application in some cases.

The group should make full disclosure to TPR of all relevant matters. A clearance can later be set aside if the circumstances described in the application are not the same as those which actually occur and the difference is material to TPR's ability to exercise its powers.

10.8.3.2 When should clearance be sought?

TPR has issued guidance indicating when it would expect a clearance application to be made (see http://www.thepensionsregulator.gov.uk/guidance/clearance/ introduction.aspx). Essentially, the employer and persons associated or connected with it need to apply where they consider that an event will occur which would be materially detrimental to the pension scheme's ability to provide members' benefits (known as 'Type-A events'). The guidance divides such events into employer-related and scheme-related events.

Employer-related events are events which occur in relation to the employer or the group generally which could weaken the employer's ability to meet its obligations to the scheme. Events which TPR has identified as falling into this category include:

granting or extending of new security over group assets;

paying dividends or returning capital to shareholders;

a change in group structure, including a change of control; or

a 'phoenix event', ie an event resulting in the employer re-emerging as substantially the same entity following an insolvency event.

Scheme-related events are events which affect the scheme directly, such as a compromise of the employer's debt to the scheme. Whilst employer-related events normally only require clearance when the scheme is in deficit on one of a number of bases, scheme-related events always require clearance.

10.8.4 Compromising a pension scheme deficit as part of a restructuring

10.8.4.1 Who will be involved in any discussions?

The trustees have the ability to compromise the section 75 debt with the employer prior to any formal insolvency. However, they would not normally agree to any arrangement which places the scheme members in a worse position than they would be in on a formal insolvency. They will also be conscious that, if not entered into at the right time or in the right form, any compromise they reach could render the scheme ineligible for the PPF should the employer later enter into formal insolvency.

The PPF however is concerned to ensure that it receives fair treatment in any insolvency process and that schemes are not transferred to the PPF with less than the expected dividend in respect of the section 75 debt. The PPF has called upon TPR to use its moral hazard powers to ensure there is no abuse. Therefore, where a section 75 debt is to be compromised as part of a restructuring, each of the trustees, the PPF and TPR will be involved in any negotiation process. The group will need to demonstrate that the employer could no longer survive if it had to continue to meet its existing pension liabilities and that the compromise will lead to a better recovery for the PPF than the likely alternative, bearing in mind, among other things, that in granting clearance TPR will be giving up the opportunity to recover monies for the PPF from third parties by issuing an FSD or contribution notice. (In practice the PPF and TPR may also take into account preservation of employment.)

The PPF will aim to ensure that it gains an appropriate share in any upside from the restructured business. Its standard practice is to seek a non-voting shareholding in the amount of one-third if the existing stakeholders are to remain owners following the restructuring, or one-tenth if the business is transferred to an unconnected party. To support the PPF, TPR will generally not give clearance on a restructuring that results in the pension scheme transferring to the PPF unless the PPF is satisfied with the arrangement.

10.8.4.2 Which entity will enter into formal insolvency?

One option is for the employer's business to be sold to a new company through a pre-packaged administration. This will involve a planned formal insolvency of the scheme's principal employer to transfer the pension scheme to the PPF. The PPF would then take its non-voting shareholding in the new company and would receive a dividend in respect of the section 75 debt from the formal insolvency of the employer.

Where the existing employer is a trading company, a sale of its business through pre-packaged insolvency may still prove disruptive. However, a route to avoid this was approved by the court in L v M Ltd [2007] EWHC 3395 (Ch). A new company was formed to convert the pension scheme in question into a multi-employer scheme, and took on a couple of employees for this purpose. The scheme rules were amended to provide that, on a winding-up of the scheme, the trading company would bear only £1 of the section 75 debt and the new company the balance. Once the scheme was wound up, the trading company paid the £1 debt and ceased to be an employer for the purposes of the scheme. The new company was unable to pay the balance of the section 75 debt, but on its inevitable insolvency, the pension scheme was able to transfer to the PPF. It is understood that the PPF took a shareholding in the surviving trading company. The process has since become a recognised structure.

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