Overcoming the Divergence Gap Between Applicable State Law and Sharia Principles: Enhancing Clarity, Predictability and Enforceability in islamic Finance Transactions Within Secular Jurisdictions

Osman Sacarcelik, M.A.

With the emergence of Islamic finance, legal precepts of Islam gained momentum through voluntary adherence by market participants. Transactions are not governed by Islamic law as such. Rather they are structured within the framework of freedom of contract in a way that is coherent with Sharia principles. In absence of an authoritative judicial institution deciding on the Sharia conformity of a commercial transaction, individual Sharia scholars fill this gap. They interpret Islamic legal principles and exercise oversight of the products and operations of the Islamic finance industry. In Islamic finance transactions, there is frequently a dichotomy and tension between Sharia principles and perceptions underlying contractual agreements and their de jure qualification and treatment in secular jurisdictions. This paper investigates the divergence gap between Sharia precepts and the contractual design of Sukuk transactions as well as transparency issues under the German legal regime. Sukuk is taken pars pro toto for Islamic finance products. German law is chosen as case example within the circle of European civil law systems. One of the problematic issues is ownership status of Sukuk holders in sale-and-lease-back based Sukuk. Although, asset linkage is a major characteristic that distinguishes Sukuk from conventional bonds, the transfer of ownership in some sale based Sukuk structures is highly controversial not only from a Sharia perspective but also from a legal perspective. This is particularly the case when Sukuk transactions are structured in civil law legal systems where the common law concepts of trust and beneficial ownership are not recognized. The disengagement of Sukuk transactions from their underlying originating assets can be problematic for Sukuk holders in the event of a bankruptcy of the Obligor. The asymmetrical risk allocation between Sukuk issuer/obligor on the one side and the investor on the other may not only be problematic from an inner-Islamic point of view. In some cases this situation may also cause legal liability issues. Besides the issue of ownership status, some other terms and conditions of widespread Sukuk issues appear to be problematic with respect to legal transparency requirements on national and EU level. This paper suggests solutions to bridge the gap.

Key words: Sukuk, ownership issues, trust, insolvency, transparency, legal enforcement, conflict of laws

I. INTRODUCTION AND OVERVIEW OF THE ISSUES

While Islamic law is applicable in most jurisdictions of the Arab world in the field of "statut personnel" (*akhwal al-shakhsiyya*) such as family law, it is generally not applied in commercial matters which are instead governed by codified civil law, even though many Arab constitutions declare Islamic Sharia to be a "main source of legislation". Similarly, civil codes of Arab jurisdictions refer to Islamic Sharia as interpretative rule (e.g. Art. 1 (2) Qatari Civil Code 2004; Ballantyne, 1985, pp. 245-264; Al-Muhairi, 1996, pp. 219-244). Islamic finance and banking is characterized by voluntary adherence to Islamic commercial principles such as the prohibition of interest (*riba*), gambling (*maisir*) and speculation (*gharar*) as well as the principle of profit-and-loss-participation. Despite the absence of an all-binding "Islamic lex

mercatoria" and differences between the different schools of law on the admissibility of certain Islamic finance products, there is a high degree of consistency and consensus among Sharia scholars as to the core principles governing Islamic financial transactions. Moreover, standard setting organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have formulated principles pertaining to major Islamic finance transactions aiming inter alia to standardise rules and to avoid ambiguities. In recent legal disputes between parties to an Islamic finance transaction within a secular jurisdiction it had to be tested whether Islamic law is merely non-binding soft law or a set of rules that is also applicable and enforceable before secular state courts. The prevailing view in "Western" jurisprudence is that Sharia is "insufficiently determinate to be a governing law of a contract" (*Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd*, 1 WLR (CA 2004) (UK)).
Notwithstanding this finding, the parties to a Sharia compliant financial contract do have the freedom to "dress" their contracts in accordance with their belief. This can be achieved by formulating the principles of Islamic law in the form of contractual clauses.

This paper will consider contracts that *prima facie* seem to mirror and satisfy Sharia requirements but do not always stand up to further scrutiny. This problematic issue became apparent in some asset-based or "asset-light" Sukuk structures where doubts were voiced about their representation of ownership. These doubts do not only stem from Sharia law considerations (e.g. Dusuki and Mokthar, 2010; Haneef, 2009; Usmani 2007). With regard to current market practices, the validity of ownership transfer from the transfering obligor/orignator to the SPV who is the *alter ego* of Sukuk holders is also contentious under applicable laws. This further provokes the question if there is a potential risk of a prospective "claw back" of the Sukuk assets by an insolvency practicioner in the event of the obligor's insolvency or the transfer's re-characterization as a loan (see also Thomas, 2009). These problematic issues emerge predominantly in civil law jurisdictions such as Germany or the UAE which do not provide for the concept of trust or beneficial ownership, two of the main characteristics which mark the difference between common law legal systems and civil law jurisdictions.

Unlike in asset-backed structures, Sukuk holders generally do not have any security interest over assets underyling an asset-based Sukuk. The contractual agreements are designed in a way that ownership is reduced to a symbolic rather than enforceable status. This is because the perception under Sharia has generally no legal effect unless it is substantiated in the contract not by mere reference to Sharia but by virtue of material inclusion. However, Sharia positions may be taken into consideration in examining the will of the parties.
It must be remembered that asset-based structures were created due to market pressure and competition as well as legal constraints (Haneef, 2009, pp. 108-110) such as the inalienability of property to foreigners in most Gulf jurisdictions. Asset-based Sukuk are a viable financing solution for corporations and banks who are unwilling to dispose of their physical assets by way of true sale to an SPV, inter alia due to risk management considerations. From an investor's perspective, asset-based Sukuk is a Sharia compliant alternative to bonds. The Sukuk holder generally has no asset risk but credit risk.

Besides the issue of ownership status of Sukuk holders, some other terms and conditions of widespread Sukuk issues appear to be problematic with respect to legal transparency requirements on national and EU level.

As will be discussed in this paper, Sharia issues ("lex internum") can strike through to the level of applicable state law ("lex externum") in various ways. Examining this scenario under (German and UAE) civil law, the paper will discuss the consequences of this divergence. It will then examine to what extent this "conflict of laws" can be resolved and the divergence gap be bridged.

THE ISSUE OF TRANSFER OF OWNERSHIP TO THE SPV

1. Basic characteristics of Ijara-Sukuk

The AAOIFI, in its Sharia Standard 17 (2), defines investment Sukuk as *„certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity"* (AAOIFI, 2008). Accordingly, asset linkage is a major characteristic that distinguishes Sukuk from conventional bonds and required from a Sharia perspective. Asset ownership is also a condition for the tradability of Sukuk securities on secondary markets because the trading of debt (*bai al-dayn*) is not permitted (e.g. Ayub, 2007, p. 146-147). Sukuk are based on a common Sharia contract such as *Murabaha*, *Salam*, *Istisna*, *Ijara*, *Mudaraba*, *Musharaka* and *Wakala* (for an overview of Sukuk see Ali, 2011; Adam/Thomas, 2004; Thomas, 2009; Sacarcelik, 2011). One of the most frequent types of Sukuk is the Ijara Sukuk. In a nutshell, in a typical Ijara-Sukuk transaction a capital seeking sovereign or corporate entity (obligor) incorporates a special purpose vehicle (SPV) - often in a tax efficient off-shore jurisdiction. The obligor sells and transfers (the beneficial ownership of) an asset or a class of assets to the SPV whose sole purpose is to participate in that specific Sukuk transaction. The SPV issues certificates (Sukuk) to the Sukuk holders (investors) to finance the purchase of the asset. In its capacity as trustee, the SPV holds the assets in trust for the Sukuk holders. The SPV then leases the asset back to the obligor for a period that corresponds with the term of the Sukuk certificates. According to prevailing definitions, the Sukuk certificates represent pro rata ownership in the asset. Hence, Sukuk holders are seen as (beneficial) owners of the asset. Often purchase undertakings, third party guarantees, liquidity facilities, profit reserve accounts as well as covenants ensure that the cash flow to the investors is maintained and the principal returned at term end or at the occurence of a dissolution event (e.g. default on payments). Other important elements of the Ijara Sukuk are the initial purchase and sale undertakings. The obligor undertakes to purchase the underlying asset back from the SPV at face value on the maturity date (scheduled dissolution) or in case of a dissolution event. At the same time, the SPV undertakes to sell the asset back (sale undertaking) to the issuer. It is important to note for the present analysis that the SPV in its capacity as trustee does not have the power to retain or sell the assets to any third party other than the obligor. The sale and purchase undertakings do not constitute offer and acceptance but a unilateral promise (*wa'd*) from both an classical Islamic legal and German civil law perspective. Whereas *wa'd* is not binding according to the majority view in classical Islamic legal literature and creates only a moral obligation, contemporary scholars declare it to be a binding promise if the promisee incurs liabilities and expenses on the basis of such a promise (see e.g. Islamic Development Bank, 2000; for a discussion on the legal nature of *wa'd* and its application in Islamic financial transactions, Al-Masri, 2002; Mokhtar, 2011; Usmani, 2008, pp. 120). This is for example the case in *murabaha* financing and the repurchase agreement in Ijara-Sukuk structured as a sale-and-lease-back transaction. Accordingly, at the end of the lease term, the obligor (re-)purchases the underlying asset (e.g. real estate) from the SPV. The redemption price payable by the obligor equals the nominal amount of the outstanding certificates and is distributed to the investors through the SPV.

2. Ownership rights of Sukuk holders?

2.1. Common Law Trust and Beneficial Ownership

The vast majority of Sukuk issues are governed by English law. Legal certainty and familiarity demanded by investors explains the predominant use of English law. Another reason for this choice, is that ownership rights can be split into legal and equitable or beneficial ownership in English law. This dualism of ownership is the fundament of the concept of trust (Hayton, 2003) which is used both in conventional securitizations and Sukuk transactions. The obligor in a Sukuk transaction does not transfer legal title to the SPV but

only the beneficial interest in the underyling assets (Thomas, 2009, 95). Pursuant to a declaration of trust, the SPV acts as trustee and holds the (beneficial interest in the) assets upon trust in favor of the Sukuk holders who obtain (derivative) beneficial ownership. Among other qualities of a trust is that the assets do not form part of the estate of a trustee. The trustee can only act within the powers given to it by the trust deed or the statutes. As such it is not at liberty to sell on the sukuk assets or to keep the proceeds.

The concept of beneficial ownership as used in asset-based Sukuk is deemed sufficient by Sharia scholars (Thomas, Sukuk, p. 97) to meet the requirements of Islamic property law (for an introduction to traditional Islamic property law see: Habachy, 1962; Wohidul Islam 1999; Ziadeh 1993). And in fact, the legal position of a beneficial owner is similar to that of a legal owner in many respects. For example, the beneficial owners can enforce their right to the asset. They are also entitled to transfer their beneficial interest to third parties. Beneficial ownership can be obtained through inheritance. However, the protection against the legal owner who tranfers the asset to a bona fide third person is weaker (Baur and Stürner, 2009, § 64 mn. 31). In contrast to the transfer of legal title in real property (sec. 27(1), 3(a) Land Registration Act 2002), the transfer of beneficial interest in real property does not require formal registration in English law. The concept of trust and the split of ownership facilitate the transfer of an asset without incurring tax or registration burdens.

The main structural weakness of beneficial ownership vis-à-vis full legal title, however, most notably comes up in the insolvency scenario under a legal regime (*lex concursos*) that does not recognize the concept of split ownership.

Despite the fact that, for example, English law is chosen as governing law in the Sukuk documentation (e.g. offering circular), according to the conflict of laws doctrine of *lex rei sitae* (e.g. sec. 43 German Introductory Law to the Civil Code (EGBGB)), the law governing the transfer of title to property is dependent upon, and varies with, "the law where the property is situated". Choice of law is not permitted in Germany for legal transactions involving property. The same applies most likely in UAE law which is far more protective when it comes to property ownership. This can be seen for instance in the ownership restrictions for Non-UAE and Non-GCC nationals in the Emirate of Dubai (Article 4 (1) of the Dubai Real Property Registration Law).

Conclusively, it is debatable whether ownership is effectively transferred to the SPV when real property underlying an Ijara-Sukuk or similar sale-based structures is situated for example in Germany or the UAE. This might also have an effect on the validity of the English law trust structure itself because one of the required certainties of a trust is the trust property.

2.2. Doubts about ownership transfer

In his recent criticism of some widespread asset-based Sukuk structures, *Sheikh Taqi Usmani* raised doubts about the transfer of ownership to Sukuk. His famous paper "Sukuk and their contemporary application" which was circulated towards the end of 2007 caused quite a stir and led to turmoil in the Sukuk market during the global financial crisis. As a result of the controversies, the AAOIFI issued a Sharia resolution on Sukuk in 2008 to clarify the situation and restore calm. *Usmani's* main criticsm centered on the purchase undertaking in equity based Sukuk where the issuer undertakes to buy back the underlying assets from the issuer at face value and not prevailing market value or fair value on the expiry date of the Sukuk or in the event of a default. In fact, this stipulation moves Sukuk very close to a conventional debt security in terms of risk characteristics and performance. The risk is related to the credit worthiness of the provider of the purchase undertaking (obligor) and not the assets underlying the Sukuk. Whether recourse to the issuer or the asset (or a combination of both) is allowed, also affects the rating of a Sukuk, since rating agencies may evaluate a Sukuk either in terms of cash flow stability or default probability.

In his paper, however, *Usmani* did not deal with the issue of ownership directly or to any great depth (see already: Usmani, 2008, p. 178), saying "*generally, Sukuk represent ownership shares in assets that bring profits or revenues, like leased assets, or commercial or industrial enterprises, or investment vehicles that may include a number of projects. This is the one characteristic that distinguishes Sukuk from conventional bonds. However, quite recently, the market has witnessed a number of Sukuk in which there is doubt regarding their representation of ownership*" (Usmani, 2007).

2.3.Acquisition of ownership under German law

As previously mentioned, the issue of ownership of assets underlying Sukuk becomes indeed apparent in Sukuk default scenarios where risk mitigating mechanisms cease to operate and both the distressed issuer and the obligor fail to fulfill their payment obligations. As a last resort, Sukuk holders seek recourse to the assets.

Protecting Sukuk holders from any prospective "claw back" of the assets by creditors of the obligor the SPV or the transfer's recharacterization as a loan requires that:

(1) the SPV is insolvency remote and
(2) the transfer of ownership is valid and legally binding ("true sale" or off-balance sheet treatment).

Hence, in an inolvency of the obligor, it is decisive to identify the status of the SPV: Is it the owner of the Sukuk assets, a secured creditor or an unsecured creditor? This is crucial because according to s. 47 of the German Insolvency Code (Insolvenzordnung), for example, third party property does not belong to the debtor's bankruptcy estate. Owners have a right to segregate their property (*Aussonderungsrecht*) and enjoy a priority status over other creditors and equity holders who will only receive distributions after the higher priority claims are satisfied. Because of the disputed and unclear situation, the issue of propriertary rights and of Sukuk holders needs further examination from a civil law perspective.

2.3.1. Legal conditions for the transfer of moveable and immoveable property

In Sukuk transactions, the obligor and the SPV formally agree to conclude a contract of sale. The initial purchase agreement is also mentioned in the prospectus. Pursuant to this agreement, the Sukuk assets are sold to the SPV and leased to the obligor according to a lease agreement. The obligor undertakes to purchase the asset back on the maturity date or a dissolution event. The SPV is obliged to sell the assets back to the obligor and it is not at liberty to dispose of the assets. This arrangement shows structural similarities to the "Sicherungsübereignung" in German law where ownership in a *res* is transferred to a creditor for the security of a debt that is owed to them by the owner of the transferred *res*, or by another debtor. However, while the "Sicherungsübereignung" which resembles chattel mortgage is used for security purposes and is comparable to a lien on property, the agreements in a Sukuk transactions aim to ensure Sharia compliance.

Regardless of the purpose of the ownership transfer, the transfer is only valid if certain conditions are met.

In contrast to common law systems, in civil law systems, and particularly in the German one, there is a much greater differentiation between the "contract" (e.g. a contract of sale) (Verpflichtungsgeschäft), which creates the obligation to transfer, and the "conveyance" (Verfügungsgeschäft), the actual transfer of a proprietary right (especially ownership) in a *res* which effects the alienation of that *res*, i.e., the passing of the real right from transferor to transferee. The contract of sale does not effectuate the transfer of ownership *ipso iure*. Rather, the transfer of ownership in a *res* is a twofold process that requires first an agreement by the parties that ownership shall pass in respect of a specific *res*, and second the handing over of

the res (delivery) as a factual act. If the *res* is immovable property, the conveyance must be approved by a notary (§ 311b German Civil Code) and the agreement on the transfer of ownership must be in the presence of a notary (§ 925 German Civil Code). Moreover, the transfer of ownership requires registration with the land registry (§ 873 German Civil Code). Similarly, in Dubai, it is compulsory to register real estate with the Dubai Land Department (Article 1277 UAE Federal Law No. 5 of 1985 (Civil Code) and Articles 6, 7 of the Dubai Real Property Registration Law - Federal Law No. 7 of 2006).

Despite the use of terms such as "sale" or "ownership" in the transaction documents, the initial transfer of ownership is often not perfected in asset-based Sukuk.

2.3.2. Characterisation of the transfer as a loan?

Because German law does not recognize the concept of trust or beneficial owner, the transfer of ownership in real property forming the underlying of a Sukuk and situated in Germany requires registration. It is expressively stated in the transaction documents of some Sukuk offerings that transfer of the ownership will not be perfected (see e.g. ADIB Sukuk, Offering Circular, Risk Factors, pp. 9-10). This provokes the question if this statement is merely of declaratory nature clarifying that the factual act of transfer, e.g. registration of real property did not take place. Assuming this is the will of the parties, one could argue that the registration of the property to perfect the transfer of the legal title could be made good at a later point in time, e.g. when investors fear the near default of the obligor. A counter-argument against this view could be that there is no convincing reason as to why the SPV representing the Sukuk holders should be given the right to pursue property registration although both parties willingly and knowingly did not act in conformity with their contractual sales agreement just until a critical stage is reached, i.e. payment problems of the obligor evolved. Sukuk holders who set themselves in contradiction to their previous conduct might forfeit their right to obtain ownership (*venire contra factum proprium*). However, this rigid sanction cannot be justified if there is a valid claim and only a relatively short of time elapsed after the conclusion of the contract of sale.

Taking into consideration that the intention of the parties of an asset-based Sukuk is to structure an instrument that replicates the economic features of an unsecured bond, one could also take the view that the obligor at no time intended to fulfill its obligation to transfer the assets to the SPV. One has to bear in mind that asset based Sukuk were created due to market pressure and competition (Haneef, 2009, pp. 108-110) as well as legal constraints such as the impossibility of true sales due to the inalienability of real property to foreigners in Gulf jurisdictions. Moreover, the SPV is not more than an "orphan shell company".

The assumption that the Sukuk holders generally are not quite interested in the underyling assets or structure of a Sukuk but rather the cash flow generated by them is supported by the fact that no asset due diligence or valuation is performed by a neutral third-party expert. This aspect is clearly indicated in certain prospectus: *"No investigation or enquiry will be made and no due diligence will be conducted in respect of any Sukuk Assets. Only limited representations will be obtained from IDB in respect of the Sukuk Assets of any Series of Trust Certificates. In particular, the precise terms of the Sukuk Assets or the nature of the assets leased or sold will not be known (including whether there are any restrictions on transfer or any further obligations required to be performed by IDB to give effect to the transfer of the relevant Sukuk Assets). No steps will be taken to perfect any transfer of the relevant Sukuk Assets or otherwise give notice of the transfer to any lessee or obligor in respect thereof. Obligors and lessees may have rights of set off or counterclaim against IDB in respect of such Sukuk Assets"* (IDB Sukuk 2005 Offering Circular, Risk Factors, pp. 69-70). Thus, in most cases it will also not be possible to asses whether the face value of the Sukuk certificates truly reflects the real market value of the underlying assets. Similar to the "disclaimer" mentioned above, one can also find the clarification in some prospectuses that

Sukuk holders will not have interest in the assets from a legal perspective. This is indicated for example in the DP World offering circular: *"Each of the Mudaraba Agreement, the Purchase Undertaking and the Sale Undertaking are governed by English law under which the interest under Sharia in the Mudaraba Assets of either the Issuer and/or the Trustee may not be recognized. Neither the Issuer nor the Trustee has any interest in the Mudaraba assets under English law"* (DP World Offering Circular, Risk Factors, p. 22).

The lack of interest of Sukuk holders in the assets – at least so long they receive payments - may not be a sufficient evidence to negate ownership. Similarly, the (fiduciary) restrictions on the transferability of the assets to third parties by the SPV is legally permissible in German civil law (sec. 137 German Civil Code) and serves the interests of the Sukuk holders. However, the fact that payment obligations of the issuer rank *pari passu* with the claims of all its other unsecured and unsubordinated creditors possibly can be taken as an argument against ownership of Sukuk holders.

On the basis of the statements in the sales contract or the prospectus stating that "no steps will be taken to perfect any transfer of the relevant Sukuk assets" one could argue that the claim of the SPV for procuration or transfer of the assets as promulgated in sec. 433 subsec. 1 German Civil Code is waived. In view of these circumstances, one would perhaps not go to the lenght of holding the transfer of property or the sales contract as fictitious and thus null and void (e.g. sec. 117 German Civil Code). If, however, the sales contract is "deformed" to such a degree that the most fundamental obligation of a sales transaction, i.e. the transfer of the subject matter, is excluded bilaterally on the basis of a (side) agreement, one will usually tend to take a substance over form approach and classify the transaction as sale and not a loan - irrespective of the designation by the contracting parties. The financing character of the described structures dominates the transactions. Thus, there is little room to classify the transaction as a contract of sale. Rather, the contract would be classified as a loan according to sec. 488 German Civil Code.

In recent judgments in the UAE or Saudi Arabia, courts took a substance over form approach when they had to consider Islamic finance transactions. In a decision dated 24 March 2010, the Dubai Court qualified an Ijara Contract as a sales contract taking a substance over form approach (Personal communication). The Saudi Board of Grievances declared that „the Circuit is concerned about the substance, not the title" (Khalid Bin Abdulaziz Alanzan v. Saudi American Bank (Samba Financial Group), 17.1.1429 A.H. / 26 January 2008, Personal communication). Accordingly, taking a substance over form approach, the courts in the GCC could declare the Sukuk construction with the aforementioned features to be a disguised form of an interest bearing bond.

Similarly, in the recent case *Blom Development Bank vs. The Investment Dar Company* ([2009] EWHC 3545 (Ch)), the English High Court moved away from the previous view taken in *Shamil Bank of Bahrain vs. Beximco* ([2004] EWCA Civ. 99) and held that TID's legal counsel had made an arguable case that a *Wakala* agreement entered into between TID and Blom was not compliant with Sharia and, therefore, that the agreement was beyond the corporate powers of TID and void.

The classification of the underyling contract not as a sales transaction but a loan could also trigger unpredictable international enforceability issues (see e.g. Salah, 2010). If, for example the Sukuk transaction is structured under German law but the assets are in Doha or Dubai, the local court could accept the German judicial assessment and commence with the enforcement procedure. In this case the court could ignore the limited recourse or insolvency remote structure of the Sukuk transaction, pierce through this veil and realise the assets of the obligor. However, the local court might also revisit the merits of the case and could make Sharia considerations fully or partially effective. Hence, the court could give effect to the sale contract and acknowledge the proprietry rights of Sukuk holders. It would first urge the parties to register the underyling real estate with the Land Department. In this scenario, Sukuk

holders would only have recourse to the assets taking the risk that the asset value is not sufficient to cover the invested capital.

One possible way to avoid these problems would be to use the concept of German "custody" or "fiduciary agency" (*Treuhand*) which is very close to the Common Law Trust. Whereas the opinions in legal literature are "liberal" as to the conditions of an insolvency remote *Treuhand*, the German Federal Court (Bundesgerichtshof) requires an immediate transfer of the *Treuhand* asset from the Beneficiary (*Treugeber*, here: SPV) to the Trustee (*Treuhänder*, here: Obligor). According to this restrictive view, a declaration by the Obligor that it holds the assets on trust for the SPV is not sufficient. Furthermore, in case the *Treuhand* asset is a real estate, the Federal Court takes the view that the registration of a priority notice (*Vormerkung*, sec. 883 German Civil Code) is compulsory. In light of this judicature it is recommendable to register the real estate with the land registry in order to grant Sukuk holders recourse to the assets in case of insolvency of the Obligor and to avoid a "claw back" by an insolvency practitioner.

2.4. Legal concequences of deficient transparency in Sukuk documents

Sukuk structures, as described above, may be particularly problematic if they are publicly offered to retail customers. Despite the disclaimers and statements in the prospectuses, confusions on the side of average retail customers about the *de facto* characteristics of an asset based Sukuk cannot be entirely dispersed. Especially the terms "sale", "lease" or "repurchase" used in Sukuk prospetuses may be misleading. Market participants who, without access to (or interest in) the legal detail, could sincerely believe there is asset security and that the investment/financing provided is collateralized (see Moody's, 2009, p. 5).

Poor transparency in the terms and condition of Sukuk offerings can violate the transparency requirement promulgated in sec. 3 Bond Act (Schuldverschreibungsgesetz) or the unfair terms provisions, most notably sec. 307 of the of the German Civil Code, rendering the relevant clause void. Moreover, prospectus liability may arise, e.g. when the formulations in the prospectus are misleading. Prospectus liability can be triggered also in case of explicit violation of fundamental Sharia rules (Casper 2011; Sacarcelik, 2010).

II. SHIFTING OWNERSHIP RISKS TO THE LESSEE

Another major concern in Ijara Sukuk is that Sukuk holders who are owners (i.e. lessor) from the Sharia point of view are responsible for major maintenance or insurance expenses of the subject matter of the sale and lease agreement. In practice, the obligor is frequently appointed as servicing agent for the asset. In this capacity, the lessee manages the maintenance on behalf of the Sukuk holders. The lessee usually receives a servicing fee and can claim reimbursement if any additional expenses incurred. However, the ownership responsibilities and costs are passed on to the lessee through charging a supplemental rental in the amount equal to the expenses claimed by the lessee. The lessees obligation to pay supplemental rent is then set off against the lessor's (SPV/Sukuk holders) obligation to reimburse expenses. Passing on maintenance responsibilities can be agreed under German law between the lessor and the lessee within certain statutory limits. In conventional finance lease contracts the lessee usually bears this responsibility. Since Sukuk holders economically benefit from this arrangement there is generally no legal objection, e.g. with respect to unfair terms rules. However, this risk shifting might be problematic from a Sharia perspective because it disburdens Sukuk holders from genuine ownership obligations. Moreover, German tenancy law sets limits to the rent increase both for residential and commercial real estate. Consequently, charging supplemental rent to absorb expensive maintenance costs might be barred when it exceeds a certain level.

III. CONCLUSION

This article has shown that Sharia considerations underlying Islamic finance transactions and legal structuring can fall appart and create a gap. This divergence gap can be seen, for example, when it comes to ownership issues in asset-based Sukuk. The compexity of the issues increase due to the international scope of these transactions involving different jurisdictions. The disengagement of Sukuk transactions from their underlying assets leads to a risk structure which is not always reflecting the stipulations of Sharia compliant finance.

This paper suggests that in absence of the trust structure in German law or comparable civil law legal systems, a true sale has to be effectuated to grant Sukuk holders ownership rights. Formal registration is mandatory where the underyling asset of a Sukuk is immovable property. The valid transfer of the assets can eliminate the risk of a "claw back" of the assets or the characterization of the transfer as loan. Alternatively, the concept of Treuhand can be used to approximate the relevant Sukuk under German law to transactions utilizing an English law trust.

Legal issues in Sukuk transactions structured in civil law jurisdictions are not limited to Ijara Sukuk. Equity-based Sukuk such as Mudaraba and Musharaka also show features that might conflict with existing legal provisions of German law. Moreover, the Mudaraba or Musharaka arrangement could qualify as civil or commercial company. However, complying with Sharia requirements usually does not cause legal frictions as long as the relevant statutory rules are observed. Despite challenges and some problematic issues reagrding current Sukuk market practices, German law provides a liberal and secure legal environment for Islamic finance transactions including Sukuk. This has been already proven by various Islamic funds, certificates and the prominent Saxony Anhalt Sukuk being the only "European" Sukuk to date.

REFERENCES

1. AAOIFI, 2008. *Accounting and Auditing Organization for Islamic Financial Institution's Shari'a Standards*. Manama: AAOIFI.
2. Adam, N. and Thomas, A. (eds.), 2004. *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk*. London: Euromoney Books.
3. Ali, R. (ed.), 2011. *Sukuk and Islamic Capital Markets*. London: Globe Law and Business.
4. Al-Masri, R.Y., 2002. The Binding Unilateral Promise (wa'd) in Islamic Banking Operations: Is it Permissible for Unilateral Promise (wa'd) to be Binding as an Alternative to a Proscribed Contract? *Journal of King Abdulaziz University: Islamic Economics*, 15, pp.29-33.
5. Al-Muhairi, B. 1995. The Position of Shari'a within the UAE Constitution and the Federal Supreme Court's Application of the Constitutional Clause Concerning Shari'a. *Arab Law Quarterly*, 11, pp. 219-244.
6. Ayub, M., 2007. *Understanding Islamic Finance*. Sussex: Wiley.
7. Ballantyne, W., 1985. The New Civil Code of the United Arab Emirates: A Further Reassertion of the Shari'a . *Arab Law Quarterly*, 1, pp. 245-264.
8. Baur, J.F. and Stürner, R., 2009. *Sachenrecht*. 18th ed. Munich: C.H. Beck.
9. Casper, M., 2011. Islamische Aktienfonds – eine kapitalmarktrechtliche Herausforderung? In: U. Burgard et. al., ed. 2011. *Festschrift für U. H. Schneider*. Cologne: Otto Schmidt.
10. Dusuki, A. W. and Mokhtar, S., 2010. *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukuk as Implemented in the Islamic Debt Market*. (ISRA Research Paper No: 8/2010) [online] Kuala Lumpur: ISRA (Published 2010) Available at: <http://www.iefpedia.com/english/wp-content/uploads/2011/02/B108.pdf> [Accessed 3 July 2011].
11. Habachy, S., 1962. Property, Right, and Contract in Muslim Law. *Columbia Law Review*, 62/3, pp. 450-473.
12. Haneef, R., 2009. From „Asset-Backed" to „Asset-Light" structures: The intricate history of Sukuk. *ISRA International Journal of Islamic Finance*, 1 (1), pp.103-126.
13. Hayton, D., 2003. *The Law of Trusts*. 4th ed. London: Sweet & Maxwell.
14. Islamic Development Bank, 2000. *Resolutions No. (2) and (3) of the fifth conference of the OIC Islamic Fiqh Academy held in Kuwait in 1988/1409 A.H.*. Resolutions and Recommendations of the Islamic Fiqh Academy 1985-2000. Jeddah: Islamic Development Bank.
15. Mokhtar, S., 2011. *Application of Wa'ad in Equity Based Sukuk - Empirical Evidence*. (ISRA Research Paper No: 20/2011) [online] Kuala Lumpur: ISRA (Published 2011) Available at: <http://www.isra.my/media-centre/downloads/summary/29/294.html> [Accessed 3 July 2011].
16. Moody's, 2009. *The Future of Sukuk: Substance over Form?* London: Moody's Investor Services. [online]
    Available at:
    <http://www.institutfrancaisdefinanceislamique.fr/docs/docs/doc_id95.pdf>
    [Accessed 2 September 2011].
17. Sacarcelik, O., 2010. Trends and challenges in Islamic Finance – A case study of Switzerland. *Swiss Review of Business Law (SZW)*,Vol. 1, pp. 10-21.
18. Sacarcelik, O., 2011. *Sukuk – An Innovative Islamic Finance Instrument*. Würzburg: Ergon.
19. Salah, O., 2010. Dubai Debt Crisis: A Legal Analysis of the Nakheel Sukuk. *Berkeley Journal of International Law Publicist*, 4, Spring issue, pp.19-32.

20. Thomas, A. (ed.), 2009. *Sukuk*. Petaling Jaya: Sweet & Maxwell Asia.
21. Usmani, M.T., 2007. *Sukuk and Their Contemporary Application*. [online] Available at: <http://www.muftitaqiusmani.com/index.php?option=com_content&view=article&id=3:sukuk-and-their-contemporary-applications&catid=12:economics&Itemid=15> [Accessed 2 July 2011].
22. Usmani, M.T., 2008. *An Introduction to Islamic Law*. Karachi: Quranic Studies Publishers.
23. Wohidul Islam, M., 1999. Al-Mal: The Concept of Property in Islamic Legal Thought. *Arab Law Quarterly*, Vol. 14 (4), pp. 361-368.
24. Ziadeh, F., 1993. Property Rights in the Middle East: From Traditional Law to Modern Codes. *Arab Law Quarterly*, Vol. 8 (1), pp. 3-12.