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Dana Gas Sukuk: A red herring or cause for concern?

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The recent move by Dana Gas PJSC ("**Dana Gas**") to declare its approximately US$700 million of outstanding trust certificates unlawful and, accordingly, unenforceable on grounds that, in the company's view and that of its advisors, the certificates (or sukuk) had ceased to be *Shari'a*-compliant has been a troubling and potentially destabilizing development for the international sukuk market and the Islamic finance industry as a whole.

Whilst Dana Gas has initiated proceedings in the UAE to declare the sukuk illegal and it has secured a series of injunctions around the globe preventing enforcement by creditors (including by the Sharjah Federal Court of First Instance, the Commercial Division of the High Court of Justice in the British Virgin Islands and the High Court in London), the key question that remains unanswered, is whether non-compliance with *Shari'a* principles would (or should) have any bearing on the legal enforceability of these instruments. Suffice it to say, any judgment in favour of Dana Gas could have wide ranging implications on the sukuk market, at least in the Middle East, in terms of how such transactions are structured, particularly if conventional (i.e., non-Islamic) investors come to view sukuk as 'high-risk' financial instruments. Further, it could open the floodgates for issuers to use the argument that their instruments are not *Shari'a*-compliant as a precursor to force creditors into debt restructurings. Both outcomes could result in greater uncertainty in the market. We would argue that, in general, the concept of *Shari'a*-compliance (or the lack thereof) should be treated as distinct from legal enforceability. However, as discussed further below, in Dana Gas' case, this distinction is not entirely straightforward.

Shari'a-compliance

Before we look at whether Dana Gas' legal analysis holds water, we note that the question of whether any particular sukuk structure is actually *Shari'a*-complaint is ultimately a subjective matter for individual investors to determine based on their own personal investment criteria. We also recognise, along with other stakeholders and participants in the sukuk and broader Islamic finance industry that the sukuk market is still relatively young and continues to develop. It therefore comes as no surprise that *Shari'a* standards may vary over time and also across geographies as, for example, *Shari'a* standards generally applied to Islamic financing transactions in the Middle East are not necessarily the same as those recognised as established principles in the Malaysian market. No person involved with a sukuk issuance can assure investors that such sukuk and the related transaction documentation will be deemed to be *Shari'a*-compliant in perpetuity. Accordingly, Dana Gas' *Shari'a* argument is certainly tenable that scholarly consensus has shifted since 2013 to the extent that Dana Gas' outstanding sukuk are no longer considered *Shari'a*-compliant by a sizeable enough portion of the Middle Eastern market to warrant Dana Gas' declaration of unlawfulness.

Separately, we note that regardless of the shifting preferences amongst *Shari'a* scholars and market participants in respect of the "mudaraba with purchase undertaking" structure used in Dana Gas' sukuk, the fact is that Dar Al Sharia Legal & Financial Consultancy issued a pronouncement on the *Shari'a*-compliance of Dana Gas' sukuk at the time the sukuk were issued. Pronouncements of such nature are generally not open to retroactive invalidation as is being sought by Dana Gas.

Contractual compliance

What appears more contentious, however, is Dana Gas' position that the lack of *Shari'a*-compliance necessarily invalidates the legal enforceability of Dana Gas' payment obligations under its sukuk. In short, our view is that this should not be the case and, subject to the underlying contractual agreements entered into by

Dana Gas, particularly the Purchase Undertaking, being diligently drafted to contain certain market standard English law indemnities and restitution provisions, Dana Gas' sukuk should remain a legally enforceable fixed income instrument, even if it can no longer be considered, for (purported) lack of *Shari'a*-compliance, as "sukuk". In short, such lack of *Shari'a*-compliance may have reputational implications, but it should not necessarily have adverse legal consequences. This is particularly pertinent because the key contract prescribing Dana Gas' payment obligations upon the occurrence of a non-payment event of default (which Dana Gas has surely triggered or at least indicated that it will trigger), the Purchase Undertaking, is governed by English law and specifies dispute resolution in the English courts.

Legal compliance

Notwithstanding that the High Court in London has granted an interim injunction in favour of Dana Gas, the merits of the case have not been heard and are unclear. We would expect the English courts, in applying English law, to come to the conclusion that *Shari'a*-compliance and legal enforceability are distinct issues and that the critical contractual provisions contained in the English law documents (including those set out in the Purchase Undertaking) obliging Dana Gas to make payment to creditors are legal, valid, binding and enforceable against it. However, regardless of the eventual outcome in the English courts, ultimately, any meaningful enforcement action taken by creditors against Dana Gas would need to be taken in the UAE since it is an entity established in and with a significant part of its assets located in the UAE. This would require the UAE courts to recognise and enforce the relevant English courts' judgment under Article 235 of the UAE Civil Procedure Law and, short of the arrangements constituting the sukuk in question breaching express provisions of UAE law, the primary grounds upon which we envisage enforcement being refused (at least, without a re-trial) would be for public policy reasons. Additionally and related to this, we note that it is not unheard of for the English courts to rule that English law contracts may be unenforceable in circumstances where a party can show that (i) a foreign jurisdiction is the contractually required place of performance of an obligation, and (ii) performance of such obligation would be unlawful in the foreign jurisdiction (see, e.g. *Ralli Bros v Compania Naviera Sota y Asnar [1920] 2 KB 287*).

In Dana Gas's circumstances, the onus should be on it to prove both that the Purchase Undertaking is to be performed in the UAE and that the payment obligations contained therein are unlawful under UAE law, i.e. for public policy reasons relating to the lack of compliance of such obligations with the applicable *Shari'a* principles and/or due to contravention of express provisions of UAE law. So far as we are aware, it is not possible to extrapolate any further on what these "public policy" reasons might entail given the lack of relevant case law in the UAE on this topic.

In Dana Gas' specific circumstances, however, we note that there is a possibility that certain provisions of the UAE Civil Transactions Law (Federal Law No. 5/1985) relating to mudaraba arrangements work in Dana Gas' favour, specifically, Article 693 which provides that[1] a mudaraba is "*an agreement whereby the capital owner agrees to provide the capital and the other party to endeavor and work aiming at realizing a profit*" and Article 696 which provides that[2] *"the party receiving the capital may not be asked to warrant it if lost or perished without negligence from his part*".

This raises some uncertainty and potentially blurs the distinction mentioned above between *Shari'a*-compliance and legal enforceability as it could be argued that the Purchase Undertaking, which effectively ensures that sukukholders achieve a fixed or pre-determined return (in the form of the relevant exercise price) from the sale of the mudaraba assets, conflicts with Article 696, which ostensibly prohibits a guaranteed return of capital under a muradaba arrangement.

Ultimately, we will need to see what the UAE courts conclude on this point, which may hinge on: (i) whether the English law governed Purchase Undertaking can be enforced on a standalone basis independently of the legality of the UAE law governed Mudaraba Agreement; or (ii) whether the sukuk and the underlying transaction documents are viewed as a whole, forming one single transaction, in which case the Purchase Undertaking (and any English court judgment requiring the enforcement thereof) could be deemed to be unenforceable in the UAE on the basis that it is intrinsically tied to and complements the Mudaraba Agreement and therefore creates an unlawful mudaraba arrangement in contravention of Article 696.

1 English translation from Lexis/SADER Legal Publishing

2 English translation from Lexis/SADER Legal Publishing

Market practice and the sukuk industry

Market practice (at least in the international Regulation S sukuk space) has developed such that "English law sukuk" transactions are structured and documented so that, among other things, payment obligations thereunder are expressed as independent obligations contained in English law contracts (which themselves contain now standard English law indemnities and restitution provisions and protections) in order to be insulated from the legal (if not reputational) implications of *Shari'a* non-compliance as well as from the risk of failures in compliance with provisions of local (i.e., non-English) law. This is arguably one of the main reasons why the sukuk market has grown so quickly in a relatively short space of time as such structural features have proved critical in satisfying investors, rating agencies, issuers and other stakeholders that sukuk are truly fixed income in nature. Accordingly, when the relevant UAE courts come to determine Dana Gas' case, one consideration which may be integral to their judgment would be whether such ruling (whichever way it falls) is likely to promote or stunt the growth of the international sukuk market and, closer to home, reinforce or hamper the UAE's position as a leading centre of Islamic finance.

However, given the unique circumstances of the Dana Gas dispute and the lack of relevant judicial precedent on the issues raised, any further commentary from this point onwards on the outcome of the dispute would be pure speculation. As a final observation, we must note that Dana Gas does not represent the entirety of the sukuk market and the bespoke *Shari'a* structure used in the Dana Gas sukuk lends itself to the aforementioned uncertainty *vis-a-vis* the UAE Civil Transactions Law. The vast majority of other "English law" sukuk issued from the Middle East do not utilise the "mudaraba coupled with purchase undertaking" structure at the centre of the Dana Gas dispute and, accordingly, this issue does not arise in practice across the wider sukuk market. However, the Dana Gas saga does serve as a timely reminder to us and other participants in the sukuk industry at large that we must be diligent, when structuring, documenting and reviewing sukuk transactions, in ensuring that such transactions do not fall foul of provisions of all applicable laws, however obscure.

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