

Sukuk Al Mudaraba: Issues relating to Distribution of Losses between the Issuer and Investors

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Companies have increasingly looked to Sukuk issuances as a Shari'a compliant method to raise finance for their growing financial needs. Sukuk attracts investors in the region and internationally who are keen to invest in Shari'a compliant instruments. Unlike bonds, Sukuk are structured as asset based certificates which represent an interest (typically ownership or usufruct rights) in the underlying assets. The most popular Sukuk structures include the Sukuk Al Ijara, based on a lease finance structure, Sukuk Al Mudaraba based on a joint investment structure and Sukuk Al Musharaka based on a partnership structure.

One of the key debates centres around the issue of sharing of losses between the investors and the issuers. In a conventional bond issuance, the issuer is responsible for the payment of interest and principal to the bondholders without any correlation to the performance of the issuer's underlying business. However, in equity linked Sukuk structures such as the Sukuk Al Mudaraba and Sukuk Al Musharaka, there are restrictions both from a legal perspective as well as from a Shari'a perspective on guaranteeing the principal and profit elements.

Who Bears the Losses?

According to the definition provided by the Accounting and Auditing Organization for Islamic Financial Institutions ('AAOIFI') of Mudarabah certificates (Mudarabah Sukuk), the issuer of the certificates is the Mudarib or manager of the capital, the subscribers are the Rab Al Maal or the owners of the capital, and the proceeds of the issuance form the Mudaraba capital. The Mudaraba capital is then used for investing in the issuer's business which forms the Mudaraba. The Sukuk certificate holders who proportionately own the assets of the Mudaraba, are entitled to a preagreed share of the profits and bear the losses in proportion to their respective share in the Mudaraba capital, if any, unless such loss is a result of the negligence of the Mudarib (Issuer). The distribution of profit between Rab Al Mal and the Mudarib should be clearly defined in the Mudaraba agreement between the parties. If the parties to a Mudaraba agree to a fixed return on investment or a guarantee of capital, such agreement will be inconsistent with Shari'a principles as agreed by Shari'a scholars. The applicable AAOIFI guidance provides: 'The Sukuk manager can only guarantee to repay the capital to Sukukholders at face value in cases of negligence or violation. Sukukholders in a mudaraba or musharaka based structure need to understand that the Sukukholder must have some risk in these structures. Shariah principles encourage the sharing of risk and profit.'

Profit distribution in Mudaraba can only be made after the capital of Rab Al Mal has been restored. The additional profit over and above the capital is distributed as profit at a preagreed ratio between the Mudarib and Rab Al Mal. If there are losses, such losses are offset by any profit made and then from the Mudaraba capital if necessary. This concept of profit distribution is contrary to the conventional notion of bonds being 'fixed income' instruments and many attempts have been made to develop instruments such as the 'purchase undertaking' to safeguard and lock-in the principal and profit element or coupon payments under the Sukuk certificates.

Position under Civil Code: Losses and guarantee of capital

The UAE Civil Code also governs Mudarabah arrangements. The UAE Civil Code confirms the position of Shari'a scholars regarding who bears the losses. Article 704 of the UAE Civil Code addresses the issue of bearing losses in Mudarabah agreements. The Article states that:

1. Rab Al Mal shall bear, alone, the loss, and any condition to the contrary shall be void.
2. If any part of the Mudarabah capital deteriorates, it shall be deducted from the profit and, if it exceeds it, the remainder shall be charged to the capital. The Mudarib shall not guarantee the capital.

Mitigation through Purchase Undertaking

The purchase undertaking has been used as a mechanism to mitigate losses arising from the Mudarabah in order to protect the investment of the investors. Under the purchase undertaking, the Mudarib undertakes to purchase the Mudarabah assets from the subscribers at the aggregate of the face value of the certificates and the accrued profit. The purchase undertaking is triggered on each periodic payment date or upon the occurrence of an event of default. The purchase undertaking serves as a call option granted by the issuer to the certificate holder under which the investment (principal amount) and the coupon payment is guaranteed.

Enforceability of Purchase Undertaking

As noted above, Article 704 of the UAE Civil Code requires the investor to bear its proportionate share of the losses in a Mudaraba. From a Shari'a point of view (as noted by AAOFI), it is permissible for an issuer of the Sukuk to undertake to purchase the Mudaraba assets at market value and not at a predetermined fixed price. These factors do put in doubt the viability of the purchase undertaking in the context of the Mudaraba structure under UAE law.

To mitigate against this risk, the transaction documents relating to a Sukuk Al Mudaraba are often made subject to English law. In a recent decision of the English court in *Dana Gas PJSC v Dana Gas Sukuk Ltd & Ors* [2017] EWHC 2928, involving a Sukuk that was structured as a Mudaraba, the judge stated that the purchase undertaking in that instance was enforceable and disregarded both UAE law and Sharia principles. Mr. Justice Leggatt stated:

'As mentioned earlier, the Purchase Undertaking is governed by English law and so (as Dana Gas is constrained to accept) it is English law which determines whether the Purchase Undertaking is a valid and enforceable contract. It is perfectly lawful in English law to guarantee the return from an investment and to pay and receive compensation for the use of money. Prima facie, therefore, the Purchase Undertaking is a valid and enforceable contract whatever view would be taken of its validity and enforceability if UAE law were applicable.'

Conclusion

In light of the provisions of Article 704 of the UAE Civil Code and AAOIFI's interpretation of the usage of purchase undertakings, there are concerns relating to the usage of purchase undertakings where a Mudaraba is used to structure the Sukuk. The Mudaraba continues to be an attractive structure for equity linked Sukuk and we expect that it will continue to be used with the appropriate mitigants.

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