

The Intricacies of Default in Islamic Finance: A Case Study of Dana Gas *Ṣukūk* Litigation

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Abstract. This narrative study presents the ongoing Dana Gas *Ṣukūk* nonpayment and its consequent legal proceedings and implications. Dana Gas (the company) stirred the global Islamic finance market when in June 2017 it announced that its *muḍārabah* based *ṣukūk* instrument is no longer Shari'ah compliant due to changes in Shari'ah interpretation. It claimed that this situation has made the *ṣukūk* unlawful in the UAE and therefore the company will not be fulfilling its payment obligation under the *ṣukūk* and will instead seek a restructuring of the instrument. The decision was contested by the *ṣukūk* holders, who appealed against the company in the court of United Kingdom. On the other hand, Dana Gas opted for Sharjah court to proceed with litigation. This situation is the result of the fact that the *ṣukūk* document is governed by the United Arab Emirates laws but the 'Purchase Undertaking' which was part of this contract is governed by English law. After months of litigation in these two courts, the English court decided in favor of the *ṣukūk* holders asking the company to fulfill its payment obligations as its Purchase Undertaking is enforceable. On the contrary, the Sharjah court ordered the company not to follow the orders of the UK court and instead follow the instructions of the UAE court. The Sharjah court further added that the question of whether the *ṣukūk* are Shari'ah compliant or have ceased to be so is to be decided by the Sharjah court itself, and not by the English court. Thus, there is standstill situation due to the conflicting decisions of the two courts. In this case study, a detailed description of the legal proceedings as well as other important episodes like the attempts of an out-of-court restructuring of the *ṣukūk*, the causes of the failure of restructuring attempts, the behavior of the *ṣukūk* issuer and *ṣukūk* investors and the overall legal uncertainty in *ṣukūk* documentation and default are discussed.

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INTRODUCTION

Dana Gas is the Middle East's first and largest regional private sector natural gas company. It was established in December 2005 with a public listing on the Abu Dhabi Securities Exchange (ADX). Dana Gas has exploration and production assets in Egypt, Kurdistan Region of Iraq (KRI), and the UAE. As part of its strategy to put in place an optimal structure for funding its rapid growth in the natural gas business sector, Dana Gas issued convertible *ṣukūk*. the first convertible *ṣukūk* to be issued in the Middle East, in October 2007. The *ṣukūk* were structured on the basis of *muḍārabah* which offered a profit rate of 7.5 percent. Its proposed size was \$750 million initially, later on the the issue was increased times, and it reached to \$1 billion due to a strong demand from investors. Maturing in 2012, the *ṣukūk* were issued in denominations of US\$10,000, subject to a minimum holding of US \$100,000. JPMorgan acted as sole book runner and lead manager on the offering while Barclays Capital and Citi were joint lead managers on the offering.

Though Dana Gas enjoyed a good business model initially, but later on it faced some financial and non-financial problems putting it into a distressed financial situation. The lack of guidance from Dana's management, the company's weak liquidity position, as well as the likely absence of government support led to intense speculation that the company may default on its *ṣukūk*. The limited availability of commercial bank credit to distressed companies in the region also bolstered these negative sentiments. Likewise, issuance of a large equity to meet the funding gap was also not an option because Dana's market cap was only \$665 m. In short, both internal and external factors were grouping together to push the *ṣukūk* to the brink of default. Eventually, Dana Gas *ṣukūk* went into default in October 2012.

In November 2012, Dana Gas announced that it had reached an in-principle agreement with the Ad hoc Committee of *ṣukūk* holders on the restructuring terms of the *ṣukūk*. Both shareholders and *ṣukūk* holders approved the restructuring proposal as the terms were favorable for both of them. The approval of restructuring plan enabled Dana Gas to monetize its assets instead of entering into a complex liquidation process with recovery potentially below 40 cents on the dollar.

Objectives of the Case Article

The case article has been prepared keeping in view the following objectives:

- It would help understand the complexities of default in the context of *ṣukūk* that is a kind of quasi equity;
- It would indicate the the nature of possible legal disputes in Islamic instruments of finance with particular focus on the issue of governing law and jurisdiction/court;
- It would also indicate the importance of proper legal documentation and the need for a solid alternative dispute resolution mechanism in Islamic finance
- It also explains the impact of Shari'ah risk and its implications for investors and issuers of *ṣukūk*

Looming Default and Attempts of Second Restructuring

Dana had not been able to fully overcome its financial problems ever since the restructuring of its *ṣukūk* in 2012. The most notable reasons for this is the political instability in the regions where Dana operated. In the wake of Arab Spring, many of the Gulf countries, especially where Dana had assets and where it mainly operated, had been facing with political instability and weaker law and order situation. In addition, the historically low oil prices is another major macroeconomic factor that hit the company hard and make it unable to recover its financial position. Consequently, Dana's financial position was not encouraging after the restructuring. For instance, it had \$322 million in cash at the end of year 2016. But at the end of March 2017, the company's cash balance reduced to \$298 million. The company was also involved in different legal disputes in different regions. Also, the oil and gas producers faced pressures on profits after a fall in oil prices from an average of almost \$100 in 2014 to about \$50 during the years 2015-16. Fearing that it may not be able to fulfill its payment obligations under the *ṣukūk*, Dana started discussions with *ṣukūk* holders about a possible second restructuring of the *ṣukūk* in May 2017. Pursuant to the proposed restructuring plans, Dana appointed Houlihan Lokey Inc. and Squire Patton Boggs LLP as financial adviser and legal adviser respectively in June 2017 for discussing the restructuring plans of the *ṣukūk*. On the other hand, the *ṣukūk* holders appointed the New York-based bank Moelis and U.S. legal firm Weil, Gotshal & Mangers as financial and legal advisers to negotiate the second restructuring of *ṣukūk* with Dana.

Claim of Shari'ah Non-Compliance

However, there was a new twist in the story in second week of June 2017, when Dana announced that the *ṣukūk* were no more Shari'ah compliant under the United Arab Emirates law due to changes in Shari'ah interpretations. Explaining the nature of the non-compliance of its *ṣukūk* with Shari'ah, the company stated that:

In brief, the major issues with our current *muḍārabah ṣukūk* include that it guarantees a fixed rate of return to certificate holders, it makes the Company responsible for any loss of capital, and it does not contain a mechanism to reconcile the fixed amounts paid to the certificate holders over time against the actual profit generated by the *muḍārabah* Assets, and finally any capital loss is not reflected in a reduction in value of the *muḍārabah* Assets. These terms make our current *muḍārabah ṣukūk* contrary to Shari'ah and unlawful under UAE law.

Consequently, Dana stated that the upcoming two distributions scheduled on July 31 and October 31 respectively will not be made due to the unlawful nature of the *ṣukūk*. However, these payments would be accounted for in the proposed restructured *ṣukūk* instrument. As per its restructuring plan, Dana proposed the new profit payments to comprise a cash and payment-in-kind element in addition to the possibility of *ṣukūk* repayment either in whole, or in part at par, prior to its maturity without any penalty. It proposed exchanging \$350 million of the 7% exchangeable certificates with a new four-year security/instrument but with a profit rate of less than half of the current profit rate.

The announcement as well as the restructuring proposal by Dana was not welcomed by

the *ṣukūk*-holders who rejected it outrightly. They wanted the *ṣukūk* restructuring to be on more favorable terms which the company did not agree to. The contested question was the profit rate for the new issuance. Since the two parties did not agree on the restructuring terms, court proceedings were highly expected to commence forthwith, but there was a grey area as to what will be the suitable jurisdiction for such proceedings. This question arose due to the fact that while the *mudārabah* agreement underlying the *ṣukūk* structure was regulated by UAE law, the Purchase Undertaking, the part of the *ṣukūk* contract, was governed by the English law. Thus, it was unclear which law would eventually prevail.

Initiation of Court Proceedings in the UAE

Subsequent to its announcement that the *ṣukūk* is no longer Shari'ah compliant, Dana involved the UAE court system by asking the Federal Court of First Instance in the Emirate of Sharjah to rule the *ṣukūk* as unlawful and unenforceable. Dana also obtained an order from the Sharjah court which barred the *ṣukūk* holders from taking any action against the company's securities until the court reviews Dana's application to declare the *ṣukūk* unlawful and unenforceable. Dana Gas was also granted an additional order from the commercial division of the High Court of Justice in British Virgin Island on June 13. In addition, the company also filed a pre-emptive lawsuit in the English High Court of Justice in London to protect its interests against any hostile action by the *ṣukūk* holders. Similarly, some of Dana's shareholders obtained an injunction in a court in the Emirate of Sharjah preventing the company from taking part in the London hearings initiated by *ṣukūk*-holders who preferred UK as the litigation platform. This was primarily due to the reason that Purchase Undertaking, a document on which the *ṣukūk* holders relied mainly for security of their payment rights, was governed by English law. Since some of Dana Gas shareholders obtained a last minute order from the Sharjah court in the UAE, it prevented Dana Gas from participation in proceedings in the UK court. In spite of this injunction, the UK court decided to go ahead with the proceedings/hearing of the case which started in July 2017.

Initiation of Proceedings in and Judgment of the UK Court

The *ṣukūk* holders' group challenged the actions of Dana Gas in the English court through the world's largest asset manager-Blackrock, and argued that the company should either repay them the *ṣukūk* amount, or hand over stocks, that were kept as a repayment security, in a subsidiary that runs its operations in Egypt. They also demanded the court to ban Dana Gas from issuing any new *ṣukūk* to secure further funds for the company. It was further claimed that the absence of Dana Gas from the courtroom, due to an injunction by UAE court, is a deliberate attempt by the company to frustrate the UK court hearing. After hearing the arguments, the English court decided in favor of the *ṣukūk*-holders in November 2017 and held that the Purchase Undertaking was valid and enforceable. The judge remarked that:

I conclude that, even on the assumptions made for the purpose of the preliminary issue, all the grounds on which Dana Gas has sought to challenge the validity and enforceability of the Trustee's rights under the Purchase Undertaking to oblige Dana Gas to pay the Exercise Price are unfounded. Accordingly, I will make a declaration that the Purchase Undertaking is valid

and enforceable in accordance with its terms. The English court not only rejected Dana's application, it also granted order in favor of the *ṣukūk*-holders restraining the company from further proceedings in the Sharjah Court on the ground that such proceedings would be unconscionable and an affront to the English Court's jurisdiction. Moreover, the court also discharged an interim injunction that Dana had obtained in England in June 2017 restraining enforcement of creditor's rights under the transaction.

Response of DANA Gas

As expected, Dana filed an application against this decision in the English court requesting that the decision be set aside. The company argued that the English court should stay the proceedings in favor of Sharjah court and the question of the contract's validity under Shari'ah should be left to the Sharjah court. However, after three-days of hearing, Judge Leggatt was not convinced by this argument and he rejected Dana's application ruling, "it is clear that to permit Dana Gas to advance the same claim at the same time in different jurisdictions would be vexatious and oppressive". Furthermore, the court also held that it should decide all aspects of the case, rather than have some issues go before a Sharjah court.

Responding to this decision of the English court, Dana Gas reiterated that: The judgment and orders made by [Judge Leggatt] have not given due consideration to the company's strong arguments regarding determination of foreign law issues...particularly that the UAE Courts are the appropriate forum to determine the UAE law issues which are closely intertwined with Shari'ah principles which the UAE Courts have to apply as a matter of public policy and public order.

Decision of the UAE Court

In contrast to the timely response by English court, the hearing of the case in Sharjah court was initially scheduled for December 2017 but it was not until March 2018, when it issued its first order about the case. Pursuant to this order, Dana was asked by the Sharjah court to carry on with legal proceedings in the UAE in order to determine whether the *ṣukūk* are valid under the UAE laws or not. The court further prohibited Dana from withdrawing its UAE lawsuits or disregarding the UAE court orders that have been made in the company's favor. The court also held that the enforcement of the English court decision are suspended until the UAE courts have deemed them eligible for enforcement. This decision by the Sharjah court led to a direct conflict between the courts of the UAE and the UK.

Out-of-Court Restructuring Attempts

While the legal proceedings are still continuing in both English and UAE courts, certain attempts have been made along with the litigation to reach an out-of-court settlement of the dispute. In February 2018, the company offered to redeem 10 per cent of the *ṣukūk* in cash and to roll over the remaining 90 per cent over four years at an annual profit rate of 4 per cent. Part of the restructuring deal was an offer to buy back up to half of the bonds at a 15 per cent discount. However, the committee representing the *ṣukūk*-holders' rejected this restructuring proposal explaining that the *ṣukūk*-holders are ready to accept an offer to exchange the *ṣukūk*

for new instruments but on more favorable terms. Their primary demand was that the *ṣukūk* should be redeemed at par and the redemption amount should be higher.

CONCLUSION

It is not clear till this point what will be the outcome of this case. It is for the first time in the history of Islamic finance related legal disputes that we find two courts in different jurisdictions coming into direct conflict. The case sheds ample light on, inter alia, the issue of legal documentation and uncertainty, insolvency and default, the question of governing law, cross border disputes and their resolution, alternative dispute resolution in Islamic finance, the protection of investors, the nature and mitigation tools of Shari'ah risk, as well as the lack of moral and ethical guidelines in case of insolvency that a redrafted on the basis of Shari'ah principles and is to be followed in such cases.

The case study is suitable for the following stakeholders and groups:

- Graduate and post graduate students studying Islamic banking and finance who already have basic understanding of *ṣukūk*
- Researchers in the area of legal dispute, insolvency and restructuring in Islamic finance in general and *ṣukūk* in particular
- Legal community who want to know about the nature and complexities of Islamic finance related legal disputes

Further Research Areas on the Subject

The readers may go through the reading material provided at the end in order to comprehensively analyse the issues involved.

1. Why the restructuring attempts failed? Which one of the two litigants (or one of them) is at fault for the failure of restructuring attempts?
2. To what extent the claim of the company that its *ṣukūk* are no more Shari'ah compliant is sensible? Can it be considered just an attempt to hide behind the veil of Shari'ah?
3. Could this and other similar instances of disputes in Islamic finance be better handled under the umbrella of alternative dispute resolution mechanism?
4. What might be the possible outcome of this case? A win for Dana Gas, a win for *ṣukūk* holders or a win (loss) for both?
5. What is the possible impact of this case and its proceedings on Islamic finance community in general and *ṣukūk* investors and issuers in particular?

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