

CHAPTER 29

Sukuk restructuring

29.1 Introduction

A sukuk transaction is restructured either as a result of an originator's default or voluntary restructuring due to merger, acquisition or general corporate restructuring of an originator. The latter should not raise any concerns for sukukholders, as it is indicative of the performance strength of the originator. If a sukuk transaction is required to be restructured due to default of the originator, then the restructuring proposition of the transaction has a whole set of challenges from Shari'a, commercial and legal perspective. This chapter endeavors to identify some of the challenges that an issuer and related parties may come across in restructuring a sukuk transaction.

29.2 A Case for restructuring

The first question that strikes one's mind is: what purpose does a sukuk restructuring serve? No single answer can satisfy the reader. A number of factors may favour restructuring of a sukuk transaction. The foremost purpose is to save the transaction. It also provides the originator sufficient time to financially reorganize itself and fulfill its obligations towards creditors and financiers in addition to offering better terms to the sukukholders, saving them from the undesirable consequences of excruciating enforcement proceedings.

Sukukholders may have to answer hundreds of questions, both legal and Shari'a, before even considering to make a move for enforcement proceedings. Out of the hundred questions, the first one could be: where do they stand considering the underlying sukuk structure? Which category do they fall in – creditors, owner of the underlying assets (sukuk ijara or ownership or co-ownership in a portfolio of assets) or investments

(musharaka, mudaraba or wakala)? The determination of their categorization for a better position in enforcement proceedings very much depends on which side they have chosen to be at the time of choosing the sukuk structure; assets; investments; risk allocation; Shari'a considerations in relation to the relevant structure and balancing the foregoing consideration in the applicable legal regime in their favour. It appears that there has been less attention towards all of these important considerations.

Almost every sukuk structure, regardless of the underlying structure and jurisdiction, has some shortcomings and are more or less structured on exceptions and compromises on both sides – legal and Shari'a. Whether sukukholders would be treated as exclusive owners of the underlying assets and/or investments (whatever the underlying structure may be) and, therefore, have an exclusive recourse to the assets underlying investments and proceeds, or they have, in the absence of a security or collaterals, a pari passu claim against the originator like other unsecured creditors. One important thing, that one can infer from the previous transactions, is that sukukholders seem to have ignored the fact that in order to have a claim against the originator, they may be required to fulfill certain requirements otherwise they may not have even an unsecured claim let alone a preferred or semi-preferred position being the owner of the assets or investments.

It may be safe to assume that if a sukuk transaction is structured keeping in view the Shari'a requirements, the result would certainly be different, as the same would give the sukukholder similar rights to that under covered bonds and securitization. In this context, it is necessary that when structuring a sukuk, one has to take into account the outcome of the enforcement proceedings

and the adaptability of the transaction for any possible restructuring as some of the structures may offer serious challenges when it comes round to restructuring.

29.3 Classifications of sukuk for restructuring

For restructuring purposes, sukuk can be categorized as follows:

(i) sale based structures which generally cover short-term liquidity instruments such as murabaha, salam and sale istisna sukuk;

(ii) investment based structures such as musharaka, mudaraba and wakala (this may include a combination of investment based structures, sale based structures and ijara structures; and

(iii) ijara structures.

29.4 Restructuring of sale based sukuk – murabaha and istisna

The sukuk which are based on pure sale transactions and result in a payment obligation (murabaha and istisna), or delivery of assets (in case of salam), the restructuring of such sukuk is a real challenge from a Shari'a perspective. There are two possible options in relation to sukuk based on murabaha and istisna: (i) an extension in the payment obligations without any increase in the existing obligations; or (ii) in kind settlement i.e. exchanging the existing murabaha or istisna certificates with new certificates based on either an investment based structure or an ijara structure or combination of both.

The exchange cannot, due to Shari'a principles in relation to sale and assignment of the debt obligations, be for another debt instrument like another murabaha or istisna certificate. However, the real challenge is the structuring of another sukuk transaction by the originator, in order to exchange the existing certificates as it requires:

(i) assets (if it is an ijara structure);

(ii) portfolio of assets (if an agency or co-ownership structure is intended); or

(iii) on-going profitable Shari'a-compliant business and investment activities of the originator (if either of musharaka, mudaraba or wakala structure is intended).

Such exercise requires meeting various legal, regulatory and Shari'a requirements and in relation to (ii) and (iii) above, seems to involve whole-sale restructuring of the organization and requires approval of all stakeholders in addition to the painstaking exercise of getting the exchange offer through the existing sukukholders. The success of this depends on the post-restructuring credit-worthiness of the originators and the sukukholders' con-

sent and the Shari'a considerations which must be taken into account in an exchange offer, more particularly when an exchange of existing certificate with a new certificate is taking place. For the exchange process, Shari'a requires that the new certificate offered in exchange for the existing must represent ownership interest in the underlying assets and/or investments at the time of exchange.

The transfer of ownership should not be withheld post-exchange, offer and acceptance through any recognized clearing system or over the counter transactions.

Other than ijara sukuk offered in exchange for an existing murabaha and istisna sukuk, it is necessary that sukuk structured on investment based structures, should be independent of the existing murabaha and istisna payment obligations.

As for musharaka, mudaraba and wakala, which only come into existence once the relevant capital, either cash or in kind, is paid or placed at the disposal of the other partner, mudarib or wakeel. A debt or receivable cannot qualify as the required capital in the case of musharaka, mudaraba or wakala. No contractual set-off would be acceptable under Shari'a.

In view of the aforementioned Shari'a principle, musharaka, mudaraba and wakala sukuk to be offered in exchange for the existing sale based sukuk (murabaha and istisna) should represent at the time of exchange, ownership in the underlying investments. This is nearly impossible for an originator which has defaulted or requested restructuring of its payment obligations. However, if the originator has a pool of assets, the same (or part of them – even undivided share) can be sold in exchange for the existing certificates and therefore, provide a clean slate to both – originator and sukukholders – for another agreed term on better terms and conditions as a fresh transaction.

One can easily infer how much input from Shari'a scholars would be required in restructuring murabaha and istisna sukuk transactions, as each step involved in the restructuring must ensure Shari'a-compliance in form and substance. An oversight, no matter how trivial may lead to Shari'a repugnancy due to the transactions' close proximity with dealing in debts / receivables and extension of time in relation to discharge of such obligations for a consideration.

29.5 Restructuring of salam sukuk

Restructuring of salam sukuk is very complicated. Other than extending the date of delivery of the underlying assets or replacement of the existing assets with other assets of the same market value, there does not seem to be any viable solution. However, the question is how to compensate the sukukholders?

An equally important question is: can the permission to extend the delivery date apply to the substitute assets? Another option for the sukukholders is to mutually can-

cel the salam contract and require the payment of salam price (capital) without any increase or decrease.

Again the question would arise as to the permissibility of the right of set-off in relation to the originator's obligation to refund the salam price (capital), against the existing sukukholders' obligation to pay for the new sukuk offered in exchange for the existing obligations of the originator, under salam sukuk.

As mentioned above, the only workable option is a substitute and extension in time of delivery. However, there seems a way out for sukukholders to revise the commercial terms, in the event of substitution or extension in time of delivery. This is done by amending the incentive calculation mechanism in the agency agreement under which, (in most of the cases) the agent is entitled to receive the excess amount as an incentive if it is able to sell the assets for and on behalf of the sukukholders, for a sale price over and above an agreed threshold (base price including profit).

If this is not the case, and there is a promise to purchase at cost plus profit from an off-taker or purchaser, such a promise can also be amended to accommodate the extension in time of delivery, and the terms for the calculation of the profit for the sale to be concluded pursuant to promise to purchase.

29.6 Restructuring of sukuk based on investment structures – musharaka, mudaraba and wakala

Restructuring of sukuk based on investment structures such as musharaka, mudaraba and wakala or a combination of investment structures and sale structures (whereunder money is pooled or invested using investment structures and the return earned, together with the recovery of the invested capital, through a sale based structure), is relatively simple and offers less legal and Shari'a implications.

Nevertheless, nothing is as simple as it may appear to be. Restructuring can be achieved in two ways: (i) amending and restating the existing documents in accordance with the agreed terms and conditions between the sukukholders and other stakeholders; and (ii) exchanging the existing certificates with new certificates using the same underlying investments or different assets, investments or combination of both.

From the sukukholders' perspective, consent of the required number of sukukholders as per the transaction documents would be required, which can be procured as per the transaction documents through circulation of notices on the recognized clearing systems or through dealers and agents.

Circulation of notice for the amendment and restatement of the transaction documents would require in-

volvement of the relevant parties and entail costs and expenses which, considering the fact that the relevant parties would benefit from the restructuring do not seem to affect the balance of convenience and commercial benefits.

Considering that the restructuring only involves amendment and restatement of the existing transaction documents including capital markets documents, there may not be too many substantial legal and Shari'a implications and even if there are any, the same should not materially affect the underlying structure. However, restructuring through amendment and restatement may not have the effect and look of a new transaction, which usually is the most important consideration for the institutions as they would clean-up their books by removing the default transaction with a new transaction.

Another downside of such restructuring is the extension in the inherent risk which is an essential characteristic of investment based structures. Quite understandably, the investor of the existing certificates would like a change in the risk exposure from investment based, to a sale structure or at least an investment based structure in relation to the portfolio of the revenue generating assets. They could have recourse to this in the event of default or a change of the structure; from a pure investment structure to a sale structure (like sukuk ijara or sukuk of leased assets).

The second choice is replacing the existing transaction with a new transaction. This can be done either using the same underlying investments / assets or different investments or a combination of both. In order to achieve any of the foregoing, the following steps would be required:

(i) an exchange offer should be circulated by a new issuer offering the existing sukukholders to sell their sukuk to the new issuer, against a new issuer's promise to issue new sukuk either based on investment structures (in case the existing investments / assets are intended to be used to restructure the transaction), or sale structure (in case the new ijara assets are to be used for restructuring). If the existing assets / investments are to be used, the process flow will be different;

(ii) the new issuer will have to appoint different dealers and agents to explain and arrange the exchange offer; however, the exchange process will be through the recognized clearing systems;

(iii) trading of the sukuk will be suspended; and

(iv) all other relevant regulatory requirements to be completed before the exchange offer. In order to offer an incentive for the exchange, the new issuer may combine the exchange offer with a tender offer, either to the extent of its ability to partially redeem the sukuk or as agreed with the sukukholders.

Tender offer, acceptance and settlement require strict compliance with Shari'a principles as to the transfer of ownership of the certificates, in order to avoid a forward sale or a conditional sale or retention of title, which may vitiate the sale from a Shari'a perspective. Following the

exchange offer and tender offer, if the new issuer acquires the relevant number of sukuk certificates, it would be in a position to impose a compulsory exchange provided that such resolution is acquired pursuant to the terms of the transaction documents.

Upon becoming owner of the existing certificate (provided in all cases it has the required number of the existing sukuk certificates, which is necessary for passing a resolution for amendment or early redemption of the existing sukuk certificates), the new issuer will exercise its right under the transaction documents and require the existing issuer to formally transfer to the new issuer's ownership in the underlying assets and/or investments to the new issuer.

This can be achieved through requiring the existing obligor/originator who is acting as a partner in the musharaka or agent or a mudarib, to transfer the relevant assets to the new issuer in accordance with the terms of the existing documents. Following such a transfer, all existing documents will be terminated.

The new issuer will become owner of the assets which it has already acquired as a result of the exchange offer. The new issuer will enter into a musharaka or mudaraba or wakala arrangement with the originator on new commercially agreed terms and conditions, whereunder the new issuer's capital, to the extent applicable based on the underlying Shari'a structure, will be in the form of the assets / investments i.e. in kind contribution.

Once the underlying Shari'a contracts are in place, the new issuer will issue the new sukuk certificates to the existing sukukholders, who have sold their certificates to the new issuer pursuant to the exchange offer. Such a restructuring exercise will result in a new transaction for the existing sukukholders, replacing the old transactions based on new transaction documents including capital market documents.

It is important to note that a significant Shari'a concern as to the capital requirement for the new transactions has been met using the existing investments and assets as in kind capital - in the absence of cash. Otherwise a simple sale and purchase of the underlying investments or ownership interest for a cash settlement would not have allowed the new issuer to set-off its obligations to pay in relation to the existing certificates, against the new sukukholders' obligation to pay for the new certificates, as is necessary under the relevant Islamic investment structures such as musharaka, mudaraba and wakala. The Shari'a requires that the capital must be contributed to commence, and give effect to, the relevant Shari'a contract.

A contractual set-off in relation to musharaka, mudaraba or wakala capital is not acceptable from a Shari'a perspective. If a set-off right is used in relation to musharaka, mudaraba or wakala capital, the entire transaction would be, from the outset, Shari'a repugnant.

However, if the existing investment structure is replaced with an ijara or musharaka structure, mudaraba and wakala with a pool of segregated assets sold to the existing sukuk transactions, in exchange for their exist-

ing certificates, the restructuring seems smooth from a Shari'a perspective, except for compliance with Shari'a and legal requirements as to permissibility of the underlying transaction, risk and other commercial arrangements.

There is no precedent on sukuk restructuring which could have illustrated some of the challenges highlighted above, nevertheless, various sukuk restructuring efforts and tender offers have provided adequate insight into the potential legal and Shari'a challenges into restructuring a sukuk transaction. It is worth mentioning that in restructuring a sukuk transaction, the most important consideration is aligning the commercial arrangements with the principles of Shari'a. Learning the lessons from previous oversights in commercial, legal and Shari'a matters, the sukukholders, might at the restructuring stage, consider choosing a strict compliance approach to get better protection.

29.7 Restructuring of ijara sukuk

Restructuring an ijara sukuk is relatively simple and involves less Shari'a complications. Similar to other sukuk structures, it can be achieved in two ways: (i) amending and restating the existing transaction documents which require only consent of sukukholders in accordance with the requirements of the relevant transaction documents; and (ii) exchanging the existing certificates with new certificates either using the same assets or new assets.

The first category may not involve much intellectual input from a legal and Shari'a perspective (other than the necessary approvals and waivers from the respective parties, if required), except the commercial agreement as to the tenor, pricing and security. The amendment and restatement is achieved pursuant to obtaining the consent of all sukukholders, which very much depends on a standard procedure set out in the documents, and would be carried out if the required approvals and consents are in place.

What makes sukukholders provide their consent more or less depends on commercial decisions driven by a number of balancing factors (some of them may touch the core connection between the assets, and the sukukholders' ability to have adequate recourse to the assets to the extent of full recovery). In fact questions similar to this, provide adequate evidence as to the true nature of Islamic certificates which, apparently, never seem to have been given sufficient attention. Sukuk transactions continue to add to the long list of Islamic capital markets instruments which have not been improved in the very shape in which they should have been in the first place, being the certificates of ownership rather than another de-shaped class of financing and debt instruments. Some industry players are of the view that no improvement has been seen in both form and substance, even after much publicized criticisms and AAOIFI's clarifications in the wake of sukuk controversies.

The second option is exchanging existing certificates

with the new certificates using the existing assets or new assets, or a combination of both. A new issuer will be established, which will issue an exchange offer or an exchange offer and tender offer together. The exchange offer will be circulated through the recognized clearing system, agents and dealers appointed for this purpose. The exchange offer will make an offer to the existing sukukholders to exchange their certificates against the new issuer's promise to issue them with new certificates, after it has acquired the title to, and possession of, the underlying assets backing the new certificates.

Once the new issuer has acquired a sufficient number of certificates, it may be in a position to force non-accepting existing sukukholders to sell their certificates to the new issuer – imposing a compulsory exchange. If a tender offer was circulated, the sukukholders will get a partial redemption also. Following acquisition of the existing certificates, the new issuer will exercise its right under the purchase undertaking (issued in favor of the existing certificate holders) to purchase the underlying assets, which are the subject matter of the lease under the existing certificates.

A sale and purchase will be concluded between the new issuer and the old issuer. However, the purchase price will be deferred by the new issuer. Soon after the sale, the new issuer will buy the assets from the seller and exercise its right of set-off in relation to the purchase price it owes to the seller against the purchase price the seller owes to the new issuer under the previous sale.

Following acquisition of the assets the issuer will enter into a lease arrangement with the seller on commercially acceptable terms and conditions, and all other documents will be executed by the respective parties together with the capital markets documents. Following completion of the transaction, the new issuer will be in a position to issue the new certificates to the existing sukukholders, thereby resulting in a new sukuk transaction completely replacing the old transaction.

In doing so, if the additional assets are required to be included in the portfolio, the same can easily be achieved, thereby providing more comfort to the new sukukholders in addition to the better terms and conditions.

Shari'a scholars seem to have accepted the sale and purchase of assets for deferred consideration, and repurchase of the same assets and set-off in relation to the purchase price obligation by the respective parties, without any difficulty. Whatever the academic or practical Shari'a concerns that seem to arise from the above arrangement, or its resemblance with prohibited transaction in accordance with the principles of Shari'a and their respective implications on the Shari'a-compliance of the underlying transactions, it appears that such minor Shari'a repugnancies would be condonable (under the principle of permissible exceptions), given the fact that Islamic finance has never had the advantage of a same level playing field (in all respects) as its conventional counterpart and other comparable industries have.

When assessing the Shari'a-compliance of a transaction, it is necessary to take into account genuine impediments in ensuring strict or substantial Shari'a-compliance, that

might have been due to a number of factors such as legal, regulatory, judicial, commercial acceptability and enforceability, even in jurisdictions which claim to have derived their legislative powers from the divine revelation.

29.8 Conclusion

Since most of the popular sukuk structures are based on an ijara or an investment structure, which entails ownership in an underlying asset and investments (as the case may be), restructuring should not be complicated from Shari'a perspective. The real challenge, however, is meeting the requirements of an alternative structure and if other creditors and financiers are involved in the overall restructuring of the obligations of the originator, the sukukholders may not have a wide ranges of choices and the same level of strength to negotiate as they would have in the case of a standalone restructuring of a sukuk transaction.

Recent sukuk default cases and the difficulties faced by the sukukholder would certainly serve as a wakeup call for all stakeholders, particularly sukukholders, to consider staying closer to the fundamental principles and requirements of Islamic capital market instruments which in all cases have the potential to address any situation that may arise at any stage of the transaction. It would not be an overstatement to say that the best possible protections for the sukukholders and the relevant parties to the sukuk transaction rest in compliance with the very basic principles of the relevant Shari'a contract.

Generally, the parties do not take the risk of deviation, no matter how trivial, from standard industry practices, legal and regulatory requirements in relation to a conventional transaction which in its entirety (structure, documentation, legal and commercial viability) offers a robust comfort to all stakeholders as compared to Islamic capital market instruments, which appear to have, so far, been lagging behind in various aspects. Considering the unique profile of Islamic capital markets instruments in all aspects one may rightly expect a reflection of a greater degree of adherence to Shari'a and legal requirements at all stages in order to narrow the gap between theory and practice.