

Dubai Debt Crisis: A Legal Analysis of the Nakheel *Sukuk*

By
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INTRODUCTION

On November 25, 2009, the financial world was shocked when Dubai World requested a restructuring of \$26 billion (USD) in debts. This debt standstill caused much disturbance in capital markets and became known as the “Dubai Debt Crisis”. The main concern was the delay in the repayment of the \$4 billion *sukuk*, or Islamic bond, of Dubai World’s developer Nakheel, which was especially known for the construction of the Dubai Palm Islands.¹ The “Nakheel *Sukuk*” would mature on December 14, 2009. The restructuring request caused much distress among the *sukuk* holders, because several analyses by the lawyers of Dubai World and its creditors showed that the *sukuk* holders would probably not be able to rely on the level of protection they had expected. This raised questions about the financial structure of the Nakheel *Sukuk* and the legal issues underlying these kinds of Islamic financial structures. Although until November 2009, the impact of the credit crunch on the Islamic financial markets had seemed rather small, this perception changed at the end of 2009.

However, contrary to most expectations, the main legal issues had nothing to do with the Islamic financial structure underlying the Nakheel *Sukuk*; the issues were more inherent to the legal system of the United Arab Emirates (UAE). Questions relating to private international law were dominating the minds of the experts. This article contains a short introduction to Islamic finance, followed by a description of *sukuk* and a case study of the Nakheel *Sukuk*. The article clarifies the legal structure of these financial instruments, focusing primarily on the property law issues dominating this field. Next, private international law issues relating to Islamic financial structures are discussed—including a description of the legal framework of the UAE.

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1. *Sukuk* are among the most important Islamic financial products and are often regarded as the Islamic equivalent of bonds. *Sukuk* is the plural of the Arabic word *sakk*, which can be translated as ‘(financial) certificate’.

ISLAMIC FINANCE: SUKUK

The Islamic finance market has grown remarkably in recent years. The sector is gaining ground in the Western world as well, as is evident from certain developments in Europe and the United States. In Europe, countries such as the United Kingdom and France are working on a legal framework to develop a market for Islamic finance. In order to become one of the Islamic financial centers of Europe, these European countries have made efforts to change their legislation in order to facilitate Islamic financial products and capitalize on the growth of the sector.² Islamic banking assets rose by 28.6 % in 2009 to \$822 billion from \$639 billion in 2008.³

In order to understand the legal structure of the Nakheel *Sukuk*, the *Shari'a* background of *sukuk* needs to be discussed in short.⁴ The *Shari'a* background of *sukuk* results in concrete requirements, which in turn determine the formation of a *sukuk* structure. Understanding the background and specific requirements of *sukuk* enables one to gain a better perception of the structure of Nakheel *Sukuk*.

Although *sukuk* are often regarded as Islamic bonds, there are significant differences between a *sukuk* structure and a conventional bond structure. The main reason for these differences has to do with the fact that all Islamic financial products must meet certain *Shari'a* principles. From an Islamic perspective, trading and making a profit are stimulated so long as there is no involvement in *haram* (impermissible under Islamic law) activities. These prohibited investments concern investments relating to, *inter alia*, alcohol, drugs, armaments, military technology, pornography, prostitution, and gambling. However, permissibility is the default—all commercial transactions and contracts are presumptively permissible, unless there is a clear prohibition. There are three main prohibitions within Islamic finance: (i) paying and receiving interest is prohibited (prohibition on *riba*);⁵ (ii) uncertainty in contracts must be avoided as much as possible (prohibition on *gharar*); and (iii) speculation and gambling are not allowed (the prohibition on *mayseer* and *qimar*). Within Islamic finance, the concept of interest is replaced by profit and loss sharing. Therefore, it is possible to make a profit without collecting interest. These Islamic financial principles determine the structure of Islamic financial transactions. Below, this is illustrated by looking at a specific *sukuk* transaction: the Nakheel *Sukuk*.

2. D. Oakley, *The Future of Islamic Finance, London leads in race to be western hub*, FINANCIAL TIMES, Dec. 8, 2009; *Islamic finance in France, Sharia calling*, THE ECONOMIST, Nov. 14, 2009.

3. The Banker & HSBC Amanah, *Top 500 Islamic Financial Institutions*, available at <http://top500islamic.thebanker.com/index.cfm?fuseaction=top500.home&CFID=1053940&CFTOKEN=10177553>.

4. *Shari'a* means literary 'the way' or the 'path to the water source.' It is the body of Islamic religious law and is often used as a synonym for Islamic law.

5. Although *riba* is more than a mere prohibition on interest, as will be illustrated below, at this point a simplified explanation of this term will suffice.

Sukuk are certificates representing ownership claims in underlying tangible assets. As mentioned above, due to the prohibition of *riba*, receiving and paying interest is forbidden within these transactions. Another implication of the prohibition on *riba* is that the trading of debt (*bai al-dayn*) is prohibited. Therefore, the presence of underlying tangible assets is required within these transactions. For the *sukuk* to be tradable in the secondary markets, the *sukuk* holders must gain some form of ownership in these underlying tangible assets.⁶ Mostly, this is structured by giving the *sukuk* holders the beneficial ownership of these assets. As the beneficial owners, they are entitled to the profit that is generated over these underlying assets. The *sukuk* holders will receive this profit as the beneficial owners and there is, thus, no interest payment. Another important result of this ownership requirement is that the *sukuk* holders are trading their ownership in the capital markets by selling the *sukuk* and not merely a debt claim. This does not violate the prohibition on *bai al-dayn* and is permissible. Consequently, there is no *riba* in such *sukuk* transactions and the structures are permissible from a *Shari'a* perspective.

The issuance of the Nakheel *Sukuk* was based on the *ijarah* contract, which is comparable to a conventional lease contract.⁷ The underlying *sukuk* structure was the *sukuk manfaa-ijarah*.⁸ In essence, this structure is comparable to a conventional lease-and-lease-back transaction between the party who is in need of financing (the originator) and a Special Purpose Vehicle (SPV). The transaction starts with the originator, who sets up an SPV and selects certain tangible assets for the transaction. The originator leases the tangible assets pursuant to a Head *Ijarah* Lease Agreement to the SPV. This is often for a long lease period (e.g., 50 years) and the entire lease sum is paid up front. This amount is financed by the SPV through the issuance of *sukuk*. The SPV holds the assets in trust for the *sukuk* holders, so the *sukuk* holders become the beneficial owners of the underlying assets. Next, the SPV leases the tangible assets back to the originator in accordance with a Sub *Ijarah* Lease Agreement for a short period (e.g., three years). During the entire lease period, the SPV holds the assets in trust as a trustee for the *sukuk* holders (the beneficial owners). The originator makes periodic lease payments to the SPV. The *sukuk* holders are entitled to these lease payments, since they are the beneficiaries of the underlying tangible assets. The SPV in turn pays these lease payments as periodic payments on the *sukuk* to the *sukuk* holders. At maturity date (e.g., after

6. AAOIFI Shariah Board, *Resolutions on Sukuk, February 2008*, Bahrain: AAOIFI 2008, available at http://www.aaofi.com/aaofi_sb_sukuk_Feb2008_Eng.pdf.

7. There are several Islamic financial contracts which are the foundation of Islamic financial products such as *sukuk*. For more on Islamic financial contracts, see M.T. USMANI, *AN INTRODUCTION TO ISLAMIC FINANCE* (Arab & Islamic Laws Series) (2001); M.A. EL-GAMAL, *ISLAMIC FINANCE: LAW, ECONOMICS, AND PRACTICE* (2006); M. AYUB, *UNDERSTANDING ISLAMIC FINANCE* (2008).

8. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issues several standards which are followed worldwide within the Islamic finance sector. *Shari'a* Standard No. 17 of the AAOIFI on Investment *Sukuk* identifies fourteen *sukuk* structures. One of these structures is the *sukuk manfaa-ijarah*.

three years), the Sub *Ijarah* Lease Agreement ends and the Head *Ijarah* Lease Agreement is terminated. The originator pays an amount of money equal to the principal amount of the *sukuk* holders. The SPV will use this sum to repay the principal amount to the *sukuk* holders. This rather abstract description will be clarified below in the discussion of the structure of the Nakheel *Sukuk*.

NAKHEEL *SUKUK*: A CASE STUDY⁹

The *sukuk manfaa-ijarah* structure was used for the Nakheel *Sukuk*. The originator in this structure was Nakheel Holdings-1 LLC (Nakheel Holdings 1), Nakheel Holdings 1, Nakheel Holdings-2 LLC (Nakheel Holdings 2), and Nakheel Holdings-3 LLC (Nakheel Holdings 3) were subsidiaries of Nakheel World LLC (Nakheel World), which held 99% of the shares in all three Nakheel Holdings. All three Nakheel Holdings had a subsidiary, Nakheel PJSC, which was operating in the real estate sector in Dubai. The parent company and 100% shareholder of Nakheel World was Dubai World, a 100% state-owned company.¹⁰ The SPV was Nakheel Development Limited (Nakheel SPV), a newly incorporated Free Zone company with limited liability in the Jebel Ali Free Zone.¹¹

Pursuant to a purchase agreement, Nakheel Holdings 1 sold the leasehold rights to the underlying tangible assets for a period of 50 years (the *sukuk* assets) to Nakheel SPV. The underlying tangible assets were the land, buildings, and other property known as DWF South and Crescent Lands at Dubai Waterfront. The developer wanted to build a city twice the size of Hong Kong Island, with skyscrapers for 1.5 million residents, all ringed by a 75 km canal at Dubai Waterfront.¹² The aggregate amount for the entire lease period of 50 years was paid by Nakheel SPV to Nakheel Holdings 1. This amount was raised by the issuance of *sukuk*. Nakheel SPV issued *sukuk* certificates for a period of three years. The issue price of these Nakheel *Sukuk* certificates was \$3.52 billion and the entire amount was used to purchase the *sukuk* assets.¹³ Nakheel SPV acted as agent and trustee for and on behalf of the *sukuk* holders, in accordance with an agency declaration and a declaration of trust. Pursuant to this declaration of trust, Nakheel SPV declared a trust in favor of the *sukuk* holders over its title to the *sukuk* assets and all rights and benefits derived from all security documents and transaction documents (the trust assets). Consequently, each *sakk*

9. The main source for this case study has been the prospectus/offering circular of the Nakheel *Sukuk*. *Offering Circular*, Nakheel Development Ltd., available at http://blogs.thenational.ae/economy_blog/Nakheel%20Development%20Prospectus.pdf. [hereinafter *Offering Circular* Nakheel].

10. This is merely a simplified overview of the group structure.

11. *Offering Circular* Nakheel, *supra* note 9 at 53.

12. A. Sakoui & R. Wigglesworth, *Waterfront washout tests law on sukuk restructuring*, FINANCIAL TIMES, Dec. 3, 2009.

13. The *sukuk* were eventually oversubscribed. The total amount raised with the Nakheel *Sukuk* was approximately USD 4 billion.

represented an undivided beneficial ownership of the trust assets held in trust for the *sukuk* holders.¹⁴ Furthermore, the agency declaration stipulated that Nakheel SPV was acting as agent for and on behalf of the *sukuk* holders.

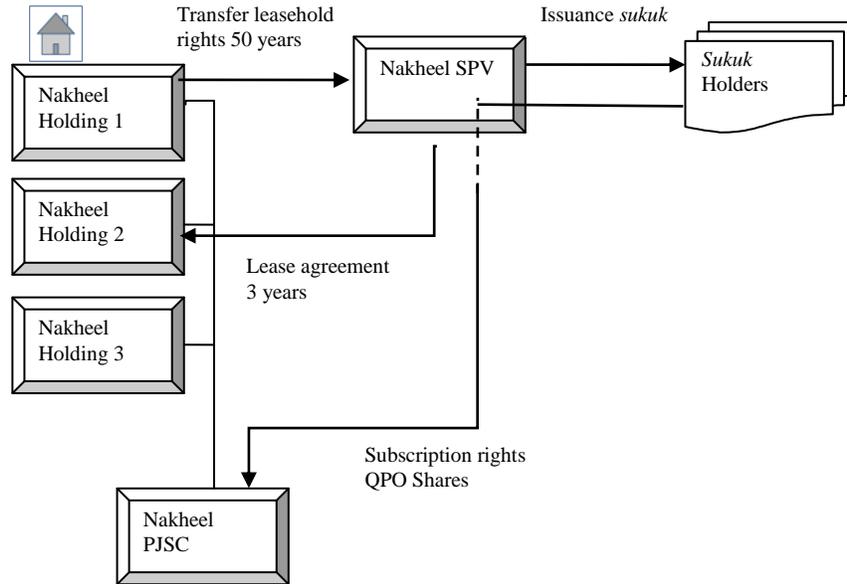
Next, Nakheel SPV, as lessor, leased the *sukuk* assets to Nakheel Holdings 2, as lessee, for a period of three years. The lease comprised six consecutive periods of six months each. In accordance with a servicing agency agreement between the lessor and the lessee, the lessee was responsible for the major maintenance, structural repair, proprietorship taxes, and insurances in respect to the *sukuk* assets. The rental payments of the lease periods matched the periodic distribution payments on the *sukuk*¹⁵, so Nakheel SPV would pay the lease payments to the *sukuk* holders. At the redemption date of the *sukuk*, the lessee had to purchase the *sukuk* assets from the lessor in accordance with a purchase undertaking at a certain exercise price. This exercise price was equal to the redemption amount of the *sukuk* and would be used to pay back the principal amount to the *sukuk* holders. In this way the *sukuk* were redeemed.

An innovative element of this structure was its pre-initial public offering (pre-IPO) convertible aspect, which in essence made these *sukuk* pre-IPO convertible *sukuk*. *Sukuk* holders had the right to subscribe for qualifying public offering (QPO) shares at the QPO exercise price, which gave the *sukuk* holders a discount of five percent. They had this right for the entire three-year period during which the *sukuk* were outstanding, for any primary or secondary equity offering by Nakheel PJSC and its subsidiaries listed on any international stock exchange. The rights of the *sukuk* holders to subscribe for QPO shares were, however, limited. The aggregate number of QPO shares could be no greater than 30% of the aggregate number of QPO shares to be issued in that QPO, and the aggregate value of the subscription rights in all QPO's could not exceed 25% of the *sukuk* issue amount (\$3.52 billion).¹⁶ The *sukuk* holders had a look back option, which meant that in certain circumstances they could exercise their subscription rights twelve months after the redemption date of the *sukuk*. In accordance with a subscription rights sale undertaking between Nakheel SPV and Nakheel Holdings 2, Nakheel Holdings 2 delivered the QPO shares to Nakheel SPV, which Nakheel SPV then delivered to the *sukuk* holders. Figure 1 gives an overview of the basic structure of the Nakheel *Sukuk*.

14. *Offering Circular* Nakheel, *supra* note 9 at 54.

15. *Id.* at 12.

16. *Id.* at 74.

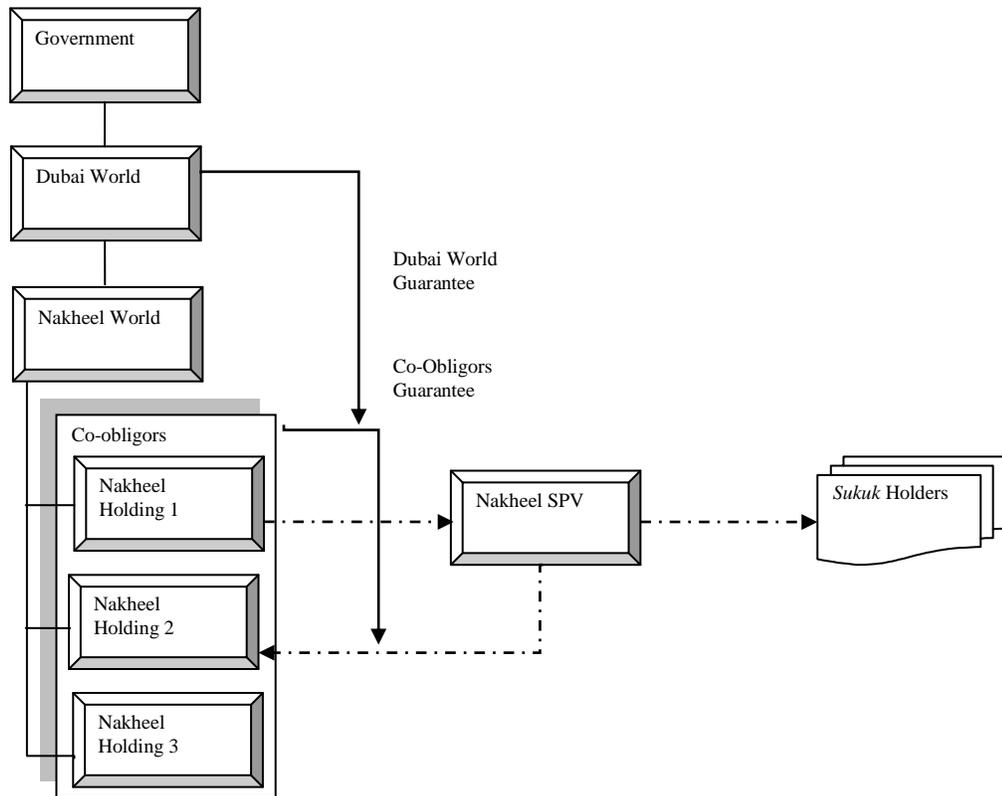
Figure 1¹⁷*Basic Nakheel Sukuk Structure*Underlying
tangible assets

Nakheel Holdings 1, Nakheel Holdings 2, and Nakheel Holdings 3 (the co-obligors) granted a co-obligor guarantee to Nakheel SPV: each of them jointly and severally guaranteed payment, delivery, and other obligations.¹⁸ Under this co-obligor guarantee, the co-obligors entered into various covenants, such as a negative pledge, change of control provisions, limitations on financial indebtedness, asset sales, loans, dividends, the granting of security, and the granting of undertakings to maintain insurance and provide financial information. In addition, Dubai World issued a guarantee to Nakheel SPV for the payment obligations of the co-obligors. Under that guarantee, Dubai World also entered into certain covenants such as a negative pledge and maintenance of ownership undertaking (stating that it would maintain ownership and control over its subsidiaries).¹⁹ Figure 2 gives an illustration of the guarantee structure of the Nakheel *Sukuk*.

17. Author's own.

18. *Offering Circular Nakheel*, *supra* note 9 at 59.

19. *Id.* at 151-2.

Figure 2²⁰*Nakheel Sukuk Guarantee Structure*

For greater *sukuk* holder security, a collateral security structure was set up securing the payment obligations of the co-obligors.²¹ Nakheel Holdings 1 granted two mortgages, free of any security interest and encumbrance, on the underlying tangible assets (the land, buildings, and other property known as DWF South and Crescent Lands at Dubai Waterfront) to the security agent to hold these as security agent for and on behalf of Nakheel SPV as agent for the *sukuk* holders.²² The security agent was Dubai Islamic Bank PJSC, which entered into a security agency agreement with Nakheel SPV pursuant to which it held the two mortgages granted by Nakheel Holdings 1 for the benefit of the *sukuk* holders. Furthermore, Nakheel Holdings 1 also granted a pledge in favor

20. Author's own.

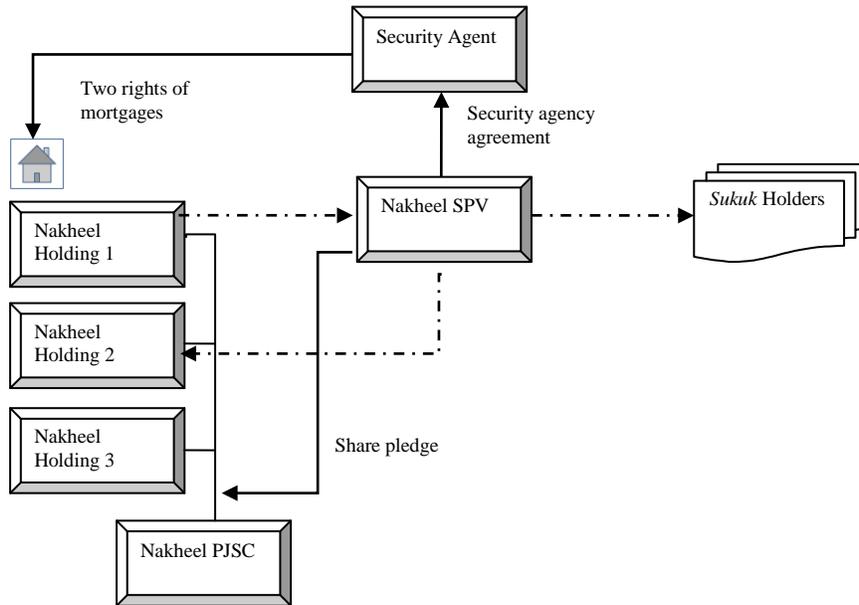
21. *Offering Circular Nakheel*, *supra* note 9 at 151.

22. *Id.* at 59.

of the *sukuk* holders on 18.89% of all the shares of Nakheel PJSC.²³ The collateral security structure is illustrated in Figure 3.

Figure 3²⁴

Nakheel Sukuk Collateral Security Structure



LEGAL ANALYSIS OF THE NAKHEEL *SUKUK*

A. Guarantees

A legal analysis of the Nakheel *Sukuk* shows the complexity of its legal structure. At first glance, the *sukuk* holders were sufficiently protected and their position was secure. First, Nakheel Holdings 1, Nakheel Holdings 2, and Nakheel Holdings 3 had each granted a co-obligor guarantee to Nakheel SPV guaranteeing their own and each other's payment obligations. This co-obligor guarantee was the first form of credit enhancement built into the structure. Second, Dubai World had issued a guarantee to Nakheel SPV guaranteeing the payment obligations of the co-obligors. So if the co-obligors failed to pay, Nakheel SPV had recourse to Dubai World's credit enhancement. Lastly, in accordance with a purchase undertaking, Nakheel Holdings 2 had undertaken to purchase all of Nakheel SPV's interests in the *sukuk* assets at maturity date or at

23. *Id.* at 142.

24. Author's own.

the occurrence of a dissolution event.²⁵ One example of such an event was a default on the payments by Nakheel Holdings 2, the other Nakheel Holdings as co-obligors, or Dubai World.²⁶ This precise scenario is what seemed to arise in November 2009, when Dubai World and its subsidiaries wanted to restructure their debts and seemed unable to fulfill their payment obligations. Pursuant to the purchase undertaking, Nakheel Holdings 2 had to repurchase the *sukuk* assets to enable Nakheel SPV to pay the *sukuk* holders. However, neither the co-obligors guarantee, nor the Dubai World guarantee, nor the purchase undertaking could help under such circumstances, since none of the parties involved were in a position to fulfill the payment obligations.²⁷

Furthermore, some *sukuk* holders had assumed that the government of Dubai had implicitly guaranteed to fulfill the payment obligations of Dubai World since the government fully owned Dubai World.²⁸ However, the prospectus had been clear on this point and had specified the risk that the government of Dubai did not guarantee any indebtedness or any other liability of Dubai World.²⁹ The government of Dubai confirmed this, once again, in December 2009 when it stated that it had not offered an explicit guarantee to Dubai World.³⁰

B. Proprietary protection

All of this need not imply the weakness of the financial structure, because several attempts were made to build proprietary protection into the structure. By itself, the fact that guarantees and purchase undertakings cannot provide full protection is not surprising: this is inherent to an insolvency scenario where all parties involved (including the guarantors, as was the case here) may be unable to fulfill their obligations. Nor does the convertible aspect of the *sukuk* continue to be attractive, since it does not make sense to obtain shares in a company in financial distress. Because the contractual agreements (purchase undertakings, guarantees, etc.) are not sufficient to give protection to creditors in an insolvency scenario involving all parties (including the guarantors), proprietary rights are especially important. The Nakheel *Sukuk* had

25. The prospectus mentioned several events which would constitute a dissolution event. See *Offering Circular Nakheel*, *supra* note 9 at 67. For more on the purchase undertaking, see *id.* at 142.

26. For more on the several events of defaults, see *id.* at 83-4.

27. B. Goud, *What can Nakheel sukuk holders expect in a default?*, SHARING RISK DOT ORG BLOG, Nov. 30, 2009, available at <http://investhal.blogspot.com/2009/11/what-can-nakheel-sukuk-holders-expect.html>.

28. R. Kasolowsky & A. Abocar, *Legal minefield awaits Dubai's Nakheel bondholders*, REUTERS, Dec. 3, 2009, at <http://www.reuters.com/article/idUSTRE5B21YH20091203>; A. England et. al., *Bank creditors unite over crisis*, FINANCIAL TIMES, Dec. 2, 2009 at 6; S. Kerr, *Tough love needed to rebuild the ruins*, FINANCIAL TIMES, Nov. 27, 2009 at 2.

29. *Offering Circular Nakheel*, *supra* note 9 at 35.

30. S. Kerr, *Dubai World prepares to sell overseas assets*, FT.COM, Dec. 7, 2009.

certain proprietary rights that were meant to provide Nakheel SPV, and eventually the *sukuk* holders, with property law protections.

However, the application of property law to these circumstances might have been problematic. First of all, an interesting question is whether there was a transfer of the underlying tangible assets from Nakheel Holdings 1 to Nakheel SPV. As described above, the prospectus mentioned a purchase agreement between Nakheel Holdings 1 and Nakheel SPV. Pursuant to this agreement, the *sukuk* assets were sold and delivered to Nakheel SPV, after which these *sukuk* assets were leased to Nakheel Holdings 2 in line with the lease agreement. This would indicate a sale-and-lease-back transaction, which from an Islamic financial perspective refers to a *sukuk al-ijarah* structure. The prospectus also called the structure a *sukuk al-ijarah* structure.³¹ However, the subject of this purchase agreement was the *sukuk* assets and, as described above, these *sukuk* assets were leasehold rights to the underlying tangible assets for a period of 50 years. This means that there was no proprietary transfer of ownership rights in these underlying tangible assets from Nakheel Holdings 1 to Nakheel SPV—there was merely a transfer of leasehold rights. This makes the transaction a lease-and-lease-back transaction, which makes it a *sukuk manfaa-ijarah* structure from an Islamic financial perspective.

The difference is evident and important. A sale agreement refers to the transfer of certain real rights, or property rights, from the originator to the SPV. Leasehold interests, however, are not viewed as real rights, or property rights, under the relevant laws of the UAE as applicable in the emirate of Dubai.³² Instead, they are viewed as unregistered personal contractual rights binding the parties as opposed to rights attached to the land in question.³³ Leases can become real or property rights attaching to the underlying land through registration, but this had not yet happened. The formal regulations setting out the mechanics and processes for such registrations had yet to be issued by the Dubai Lands Department (the governmental property registration authority in Dubai) at the time of the issuance of the *sukuk*, and the Nakheel *Sukuk* prospectus did not mention a formal registration relating to these leasehold rights anywhere.³⁴ The laws of the UAE are relevant, since they govern the so-called purchase agreement. Proprietary protection is more important than a contractual agreement—especially in case of insolvency; if there is a transfer of ownership, the assets will not form part of the bankruptcy estate of Nakheel Holdings 1, while if there is solely a contractual agreement, the assets will form part of the bankruptcy estate of Nakheel Holdings 1, and Nakheel SPV will be put on the list of creditors.

31. *Offering Circular* Nakheel, *supra* note 11 at 54.

32. *Id.* at 130.

33. ABA GUIDE TO INTERNATIONAL BUSINESS NEGOTIATIONS: A COMPARISON OF CROSS-CULTURAL ISSUES AND SUCCESSFUL APPROACHES, 993-94 (J.R. Silkenet, J.M. Aresty & J. Klosek eds., 2009).

34. *Id.*

However, this does not mean that the *sukuk* holders did not have any proprietary protection. In order to secure the position of the *sukuk* holders as secured creditors through Nakheel SPV, certain security rights were granted. The security rights were meant to secure the payment obligations of the co-obligors; in other words, they were meant to provide more protection in case the co-obligor guarantees would not be sufficient. First, Nakheel Holdings 1 had granted a fully perfected right of pledge in favor of the *sukuk* holders to 18.89% of all the shares of Nakheel PJSC. But, given the financial situation of the Nakheel group as a whole and its request for restructuring, the collateral of this right of pledge (i.e., the shares) could be worth much less than expected.³⁵ Therefore, this share pledge could not offer the proprietary protection for which *sukuk* holders hoped. In addition, there were also rights of mortgages granted by Nakheel Holdings 1 to the underlying tangible assets. These security interests were held by Dubai Islamic Bank as the security agent for and on behalf of Nakheel SPV for the benefit of the *sukuk* holders. From a structural perspective, this could give the proprietary protection *sukuk* holders were looking for.

An analysis of the financial structure of the Nakheel *Sukuk* does not reveal anything unusual. Nevertheless, testing the legal tenability of the structure shows certain complex and unanswered issues inherent to the legal system of Dubai. First, the proprietary protection given by the mortgages can be infringed by certain elements built into the legal system of Dubai. The prospectus referred to two fully perfected rights of mortgages, but taking a closer look at the perfection of security interests in Dubai raises questions about the perfection of these security rights. Perfection of rights of mortgages to real property in Dubai requires registration of the mortgage agreement in the lands register at the Dubai Lands Department.³⁶ However, only the interests of lenders licensed by the central bank of Dubai can be registered.³⁷ Although Dubai Islamic Bank was a licensed bank in Dubai, it was the security agent and not the lender in the transaction.³⁸ A structure involving a licensed bank acting as a security agent for all lenders on any enforcement of the security in the UAE, as was the case within this structure, was untested before the UAE courts,³⁹ and the enforceability of the rights of mortgages could, therefore, not be assured.⁴⁰ Even if the security interests could be upheld before the UAE courts as perfected rights of mortgages, the *sukuk* holders could still face a delay. Pursuant to Law 10 of 2005, proceedings can be brought against the government of Dubai and government entities (which could include Nakheel Holdings 1 as grantor of the

35. B. Goud, *What can Nakheel sukuk holders expect in a default?*, SHARING RISK DOT ORG BLOG, Nov. 30, 2009, available at <http://investhalal.blogspot.com/2009/11/what-can-nakheel-sukuk-holders-expect.html>.

36. R. Abraham, S. Long & S. Henderson, *Real estate finance in Dubai*, INT'L FIN. L. REV., Jan. 1, 2008, available at <http://www.iflr.com/Article/1984124/Real-estate-finance-in-Dubai.html>.

37. *Id.*

38. *Offering Circular* Nakheel, *supra* note 9 at 132.

39. *Id.*

40. *Id.* at 46.

rights of mortgages) before the courts of Dubai, but the claimants must first have given details of their claim to the Attorney General of Dubai and have entered into settlement negotiations for a period of two months.⁴¹

C. Private international law

Another potential complication in Dubai's legal system pertains to private international law. For instance, certain documents from this transaction, such as the declaration of trust and the guarantees given by the co-obligors and Dubai World, were governed by English law.⁴² Nakheel SPV had chosen the English courts to have non-exclusive jurisdiction in connection with the declaration of trust and any proceedings arising from it.⁴³ The *sukuk* holders hoped that English law would apply to these transaction documents and that their arguments would find traction in English courts.⁴⁴ A ruling by English courts favorable to the *sukuk* holders would have to be enforced in Dubai, because the majority of the assets were located within the UAE and, as a result, there could be insufficient Dubai World assets located outside the UAE to satisfy a judgment obtained from an English court.⁴⁵ However, the enforcement of the judgment in Dubai could raise several problems.⁴⁶

The UAE courts probably would not recognize the jurisdictional choice of the parties, since UAE courts almost always have jurisdiction in such matters.⁴⁷ The prospectus already warned *sukuk* holders that "[u]nder . . . Dubai law, the courts [were] unlikely to enforce an English judgment without reexamining the merits of the claim and [would] not observe the choice by the parties of English law as the governing law of the transaction."⁴⁸ UAE law does not recognize the concept of trust or beneficial interests, so there was uncertainty on the declaration of trust.⁴⁹ However, there was also an agency declaration concerning the relationship between Nakheel SPV and the *sukuk* holders and this declaration was subject to, and enforceable under, UAE law as a

41. *Id.*

42. *Id.* at 73.

43. *Id.*

44. A. England & R. Wigglesworth, *Hard times test legal system to its limits*, FT.COM, Dec. 3, 2009.

45. *Offering Circular Nakheel*, *supra* note 9 at 35.

46. S. Nixon & R. Barley, *Did Global Markets Overreact To Dubai?*, *The Wall Street Journal*, Nov. 28, 2009, at 10.

47. For more on this see H.M. Al-Baharna, *The enforcement of foreign judgments and arbitral awards in the GCC countries with particular reference to Bahrain*, 4 ARAB L. Q. 332 (1989); Al Tamimi & Company, *Case reports from the UAE*, 10 ARAB L. Q. 336 (1995); H. Arab, *Execution of foreign judgments in the UAE*, 17 ARAB L. Q. 208 (2002); S.R. Luttrell, *Arbitration in Dubai*, in ROGER JONES & GABRIEL MOENS, *INTERNATIONAL TRADE AND BUSINESS LAW REVIEW*, VOLUME 12, 156-59 (2009).

48. *Offering Circular Nakheel*, *supra* note 9 at 50.

49. *Id.*

matter of contract.⁵⁰ The bankruptcy remoteness⁵¹ of Nakheel SPV was not at stake, so this would not have been a problem.⁵² But what could have created a problem for the enforcement were the interest of the government in the companies and the legislation of the UAE on this subject. Enforcement of proceedings against the government and government entities (which could include Dubai World and all three Nakheel Holdings) would create legal obstacles. The prospectus mentioned that “[l]aw No. 10 of 2005 amending Government Lawsuit No. (3) of 1996 (as amended by Law No. 4 of 1997) [provided] that an establishment of the government may be sued, but that no debt or obligation of such establishment [could] be recovered by way of an attachment on its properties or assets.”⁵³ The parties waived sovereign immunity, but due to lack of precedent and authority, it was uncertain how a court would construe Law No. 3 of 2006 and, accordingly, there was no assurance as to whether such a waiver of immunity was valid and binding under the law of Dubai.⁵⁴ Consequently, it was possible that such a waiver could be revoked.⁵⁵ This means that even if the rights of mortgages were perfected and a period of two months was observed, recovering payments obligations by attachment on properties or assets of the Nakheel Holdings or Dubai World could be impossible due to their governmental characteristics. Not even a sovereign immunity waiver could undo this.

CONCLUSION

What the outcome of legal proceedings would have been is anyone’s guess. What actually happened was that in December 2009, Abu Dhabi, also an emirate of the UAE, granted Dubai a \$10 billion loan to repay some of its debts.⁵⁶ This loan was used to refund the *sukuk* holders their principal amount at maturity date, and the *sukuk* were redeemed. Abu Dhabi’s loan was understandable given the connection of the seven emirates; escalation of the situation would have affected the other emirates as well. In March 2010, there was good news for the bondholders of two other outstanding *sukuk* of Nakheel

50. *Id.*

51. Bankruptcy remoteness refers to the reduction of the bankruptcy risks of a legal entity. Within most financial transactions, such bankruptcy considerations weigh heavily. Reducing the bankruptcy risks of the SPV within this structure is essential in order to make sure that the structure functions as it is supposed to do in favor of the *sukuk* holders.

52. This could have been different, if the (in)solvency of Nakheel SPV had been at stake. In such a situation the concept of trust subject to English law would have provided more protection; the trust assets do not form part of the (insolvency) estate of the trustee and this offers the beneficiaries more protection than a contractual relationship such as the agency declaration under UAE law.

53. *Offering Circular Nakheel, supra* note 9, p. 46.

54. *Id.*

55. *Id.* at 50.

56. S. Bianchi, *Dubai Gets Aid To Pay Off Debt*, *The Wall Street Journal*, Dec. 14, 2009.

that come due in 2010 and 2011: they will be paid back in full as well.⁵⁷ However, the damage on the *sukuk* market is already done. The first quarter of 2010 clearly illustrates the negative impact of the Dubai Debt Crisis on the Islamic finance market.⁵⁸ Nevertheless, the government of Dubai announced in March 2010 that it is considering offering Nakheel trade creditors a large-scale *sukuk* as part of its debt restructuring plan to boost the regional *sukuk* market again.⁵⁹

This article has shown that the legal implications of the Nakheel *Sukuk* were not connected to the legal structure of Islamic financial instruments as such. They were inherent to the legal structure of this particular transaction and to the legal environment in which it was set up. The *sukuk* holders in this transaction had not adequately considered UAE and Dubai's financial legislation; in particular, they failed to take into account the legal framework in Dubai concerning specific requirements for granting security rights such as the rights created in a mortgage agreement. The strong legal protection and specific legal limitations concerning governmental entities under UAE law also had a major impact on the legal options of parties. Lastly, private international law, and the enforcement of (foreign) judgments in the UAE in particular, formed what would have been a big obstacle if legal proceedings had ensued. The lessons learned from the impact of the Dubai Debt Crisis on the Nakheel *Sukuk* may be valuable when structuring *sukuk* transactions in the future. What is more, some of these lessons may also be valuable for structuring other financial and commercial transactions in Dubai, because the legal system of the UAE and Dubai in particular was at the root of the legal complications of the financial structure of Nakheel *Sukuk*.

57. R. Wigglesworth, *Bondholders have most reasons to be happy*, FINANCIAL TIMES, Mar. 26, 2010.

58. C. Cohn & S. Pasha, *Dented sukuk market starved of sovereign benchmark*, DAILY NEWS EGYPT, Mar. 25, 2010, at 3.

59. S. Pasha & R. Uppal, *Nakheel seen offering sukuk to trade creditors*, Reuters, Mar. 28, 2010.