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Dubai: Growing Pains for Islamic Investments?

Executive Summary

The recent announcements from Dubai have turned the spotlight onto Islamic investments. This alert assesses the structure, enforceability, risks and valuation issues specifically associated with the Dubai Nakheel sukuk bond and the increased uncertainty regarding the legal structures and insolvency regimes underpinning Islamic investment structures in the region. Even though the Government of Abu Dhabi and the UAE Central Bank have recently bailed out the real estate development company Nakheel and its parent company, Dubai World, there is no guarantee that they will do so again in the future. As a result of these factors, investment managers should consider examining all of their Islamic investments, particularly those connected to Dubai, and working with valuation firms to determine how to approach the valuation of such investments.

Background

For general background, see the K&L Gates Client Alert "[Dubai World and Nakheel Sukuk - Apocalypse Now?](#)" And for a detailed discussion of the legal aspects of Dubai insolvency law, see the K&L Gates Client Alert, "[Creditors' Rights in the UAE](#)" (both December 2009).

On 25 November 2009 the Dubai government announced that its Dubai Financial Support Fund would spearhead the restructuring of the financial obligations of Dubai World, an investment company managing and supervising a portfolio of businesses and projects for the Dubai government across a wide range of industry segments.

Dubai World has sought to restructure U.S. \$26 billion (€17 billion, GB £16 billion) out of a total debt of U.S. \$60 billion. As a first step in the restructuring process, Dubai World and its subsidiary Nakheel PJSC ("Nakheel") (a real estate development company famous for large-scale projects such as the spectacular man-made island of Palm Jumeirah), requested their creditors agree to a "standstill" on repayments until at least 30 May 2010.

The most urgent problem facing Dubai World was a U.S. \$3.52 billion sukuk¹ bond (the world's biggest), which Dubai World had guaranteed and which is issued by Nakheel - maturing on 14 December 2009, along with its two other outstanding sukuk with a par value of about U.S. \$1.75 billion.

Structure of The Nakheel Sukuk

The Nakheel sukuk would most accurately be termed "Islamic investment certificates". The sukuk holders each hold an undivided beneficial ownership interest in the underlying assets. Sukuk holders are entitled to share both the revenues generated by and the proceeds of realisation of the assets. The legal structure and format of sukuk certificates may be considered analogous to U.S. trust certificates; sukuk certificates may be listed and rated.

Nakheel's obligations under the U.S. \$3.52 billion sukuk, due on 14 December 2009, were guaranteed by Dubai World by way of an English law guarantee. There was no guarantee of Dubai World from the Government of Dubai, although certain investors and banks who invested in the sukuk contend that there was an implicit one. Nakheel sukuk holders were granted a share pledge of 18.89% in aggregate of the outstanding equity in Nakheel at the time the sukuk was originated. Looking ahead, there are a further two sukuk issued by the company: the Nakheel 2 sukuk due on 13 May 2010 for U.S. \$980 million and the Nakheel 3

sukuk due on 16 January 2011 for U.S. \$750 million.

The Nakheel sukuk was set up as a '*sukuk al ijara*' sukuk based on two plots of land in Dubai, which were initially valued at U.S. \$4.22 billion (based on developments to be constructed on those plots). Long-term leases were transferred to the SPV issuer. The plots were then leased back to Nakheel for the term of the sukuk for the U.S. \$3.52 billion amount raised. For the term of the sukuk, Nakheel is due to make lease payments corresponding to periodic payment amounts on the sukuk. Half of the lease amount was to be paid to sukuk holders (through the SPV issuer) and half was to be deferred until maturity.

Enforceability

The sukuk documentation is governed by English law and is subject to the non-exclusive jurisdiction of the English courts. However, the structure of the sukuk has been established in accordance with Islamic principles. The Nakheel sukuk prospectus (the "Prospectus") warned that the Dubai courts are not bound to enforce English judgments without re-examining the merits of the case:

"The Declaration of Trust is governed by English law and is subject to the non-exclusive jurisdiction of the English courts. The laws of the Emirate of Dubai and (to the extent applicable in the Emirate of Dubai) the federation of the UAE (UAE law) do not recognise the concept of trust or beneficial interests and, accordingly, there is no certainty that the terms of the Declaration of Trust would be enforced by the courts of Dubai. The concept of agency is, however, recognised under UAE law."

The Nakheel sukuk holders, as creditors of Dubai World through the guarantee, are effectively subordinated to the creditors of the other subsidiaries of Dubai World. The Prospectus states:

"Dubai World is a holding company. As such, Dubai World is dependent on the operations of and cash flows generated by its subsidiaries. Therefore any claim that may be made by a creditor on Dubai World will effectively be structurally subordinate to any claims made by creditors directly on Dubai World's subsidiaries."

¹ Sukuk are Islamic financial instruments that have an overall economic effect similar to conventional bonds. They can be used for raising money in the capital markets and represent an undivided ownership share in an underlying asset or interest held by the issuer. Sukuk are used in combination with other Islamic-compliant financing techniques to give rise to a return on the underlying asset (in Nakheel's case these are real estate assets). In a typical sukuk structure the entity looking to raise funds (the originator or seller) establishes a special purpose vehicle (the SPV issuer) in a suitable tax jurisdiction. The SPV issuer issues the sukuk certificates to investors and the SPV issuer uses the issue proceeds to buy the underlying assets from the originator, which it usually holds under an English law trust in favour of the sukuk holders. The ownership share in the underlying assets, represented by the sukuk certificates, entitles the sukuk holders to a proportionate share of the returns generated by the assets. In this type of sukuk (known in Islamic law as a '*sukuk al ijara*') the underlying assets are leased, giving the SPV issuer a return on the asset in the form of rent.

Sukuk holders were granted a mortgage over the two properties but there is uncertainty as to how these could be enforced under Dubai law. Investors cannot touch the assets of the Government, as detailed in the Prospectus:

"In addition, Law No. 10 of 2005 amending Government Lawsuit Code No. (3) of 1996 (as amended by Law No. 4 of 1997) provides that an establishment of the Government may be sued, but that no debt or obligation of such establishment may be recovered by way of an attachment on its properties or assets."

As mentioned above, the concepts of trust and beneficial interest on which the entire sukuk is structured under English law are not recognised in Dubai. The sukuk therefore used a Security Agent as a domestic agent for mortgage enforcement. The Prospectus states:

"There is an absence of precedent or authority as how a court would construe Law No. 3 of 2006 and, accordingly, there can be no assurance in respect of Dubai World's or the Co-Obligors' entitlement to immunity in any attachment or enforcement action, whether relating to the Mortgages, the Share Pledge or otherwise. The Dubai Lands Department (the Governmental of Dubai's property registration authority) will register mortgages in favour of UAE licensed banks or persons. Further the Dubai Lands Department will not register a mortgage, inter alia, if a bank mortgagee is not licensed to operate in the UAE. The Security Agent is licensed to operate in the UAE. However, in the absence of clear judicial or legislative guidance or clarification on the arrangement contemplated by the Security Agency Agreement there can be no assurance of the enforceability of the Mortgages by the Security Agent in the manner contemplated by the Security Agency Agreement or any enforcement process or procedure."

There are many uncertainties about the assets available to and enforcement methods at the disposal of Nakheel sukuk investors. They will need to assess the new Dubai Government decree based on the bankruptcy law at the Dubai International Financial Centre (see further below).

One of the main principles of Islamic finance is that physical assets should underpin transactions in order to avoid pure financial speculation. However, the Nakheel sukuk shows that the value of physical assets is diminished or non-existent if local laws prohibit recourse to those assets as security.

Abu Dhabi to the Rescue?

On 14 December 2009 the Government of Dubai, acting through the Supreme Fiscal Committee, announced a series of actions in relation to Dubai World and Nakheel in a decree (the "Decree"):

1. The Government of Abu Dhabi and the UAE Central Bank agreed to provide U.S. \$10 billion to the Dubai Financial Support Fund to satisfy the upcoming obligations of Dubai World.
2. Of the U.S. \$10 billion, the Government of Dubai would use U.S. \$4.1 billion to pay the Nakheel sukuk obligations; the remaining funds are to be used to provide for interest expenses and working capital of Dubai World until 30 April 2010 (although this is conditional on Dubai World successfully negotiating its standstill). Trade creditors and contractors would also be paid.
3. The UAE Central Bank was prepared to provide support to local UAE banks.
4. The Government of Dubai would announce a comprehensive reorganisation law, which will be available if Dubai World and its subsidiaries are unable to achieve an acceptable restructuring of their remaining obligations.

All of these measures clearly highlight Dubai's dependence on its oil-rich neighbour. However, notwithstanding this, the payment of the sukuk debt should avoid the cross-defaults that would have arisen with Dubai World's own debt had it been forced to make good on the guarantee it gave under the sukuk.

The Decree also includes provisions for creditor rights and avoids untested UAE laws, which are seen as unsuitable for large-scale insolvencies. The actions do not answer medium-term and long-term concerns about how other regional Islamic and non-Islamic investments would be treated if they were also to run into trouble.

A new public finance law was issued in Dubai on 17 December 2009 covering all governmental departments and includes government companies that have tapped credit markets, such as the state holding company Investment Corporation of Dubai (which owns Emirates Airlines and a one-third share in Emaar Properties, a real estate development company). The new law requires government entities to transfer their surpluses to the treasury and sets criteria for public spending. However, it is explicitly stated in the law that "the law does not in any way relate to government-related entities such as Dubai World and Dubai Holding".

Is The Security Sufficient?

One of the key principles in Islamic finance is the sharing of risk by all parties to a transaction. Hence, if the value of the asset sold to the SPV company declines significantly (like the two properties backing the Nakheel sukuk), the repurchase agreement should not be fixed at par if the company defaults on the sukuk.

In the case of the Nakheel sukuk, the asset was valued at U.S. \$4.2 billion, based on the development plan for the land that backed the sukuk and also on assumptions about the timeframe for that development (there was a discount rate used for future value to bring it back to present value). Perhaps, in this case, the Ijara (lease type) structure may not have been appropriate in the first place, as there was never a physical asset that was worth the price it was sold for when the sukuk was issued.

In summary, there is no history of sukuk defaults and everyone involved with the Nakheel sukuk is in uncharted territory; nobody has any real idea about what might happen if Nakheel were to default and investors were forced to recover their money in an enforcement situation.

Some Valuation Implications for Fund Managers

In the light of the foregoing, investment managers should consider examining all their Islamic investments, particularly those connected to Dubai, and working with valuation firms to determine how to approach the valuation of such investments.

Circumstances may require a downward revaluation of any investments in Dubai government-related entities, as discussed above, if the Government of Abu Dhabi and the UAE Central Bank are not currently legally obliged to stand behind them. The real risk associated with these investments (and the fair assessment of their value) needs to be assessed in the light of Dubai's recent problems. The risk of default by quasi-sovereign vehicles, such as Nakheel, appears now to be quite large. Creditors should be aware that, if the Government of Abu Dhabi and the UAE Central Bank choose not to conduct another bail-out, there may be a substantial risk of not being able to realise any security associated with the sukuk issue, since investors are prohibited by Dubai law from touching the assets of the Dubai government (and by association its investment entities). There are many uncertainties about the assets available and enforcement methods at the disposal of Nakheel sukuk investors.

These issues should be considered in light of the fact that regulators and trade bodies have placed valuation at the top of the regulatory agenda. For example:

- The then -FSA director of retail policy, Dan Waters, said in March 2007 that "regulators around the world have long sought to ensure that the net asset value of publicly traded, mass market funds - such as mutual funds in the U.S. and UCITS in Europe - is rigorously controlled, to ensure that fair value is achieved for the underlying investors dealing in the funds."
- In 2007 the International Organization of Securities Commissions ("IOSCO") published its valuation principles for hedge funds and focused on documented policies and procedures, identification of methodologies to be used, consistent valuations, periodic reviews, independent review, the handling and

- documenting of any price overrides, due diligence on third parties appointed to perform valuation services and transparency to investors.
- Credit Suisse was fined a record GB £5.6m in summer 2008 by the FSA following a scandal in which rogue traders in its investment banking division deliberately mispriced the asset-backed securities they held.
 - The FSA's Dan Waters has more recently commented: "In the current market turmoil, in which valuing illiquid assets has been and remains a significant challenge, it is more important than ever that robust valuation methodologies and practices are in place, carefully monitored and made transparent to investors".
 - The U.S. Securities and Exchange Commission ("SEC") inspection and compliance staff has repeatedly listed advisers' valuation of investments as a major area of focus, particularly as a result of the uncertainty created by recent market conditions.

The SEC's Director of Enforcement, Robert Khuzami, noted in a November 2009 speech that inflated valuations are a focus of the Division's efforts to combat credit crisis-related misconduct and has stated that valuation will be an area of consideration for the Division's Asset Management Unit, which is currently being formed to focus on investment advisers and both registered and unregistered funds.

Conclusion

Even though the Government of Abu Dhabi and the UAE Central Bank have recently bailed out Dubai World and Nakheel, there is no guarantee that they will do so again. Furthermore, it is apparent now both that Dubai's financial position has changed significantly and that there is increased uncertainty regarding the legal structures and insolvency regimes underpinning Islamic investment structures in the region. In the light of these developments, investment managers should consider examining all their Islamic investments, particularly those connected to Dubai and working with valuation firms to determine how to approach the valuation of such investments.

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