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## A Dubai World Debt and Nakheel Sukuk – Apocalypse Now?

It was no ordinary day. On 25 November 2009, the Dubai government announced through its Supreme Fiscal Committee (SFC) that its Dubai Financial Support Fund (DFSF) would spearhead the restructuring of Dubai World's financial obligations. The resulting tsunami sent shockwaves through the world markets, as it raised doubts over the Gulf Emirate's ability to meet its financial obligations. Investors with interests in Dubai and its debt market were exposed. Or were they?

As the dust settled, it became clear that Dubai World was seeking to restructure just \$26 billion (€17bn, £16bn) out of a total debt of \$60 billion. As a first step in the restructuring process, Dubai World and its subsidiaries, Nakheel PJSC ("Nakheel") and Limitless LLC ("Limitless"), the real estate developer and investor famous for projects such as the spectacular Palm Jumeirah, requested their creditors agree to a "standstill" on repayments and an extension of a near-term maturity until at least 30 May 2010. The most urgent problem facing Dubai World is a \$3.52 billion *sukuk* (the world's biggest), an Islamic financial instrument, issued by Nakheel, and maturing on 14 December 2009 along with its two other outstanding *sukuk*, with a par value of \$1.75 billion. To complicate matters further, the *sukuk* is guaranteed by Dubai World. With this requested restructuring, the legal system of the United Arab Emirates ("UAE") faced an unprecedented test. This Alert provides an overview of what this development means to those with exposure to Dubai World and Nakheel debt, by examining the applicable Islamic financing concepts and the regional legal uncertainty, the question of what creditors should do as well as outlining possible implications for investors and buyers interested in taking advantage of the opportunities that may arise.

### The Overview

In recent years, Dubai operated under a mountain of debt, borrowing \$80 billion in a four-year construction boom that transformed it into a global tourism and financial centre. Whilst its economy expanded rapidly, Dubai World and its business entities embarked on a global real estate buying spree. Unfortunately, much of Dubai's growth emerged from construction projects that suffered greatly with the onset of the global financial crisis in 2008. Property prices fell sharply, with analysts predicting values falling as much as 80%. The current vacancy rate for Dubai office buildings is 40% with further planned new construction set to double the city's office space over the next couple of years.

Nakheel, which has undertaken much of the recent development in Dubai, has delayed indefinitely many of its projects as demand has faltered, resulting in an inability to repay the *sukuk* obligations maturing on 14 December. This may well have ramifications for the rest of the Islamic financial industry, which has grown to \$822 billion this year, an increase of 29% compared with 2008.

### The Entities

The government of Dubai formed Dubai World by decree as a holding company through which the government holds investments in a variety of businesses. Dubai World is wholly-owned by the government of Dubai and, as such, is treated as part of the government of Dubai for many purposes under Dubai law.

Dubai World conducts most of its business through subsidiary operating companies, some of which are involved in real estate investment. Nakheel and its business entities were tasked with developing and owning real estate projects in Dubai. Istithmar PJSC (“Istithmar”) and Limitless were organized to invest primarily in international real estate with Istithmar also investing in a variety of industries, both internationally and in Dubai, including hotels.

The debt giving rise to the immediate problems for most creditors is the Nakheel *sukuk*. Payments due under the *sukuk* are secured by vast swathes of development land south of Jebel Ali, outside Dubai, that Nakheel had set aside as a development twice the size of Hong Kong Island. Little work has been done on the project.

### Ijara and Sukuk

Because Islamic law (the “Shariah”) prohibits charging interest on loans (see K&L Gates’ global [Real Estate Finance: Law, Regulation and Practice](#), Chapter 14, published by LexisNexis in November 2008) alternative methods of financing have to be pursued. One method that is often used is a lease structure (in Arabic an “*ijara*”) which is designed to provide the lender a return on its loan, equivalent to interest, and eventual repayment of the loan through periodic rental payments and the reacquisition of the leased asset at the end of a specified term, in a

manner similar to a sale/leaseback. *Sakk* (singular; *sukuk* is the plural) means, in ancient Arabic, “to strike” or “to hit” as in to strike or imprint one’s mark on a document or tablet, and, as a derived term means “minting coins”. A *sukuk* offering is one method by which funds are raised and then used in a Shariah-compliant financing, like an *ijara*.

*Sukuk* are of two general types: Islamic bonds and Islamic securitizations. Islamic bonds are based upon the credit of an entity that is participating in the transaction (*i.e.*, an issuer, guarantor or other credit support provider). Securitizations involve asset transfers from an originator into a trust or similar special purpose vehicle with *sukuk* issuance by that trust or vehicle and payments on the *sukuk* derived from the payments received in respect of those transferred assets. Most *sukuk* offerings to date have been of the bond type, and the ultimate credit in most of those bond offerings has been a sovereign entity. The Nakheel *sukuk* issuance is, however, a securitization structured around a Shariah-permissible *ijara*. Although the actual structure of the Nakheel *sukuk* is multi-layered, the basic form of the transaction (in a simplified version) is as follows:

(i) Assets owned by a Nakheel subsidiary were subject to a long-term lease with another Nakheel subsidiary. The lessor then sold its rights under the lease (*i.e.*, the right to receive rents and receive the proceeds of a purchase of the assets) to a special purpose vehicle (“SPV”) organized by Nakheel.

(ii) The SPV, in turn, transferred its lessor’s rights to a trust (the *Sukuk* Trust).

(iii) The *Sukuk* Trust issued fractional interests in the lessor rights to investors, in exchange for cash proceeds which flow back up through the structure in order to fund the purchase price for the original sale of the long-term leasehold rights.

(iv) The return to the investors is paid via regular rental payments under the lease and then via a built-in repurchase mechanism of the leasehold interest by the tenant.

Supplemental forms of collateral were provided as well, but the primary source of repayment is the rental payments under the lease and the purchase obligations with respect to the lease rights.

To provide credit support for the transaction, the Nakheel-affiliated asset owner, the Nakheel-affiliated tenant and a third Nakheel affiliate provided performance guarantees. In addition, Dubai World also guaranteed the performance (*e.g.*, rental payments and purchase obligation) by the various Nakheel affiliates. As noted, however, in numerous press reports, the Dubai government provided no guarantee, which may well have implications for anyone with exposure to this issuance.

### What Does This Mean For Creditors?

Predicting the path of any restructuring of the Nakheel issuance is difficult, particularly in light of Dubai laws affecting bondholders' rights and insolvent businesses. For a detailed discussion of the legal aspects of insolvency in Dubai, see the K&L Gates Client Alert, "[Creditors Rights in the UAE](#)", 7 December 2009.

There is no equivalent of U.S. Bankruptcy Chapter 11 or U.K. administration procedures in Dubai which would be relevant to the restructuring of the financial obligations of Dubai World or Nakheel. Many of Dubai World's and Nakheel's creditors, particularly those with higher exposure, may seek to work with Dubai World in an orderly restructuring rather than risk legal action in an uncertain environment.

As stated, Nakheel's *sukuk* obligations are due for redemption on 14 December 2009. There is an automatic grace period of fourteen (14) days, until 28 December, before a failure to pay gives rise to enforcement rights. In order to avoid enforcement, a supermajority of the *sukuk* holders will have to approve the extension requested by Nakheel. If this happens, then Dubai World and its subsidiaries will have a few months of breathing room to negotiate a more permanent restructuring or to pursue repayment by liquidating assets or obtaining alternative financing. Press reports indicate that many *sukuk* holders are unwilling to agree to the

extension. Once they analyze their legal options, they may reconsider.

Under relevant Dubai law, Dubai World and its affiliates are authorized to provide security or guarantees in connection with financings. The rights to enforce the guarantees will be subject to a requirement under Dubai law that before proceedings may be brought against the government of Dubai and government entities (which would include Dubai World and the Nakheel entities), any claimant must first give details of such claim to the Attorney General of Dubai and must enter into settlement negotiations for a period of up to two months. If the parties are unable to reach a mutually acceptable settlement at the end of the two-month period, the claimant may commence enforcement proceedings. Being allowed to proceed and obtaining a judgment, however, may not lead to recovery. Although Dubai law provides that an entity formed by the government may be sued, it also provides that no debt or obligation of such entity may be recovered by way of an attachment on its properties or assets. Under the *sukuk* documents Dubai World and the various Nakheel subsidiaries waived to the fullest extent possible immunity from lawsuits, attachment of their assets and other legal process. In other words, while Dubai World and the Nakheel entities are entitled to the benefits of sovereign immunity, they have purported to waive that immunity. A question arises as to whether a Dubai court would enforce the waiver and allow Dubai World's assets to be attached if the creditors obtained a judgment.

A number of the Nakheel *sukuk* holders apparently believed, mistakenly, that the government of Dubai would stand behind the guarantee given by Dubai World, in much the same way as the U.S. government honored an implicit guarantee of the obligations of Freddie Mac and Fannie Mae. Following the 25 November announcement, however, the government of Dubai announced that it would not stand behind the *sukuk*. While some investors believe the government of the oil-rich Emirate of Abu Dhabi may step forward to repay the *sukuk*, so far, it shows no signs of bailing out Dubai World. A default in payment of the Nakheel *sukuk* not only has implications for the holders of the Nakheel *sukuk*, it raises questions over the

future attractiveness of Islamic finance and for anyone investing in the Middle East.

### Restructuring of the Nakheel Sukuk

Given the absence of an automatic moratorium within Dubai along the lines of those encountered in other jurisdictions such as the U.S. and U.K., obtaining creditors' agreement to the standstill is key.

In the context of a debt restructuring, a standstill agreement represents a temporary arrangement between a distressed borrower and its creditors that will prevent the creditors from enforcing their rights against the borrower or from generally taking action against it. By the end of the standstill period, the lenders will have assessed the financial position of the borrower and decided on the route to be taken. Where the borrower seems to be in temporary difficulty, a debt rescheduling might be envisioned. Such rescheduling may be applied to the interest and/or the principal of the existing debt of such borrower. Where the borrower is in deeper financial difficulty, a debt restructuring may be pursued. This will often mean that the debt will be separated into performing and non-performing tranches and that the non-performing debt will be amended as to its terms and subordinated to the performing debt, which usually will remain unchanged.

If the borrower's financial position later improves, some of the non-performing debt may be repaid. The non-performing part might also simply be written off from the start, in exchange for the borrower's issue of equity in favour of the lender. It is too early to tell if the *sukuk* holders would be willing to write off any portion of the *sukuk*. The uncertainty surrounding the creditors' legal rights may encourage the creditors to consider at least a significant extension of the maturity and a reduction in periodic payment amounts, if not a partial write off of principal. Other typical debt restructuring techniques, such as converting non-performing debt into equity, may be more difficult to negotiate given the ultimate sovereign ownership of the entities in question.

### What Effect Will the Crisis Have on Real Estate?

Dubai World's request for a temporary standstill, if agreed to, will give it time to restructure all of its obligations with near-term maturities, including the Nakheel *sukuk*. Given the global decline in real estate values and the global tightening of underwriting standards, it is unlikely that any new Islamic-sanctioned financial offering could raise the capital required to retire the existing *sukuk* at par. Conceivably a smaller financing could be sponsored, but any shortfall would have to be covered by a direct cash investment by the Dubai government or one of the other Emirates, such as Abu Dhabi, or by liquidating some assets. The same outcome is likely, but on an accelerated timeline, if the standstill is not implemented. Dubai World and Nakheel likely will use the two-month settlement negotiation period and the uncertainty of Dubai law to buy time to arrange for alternative financing or to negotiate a restructuring of the *sukuk*. The same choices regarding raising capital through sovereign investment, asset sales and new financing await Dubai World if the existing *sukuk* is not restructured beyond a temporary standstill.

Absent a sovereign investment and assuming the *sukuk* holders are unwilling to consent to a meaningful restructure and are able to enforce their claims under Dubai law, Dubai World will be forced to either liquidate assets or obtain financing on an asset-by-asset basis (to the extent its assets are unencumbered and such asset-based financing would not violate other financial covenants that Dubai World and its subsidiaries are subject to) in order to pay the *sukuk* holders' claims. The assets securing the *sukuk* could be offered in satisfaction of the obligations. Until the development of the real property securing the *sukuk* can be completed and supported by market demand, however, its value to the financial institutions holding the *sukuk* is limited. Were the *Sukuk* Trust to acquire this development property, it likely would seek to dispose of the property quickly. This outcome would lead to a significant value buying opportunity for patient real estate investors and developers. If the *sukuk* holders demand a more liquid resolution, then pressure on Dubai World as guarantor to sell real estate assets in the U.S., the U.K. and elsewhere likely will result in some attractive buying opportunities.

Dubai World and its subsidiaries, including its investment arm, Istithmar, have been quite active in real estate acquisitions in recent years. Large property holdings in the U.S., for example, include the CityCenter Casino & Resort, a large Las Vegas development in which Dubai World teamed with MGM Mirage. Dubai World's share of the CityCenter investment was \$5.4 billion. Other U.S. properties that Dubai World or its subsidiaries own include: Barneys, the luxury retailer, bought in 2007 for \$942 million; 450 Lexington Ave., with 911,000 square feet in Manhattan, bought for \$600 million in 2006; a stake in the Mandarin Oriental, a 248-room hotel in Manhattan that it bought in 2007 in a deal valuing the property at \$380 million; and a 50% stake in the Fontainebleau Miami, an 876-room resort hotel in Miami that was bought last year for \$750 million. In the U.K., Istithmar owns the iconic art-deco former Adelphi hotel building on the Strand, WC2.

Many of these assets are considered trophy properties though, and notwithstanding Dubai World's need for cash, buyers should not expect fire sale pricing. Some of Dubai World's trophy real estate assets are held in joint ventures, and the underlying documentation likely restricts Dubai World's ability to sell its venture interests to investors other than its co-venturers.

Given the slowly improving lending environment, Dubai World may be able to raise significant funds through the financing of unencumbered assets, to the extent permitted under its other financing arrangements. However, obstacles also exist here if the asset is owned in a joint venture, as Dubai World may lack authority under the venture documents to pledge or encumber joint venture assets or its interest in the joint ventures.

For assets owned directly (most likely in a structure involving a domestic entity with a foreign corporate tax blocker interposed along the line), Dubai World's ability to sell or finance assets will be easier to exercise. The financing of these assets would not necessarily need to be Shariah compliant and the financing structure would largely depend on the target investor base.

In summary, while the Nakheel *sukuk* maturity has the potential to effect a substantial transfer of real estate in Dubai as well as a shift in ownership of a number of signature real estate assets in other parts of the world, the pace of the shift, the favourability of pricing and the ability of buyers, other than Dubai World's existing co-venturers, to participate remain to be seen.

### How K&L Gates Can Help

K&L Gates' distressed real estate group is a key part of an integrated, interdisciplinary, multi-office practice team. The team has experience and expertise in all of the issues facing the stakeholders with an interest in the Dubai World restructuring and debt. The group works closely with the K&L Gates Islamic finance and investment group which comprises 30 lawyers across the firm in the U.S., Europe and Asia who have an interest in this discipline. Our clients include institutional real estate lenders holding troubled real estate loans and mortgage-backed securities and investors who own or desire to acquire distressed real estate, real estate loans or real estate companies. Both groups assist lenders, special servicers and their asset management firms with the restructuring of distressed real estate loans and the positioning of re-possessed assets for successful sales.

Members of the distressed real estate group have advised clients dealing with all types of troubled real estate matters across the globe, including the UAE and MENA regions, both on the real estate owner as well as on the asset level. With an office and experienced practitioners in Dubai, we are able to assist in navigating the uncertainties of the Dubai legal structure. We also have extensive experience in providing advice in relation to the restructuring of real estate investments and loans and real estate companies as well as carrying out enforcements to optimize and secure our clients' interests and income. Our experience and expertise include court actions and special enforcements in respect to real estate security or the enforcement of share pledges secured by stock in real estate companies. In addition, we advise distressed real estate investors on debt-equity swaps and repurchases of real estate-backed loans and can provide sound advice and the necessary legal skills to help clients realise maximum value for these assets.

Our lawyers work in our offices in London, Paris, Frankfurt, Berlin, Dubai, as well as throughout the United States and the Far East. Our team is consistently recognised as a market leader and has experience in acting for all types of stakeholders dealing with all aspects of international real estate finance restructuring techniques. Drawing on the experience of our Islamic finance and investment colleagues, we seek to offer a fully rounded service to those with issues similar to those faced by creditors of Dubai World and Nakheel.

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