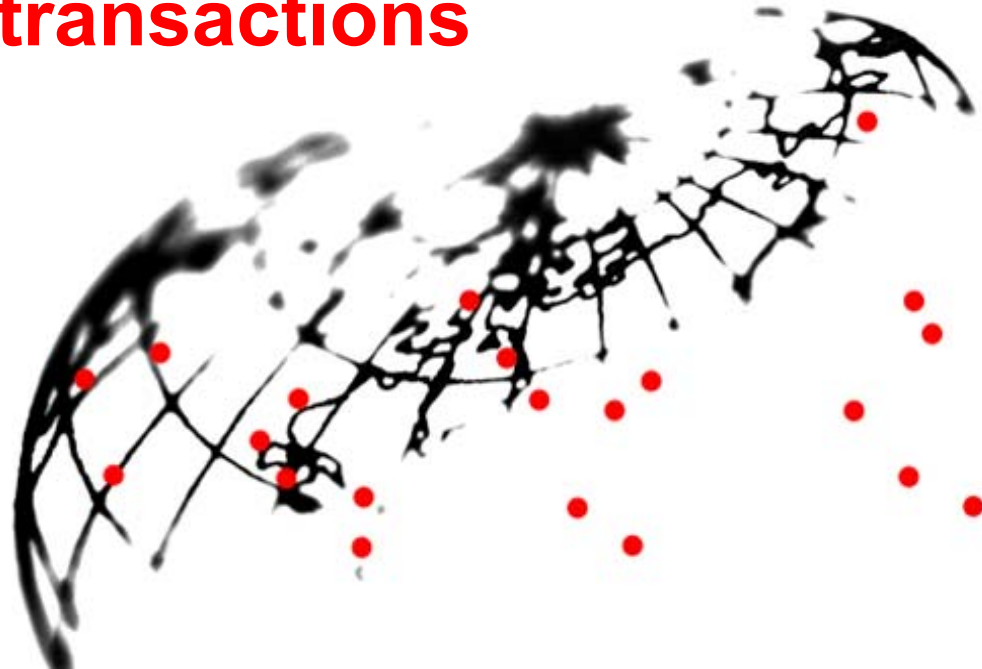


# **The International Real Estate Finance Summit 2009**

## **Cross border issues relating to Islamic finance real estate transactions**

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## Overview

- Defining Islamic finance real estate transactions
- Cross border issues that may arise
- Dealing with cross border issues
- Mitigating the risks

# Defining Islamic finance real estate transactions

- An Islamic finance real estate transaction, is a transaction which is structured using Islamic finance techniques and the underlying assets are real estate.
- Some examples of techniques used:
  - Murabaha : Mortgage
  - Diminishing Musharaka : Mortgage finance
  - Istisna'a : Property development & Project
  - Ijara : Lease
  - Mudaraba : Real estate funds
  - Sukuk : Corporate funding

## Cross border issues that may arise

- Issues relating to Legal Environment
- Enforcement issues: enforcement of foreign judgements, Shariah law –v- Conventional law
- Specific documentary issues in Islamic finance real estate transactions

## Legal issues relating to Legal Environment

- UK
  - Impact of Shamil Bank –v- Beximco
  - Finance Act 2009
  - FSA approach

## Legal issues relating to Legal Environment

- Saudi
  - Foreign ownership restrictions
- Bahrain
  - Project company needs to be established locally

## Enforcement issues

- General ruling on enforceability of foreign judgment and arbitral awards in the GCC countries
- Legal position in 4 countries: Bahrain, Saudi, Kuwait and the UAE
- Enforceability of foreign judgment and arbitral awards in that particular country

## Enforcement in GCC

Foreign judgment/awards can be enforced via any of the following:

- Multilateral treaties
- Bilateral agreements
- Procedures of local laws regarding enforcement action

## International Conventions

- The 1995 Protocol on the Enforcement of Judgments, Letters Rogatory and Judicial Notices (GCC Protocol)
- The 1983 Convention of Judicial Cooperation between the State of Arab League (Riyadh Convention)
- Inter-Arab Convention on the Enforcement of Judgment and Awards of 1952
- New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958 (NY Convention)

# Bahrain-Enforcement of Foreign Judgment

- No treaty between Bahrain and England
- Enforcement of foreign judgment is governed by Articles 252 and 253 of Law No 12 of 1971 on Civil and Commercial Procedures
- Article 252: “Court judgments and orders passed in any foreign country may be ordered to be enforced on the same conditions as are laid down in the law of that country for enforcing court judgments and orders issued in Bahrain”
- It means Bahrain court will:
  - *Examine the situation in the country of origin*
  - *Apply the same rules and conditions for the enforcement of foreign judgment*

# Bahrain–Enforcement of Foreign Judgment

- Merrill Lynch v Abdul Jalil Behbehani 1985
- Court has to decide whether to permit enforcement of English judgment in Bahrain pursuant to Article 252
- The Civil High Court ruled that conditions under Article 252 are fulfilled on the following basis:
  - *Judgment passed by a foreign court of competent jurisdiction*
  - *Rules of court have been complied with (eg notice and defence)*
  - *Judgment are final*
  - *Judgment are not inconsistent with the rules of public order and moral*

## Bahrain – Arbitration system

- There are 2 arbitration bodies in Bahrain (both set up in 1933)
  - *The Bahrain International Commercial Arbitration Centre*
  - *The GCC Commercial Arbitration Centre (more influential)*
- Arbitration system is divided into domestic and international arbitration
- Domestic arbitration:
  - *Subject to rules set out in Civil and Commercial Procedures Law of 1971*
  - *Applies to any civil or commercial dispute where the seat of arbitration is in Bahrain, regardless of place of contract, nationality of parties or choice of law*
- International arbitration:
  - *Governed by The International Commercial Arbitration Law (Decree No. 9 of 1994)*
  - *Applies to commercial dispute only*
  - *International means if both parties conduct their business in different states, contract is performed or seat of arbitration is outside one or both parties' place of business.*
  - *UNCITRAL model law applies if parties fail to refer their disputes for resolution under the relevant rules.*

## Bahrain – Enforcement of Foreign Arbitral Awards

Can a foreign arbitral awards be enforced in Bahrain?

- Yes because Bahrain is a signatory to the NY Convention.
- International arbitral awards are binding upon written application to the High Civil Court (Article 35 of UNCITRAL)
- But the recognition and enforcement can be refused if contrary to the public policy in Bahrain.

## Saudi Arabia – Legal System

- Governed by Islamic law (Shariah)
- Saudi courts do not follow a system of binding judicial precedent or case law
- The most important court for commercial disputes is the Board of Grievances (**BOG**) – decide the enforceability issue of foreign judgment/awards
- Commercial disputes outside the jurisdiction of BOG:
  - Disputes between banks and customers – adjudicated by the Banking Disputes Settlement Committee of the Saudi Arabian Monetary Authority (**SAMA**)
  - Cheques, promissory notes and bills of exchange – Commission for the Settlement of Negotiable Instruments
  - Disputes under contracts of insurance – Ministry of Insurance

## Saudi Arabi – SAMA Committee

- **Not a court** - it does not have authority to issue judgments
- **Quasi Judicial Body** – authorised to review disputes and propose settlements in relation to banking disputes
- **Does not apply Shariah law** – at least not as strictly as other Saudi courts and judicial committees

# Saudi Arabia – Enforcement of Foreign Judgment

Can a foreign judgment be enforced in Saudi?

Yes in principle.

What about in practice?

BOG will assess the judgment based on the following:

- Reciprocity of enforcement of Saudi judgments in the foreign jurisdiction
- Consistency with Shariah principles as applied in Saudi
  
- Fanari case (1992)
  - *BOG ruled that a judgment of English High Court was not enforceable on the basis of reciprocity in Saudi.*
  - Judgements which are enforceable on the basis of reciprocity are judgments from countries who (a) are a party to a treaty (b) whose authorities would give executive force to judgments of the Saudi courts
  - *The only relevant treaties where Saudi is a party are Arab League Treaty 1983 and the GCC Protocol 1995*

No conclusive answer on enforceability. No judicial precedent in Saudi so there is always a possibility of BOG ruling differently today (from the Fanari case).

# Saudi Arabia – Enforcement of Foreign Arbitral Awards

## Can a foreign arbitral awards be enforced in Saudi?

Yes in theory since Saudi has ratified the NY Convention in 1993.

## What about in practice?

Remains problematic

- BOG often consider that an award is not compatible with public policy or with the principles of Shariah
- Arbitrators must be male Saudi or Moslem male expatriates
- Saudi governmental entities may submit to disputes to arbitration only with permission of the PM (i.e. the King). May include government owned corporation although not strictly governmental entities.

No conclusive answer on enforceability. Extremely unlikely to be possible in practice.

# Kuwait-Legal System and Arbitration

## Legal System

- Civil law system (based on the Egyptian and French legal codes). Shariah is an important (but not primary) source of law

## Arbitration

- The Commercial Arbitration Centre of the Kuwait Chamber of Commerce and Industry (set up in 2000)
- Enforcement of awards set out in the Code of Civil and Commercial Procedure (not based on UNCITRAL)
- Kuwait is a signatory to NY Convention.

# Kuwait – Enforcement of Foreign Judgment

## **Is Foreign Judgment enforceable in Kuwait?**

- No reciprocity treaty between England and Kuwait
- Recognition of English judgment rested with the trial courts on ad hoc basis (to determine reciprocity) on passing of a writ of execution
- Subject to public order and morals

Enforcement of foreign judgment in Kuwait is not impossible

# Kuwait – Enforcement of Foreign Arbitral Awards

## Is Foreign Awards enforceable in Kuwait?

- If an award is rendered in a NY Convention member state, then the Kuwaiti courts will recognise and enforce it without retrial or examination
- Awards from non-member states are also enforceable provided there is reciprocity of enforcement between Kuwait and such country
- In practice, the Kuwaiti courts will only recognise and enforce the award if the procedural requirements have been satisfied and no conflict with public order or morality in Kuwait

Arbitration is a better option if client is a plaintiff pursuing assets in Kuwait

# UAE-Legal System and Arbitration

## Legal System

- Dual legal system of civil and Islamic law
- No doctrine of binding precedent and judgments of higher courts are not binding on the lower courts (although they can be used as a guide)
- No bilateral enforcement treaty with the UK but has ratified the Riyadh Convention

## Arbitration

- UAE is a signatory to NY Convention since November 2006
- Dubai International Arbitration Centre and Abu Dhabi Conciliation and Arbitration Centre
- Article 203 to 218 of UAE Civil Procedure Code 1992 provide for arbitration procedure

# UAE – Enforcement of Foreign Judgment

## Is Foreign Judgment enforceable in UAE?

- Yes in theory since UAE has treaties with various countries.
- No treaty on judicial cooperation and recognition of judgment and awards between the UAE and the UK save for criminal matters
- For English judgment to be enforceable in the UAE, conditions under Article 235 of the UAE Civil Procedure Code must be satisfied

Enforcement of foreign judgment in UAE is difficult

# UAE – Enforcement of Foreign Arbitral Awards

## Is Foreign Awards enforceable in UAE?

- Yes in theory since UAE has ratified the NY Convention (although no case has gone through the UAE courts yet) on 21 August 2006
- Arbitration award must be enforced through the courts
- Article 236 of the UAE Civil Procedure Code (enforcement of foreign arbitration awards) “Foreign awards can be executed and implemented in the UAE under the same conditions provided in the issuing country”
- No special status given to member state when it comes to enforcement. All conditions for the execution and recognition of the awards must be satisfied.

Enforcement of foreign arbitral awards in UAE is not impossible

## Specific documentary issues in Islamic contracts

- (1) Indemnities
- (2) Warranties
- (3) Rental period & Term
- (4) Rental calculation
- (5) Compensation & liquidated damages
- (6) Set-off
- (7) Events of default
- (8) Insurance & Maintenance
- (9) Total Loss

## Documentary issues

### (1) Indemnities

- General Islamic principle - unfair to seek an indemnity for loss or damage not caused by the customer (lessee) (contrast conventional financing where the desire is to simply allocate risk)
- Assumption of more risk should require reward; if an increased return is not available what are the alternatives?
  - obtain warranties from supplier/manufacturer;
  - any insurances available?
  - seek indemnities on basis of necessity / public need
- Where loss and damage arises out of use and operation of the asset by the customer it is reasonable to seek an indemnity

## Documentary issues

### (2) Warranties

- General Islamic principle - grant or restriction of warranties by an Islamic lessor must be
  - fair and reasonable; and
  - not always possible to exclude warranties (e.g. title and fitness for purpose)
- Position in sale transactions differs (*caveat emptor* applies) from leasing deals (latter more onerous)
- Lessor can assign benefit of third party warranties to lessee in substitution
- Insurance may be available
- Warranty claims may trigger an Event of Mandatory Prepayment

## Documentary issues

### (3) Rental period & term

- Approach was changed in 2001; prior to then rental could be adjusted periodically.
- Some scholars objected - *gharar* (i.e. uncertainty) still present as total rent over life of lease unknown at outset
- Rent adjustment notice - before each rent period a rent adjustment notice served - lessee given the option to accept or reject adjusted rent offered for each period.
- Rejection triggers a pre-agreed obligation to purchase
- Economic effect - still a long term financing; creates a right to prepay

#### (4) Rent calculation

- True Islamic lease (*Ijara*) is really an operating lease
- The *Ijara-wa-Iktina* is an operating lease with an option to purchase and has been developed to have some of the characteristics of a finance lease
- To-date no Islamic lease has been tax-driven (but there have been ECA leases)
- Rental combines principal (which can be a bullet or amortised) and the profit element / *Ijara* return
- Profit element / *Ijara* return can be adjusted periodically
- The benchmarking issue - and the link to LIBOR - Islamic indices awaited
- Latest twist - fixed price over term and the early termination solution

## **(5) Compensation and liquidated damages**

- General Islamic principle - a customer struggling to pay a debt should not be further penalised by the Islamic financier but accommodated
- Over the years there have been various attempts to impose an incentive to pay on time
  - compensation - various formulations
  - fixed (i.e. liquidated) daily sum - payable to charity by financier is generally the approach favoured now

## **(6) Set-off**

- Can be an issue with some institutions - is it fair and reasonable? Where statutory set off applies this may favour lessor or lessee

## Documentary issues

### (7) Events of Default

- General Islamic principle - defaults must have arisen due to the act or omission of the customer. The customer ought not to be responsible for something over which it has no control
- Conventional financing - does not necessarily make this distinction. In multi-tranche financings this can create problems (e.g. *force majeure*, nationalisation)
- Events of mandatory pre-payment - place such no-fault events into a separate category. The occurrence of the event will entitle the financier to exercise a put option. If the customer fails to purchase the asset (in accordance with a pre-agreed price), this will be treated as an event of default.

## Documentary issues

### **(8) Insurance & maintenance**

- General Islamic principle - lessor must retain responsibility for certain insurance & maintenance functions
- History - the approach changed in 1996
- Both - look at the asset class (e.g. ships, real estate, aircraft differ) as the approach to insurance & maintenance will differ for each
- Insurance - distinguish between asset insurance and liability insurance
- Maintenance - distinguish between major and minor (or day to day) maintenance
- Service agreement and set-off; initial period calculations & clawbacks

## Documentary issues

### (9) Total loss

- General Islamic principle -once a total loss has occurred asset cannot be used for intended purpose - lessor cannot continue to charge rental
- One of the hardest areas to get an acceptable Islamic solution, invariably compromises are reached
- Loss of hire/business interruption insurance - where available to cover the loss of rent before insurance proceeds paid
- Financier has to rely on insurances, if a shortfall may be able to claim compensation for the difference if lessee caused total loss
- Some argue loss of hire to cover rebuild period combined with agreement to purchase new asset - not seen in practice

## Mitigating cross border risks

- Offshore security
- Submission to jurisdiction
- Partners
- Risk assessment
- Legal and Financial Advice
- Shariah Advice
- Emerging market status (GCC only)

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Aziza qualified as a solicitor in February 2003. Before joining Norton Rose, Aziza worked at Freshfields Bruckhaus Deringer in London and Belgium, Shell Petroleum Development Company in Nigeria and Projecto Ak'Tenamit in Guatemala.

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Asmihan has extensive experience and detailed knowledge of many Islamic finance products. She has advised numerous financial institutions and corporations on various types of Islamic product financings such as Murabaha, Ijarah, Mudaraba, Wakala in the UK, Europe, Far East Asia and the Middle East. She acts for a wide range of financial institutions offering Islamic financial solutions including Citibank, Lloyds TBS, Fortis Bank, The Islamic Bank of Asia and Ahli United Bank.

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