KEY POINTS

- Where a *mudaraba* agreement effectively guarantees the investor against any financial losses, it is likely to be Shari'a non-compliant and void under UAE law.
- In *Dana Gas*, the Commercial Court has looked through an attempt to structure such a *mudaraba* agreement in such a way as to mitigate that risk.
- The *mudarib* can resist the enforceability of such agreements under English law by reference to the law of illegality and *Ralli* principle and the law of mutual mistake.

Feature

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Islamic finance – an attempt to mitigate Shari'a compliance risk

In this article, the authors consider the interim injunction made in the *Dana Gas* case which raises issues as to whether a *mudaraba* is compliant with Shari'a as codified in UAE law, so that it is unenforceable in English law, principally on the grounds of contractual illegality and/or mistake.

INTRODUCTION

Eight years after *The Investment Dar v Blom Development Bank* [2009] EWHC 3545 (Ch), the Islamic Finance (IF) world has been rocked by another case, *Dana Gas PJSC v Dana Gas Sukuk Ltd* [2017] EWHC 1896 (Comm), in which a party seeks to avoid its obligations under an IF agreement on grounds of its being Shari'a non-compliant (SNC).

There are obvious differences between the two cases. The *Blom Bank* case raised the issue of whether *wakala* contracts were Shari'a compliant, and therefore intra vires the financed party under Kuwaiti company law. The *Dana Gas* case instead raises issues as to whether a *mudaraba* is compliant with Shari'a as codified in UAE law, so that it is unenforceable in English law, principally on grounds of contractual illegality and/or mistake.

There are, however, common themes. In both cases, the English courts have been required to consider whether the agreement is SNC because the financing party assumes no financial risk and whether the financed party should be able to deny its own obligations under an IF agreement by alleging that its own agreement is SNC.

DANA GAS – A CASE STUDY

The *Dana Gas* case is on one reading the straightforward application, on an interim basis, of established English contractual principles. The wider interest in the case, however, is as a case study of investors attempting to exclude the risks of an IF agreement being found SNC.

The investors in *Dana Gas* accepted for interim purposes that there was a serious issue as to the enforceability of their agreements as a matter of UAE law. The effect of the agreements was that the investor (*rab al-mal*) transferred all of the risk to the entrepreneur (*mudarib*). The investor's delegate did not seek to argue or adduce evidence, in resisting an interim injunction, that such an effective guarantee was Shari'a compliant or lawful under UAE law.

However, the agreements had been drafted and structured so as to protect the investor's effective guarantee from any argument that the arrangements were SNC. The judge in the Commercial Court (the Judge) looked through that structure to the substance of the agreements in ordering an interim injunction against the *rab al-mal*'s performance of the purchase obligations that in effect provided its guarantee.

MUDARABA FINANCE

The basic structure of a *mudaraba* company or partnership is well known. One partner, the *rab al-mal*, contributes his *mal* or capital. The other partner, the *mudarib*, following the Qur'anic etymology of the *mudaraba*, beats the ground travelling in search of God's favour in the form of profit: *UAE Civil Code*, James *Whelan*, 2011, para [3-0406].

If the venture is successful, each partner is rewarded with an agreed share of any profit made. If not, the loss of each is ordinarily limited to their contribution, in the case of the *rab al-mal*, his capital, and in the case of the *mudarib*, his skill and labour.

THE AGREEMENTS

Dana Gas is a Shari'a compliant Sharjah company engaged in oil and gas projects in the Middle East. In 2013, it re-scheduled some US$850m of existing *mudaraba* finance that had been used to acquire assets (the *mudaraba* assets) in Egypt. The investment was through *sukuk*, so that investors received certificates as to their undivided shares in the *mudaraba* assets. Those assets were held on trust by a Jersey company (the Trustee), which was in turn the *rab al-mal* under the *mudaraba*.

The Trustee delegated many of its powers under an irrevocable power of attorney to an appointed agent incorporated in England (the Delegate).

The *mudaraba* arrangements involved three different agreements (the Agreements), the *Mudaraba* Agreement, the Purchase Agreement and the Sale Agreement.

THE *MUDARABA* AGREEMENT

The *Mudaraba* Agreement, governed by UAE law, provided for the *rab al-mal* to receive some 99% of the profits, being the final difference between the value of the *mudaraba* assets and *mudaraba* capital. It further provided for the *mudarib* to pay the *rab al-mal* a periodic fixed amount, even if the distributable profits during the relevant period were less.

The *Mudaraba* Agreement also contained the usual provision for the *mudarib*'s liquidation of the *mudaraba* assets prior to the redemption date, 31 October 2017. However, it further provided that the *mudarib* would not be entitled to liquidate the assets if the proceeds were then less than the required redemption amount, which was in effect the capital plus a fixed profit. Failure to liquidate the assets in itself constituted a "*Mudaraba* event".

If the investment was profitable, all the capital and profit would be returned and

distributed under the *Mudaraba* Agreement, without reference to any other agreement.

THE PURCHASE AGREEMENT

Under the Purchase Agreement, which was governed by English law, Dana Gas "in its corporate capacity" and not as *mudarib*, gave an undertaking (the Undertaking) to purchase on notice all of the *mudaraba* assets from the Trustee in specified circumstances. Those included a "dissolution event", which included an "event of default" or a "*Mudaraba* event", constituted by a failure to liquidate the *mudaraba* assets where the value of those assets was insufficient to repay the Trustee its capital and fixed return.

The Trustee could require either settlement of the agreed redemption amount, being in effect the capital and agreed profit amounts, regardless of the value of the *mudaraba* assets, or "physical settlement" by the delivery of certain shares. The effect of that purchase would be to return the capital and agreed profit to the Trustee as *rab al-mal*.

The "events of default" were defined to include "repudiation" and "illegality". "Repudiation" included any challenge to the validity or enforceability of any part of the Agreements. "Illegality" included it becoming unlawful for Dana Gas, as *mudarib* or in any other capacity, to perform or comply with any obligation under the Agreements.

Dana Gas further provided extensive security for its payment obligations in both real property and shares in subsidiaries, valued at around the amount of the *mudaraba* capital.

THE SALE AGREEMENT

If the Undertaking of Dana Gas under the Purchase Agreement should be triggered, Dana Gas was required, "promptly following" financial or physical settlement, to execute a Sale Agreement with the Trustee for the transfer of the *mudaraba* assets. That agreement was to be in a form scheduled to the Purchase Agreement and would be governed by UAE law.

SHARI'A NON-COMPLIANCE

It is axiomatic in IF that a financier cannot invest without taking investment risk, in contrast with conventional finance in which a lender, entitled to interest in an agreed amount, may assume only credit risk. Indeed, in a *mudaraba*, the *rab al-mal* takes all of the financial risk, and the *mudarib* is financially liable for loss only when it results from his own fault: *Visser on Islamic Finance*, 2013, p 63: *Morrison on the Law of Sukuk*, 2017, para A2-032; Al-Zuhayli, *Financial Transactions in Islamic Jurisprudence*, translated by M A El-Gamal, 2nd edn, 2007, paras 30.2.3 to 30.2.4.

If the *mudaraba* is successful, the profits can be determined only at the end of the term and after payment of the outstanding liabilities. There can be interim instalments distributed, but these can only be on account of the final distribution. Any fixed distributions of "profit" would be akin to interest or usury, forbidden under Shari'a.

Similarly, the *rab al-mal* cannot pass its financial risk to the *mudarib* by requiring security, save for losses occurring by reason of the entrepreneur's own negligence or fault.

In this case, there was no compliance issue if the investments went well and produced profit in excess of that anticipated for distribution in the agreed proportions. However, where the investments produced insufficient profit or even losses, the effect of the Agreements was to make Dana Gas, as *mudarib*, guarantor for any shortfall in profit or loss of capital.

There was no provision that the interim profit distributions should be on account. Where the Trustee required the purchase of the *mudaraba* assets under the Purchase Agreement, the fixed nature of the price gave Dana Gas an effective guarantee and removed *any* financial risk from the Trustee. The addition of security further excluded any risk at all.

UAE LAW ISSUE

The UAE Law of Civil Transactions (the Civil Code) promulgated under Federal Law No. 5 of 1985 draws not only on the modern Egyptian Civil Code of Abd al-Razzaq al-Sanhouri but also on the Shari'a. The relevant Shari'a principles are those codified in the Ottoman Empire in the 19th century as *al-Majalla* and later summarised in the Commentary on the Civil Code of the UAE Ministry of Justice (the Commentary): *Whelan* [3-0406] to [3-0440].

Part 3 of Book 2 of the Civil Code includes Section 2(3), which deals with the *mudaraba* in Arts 693 to 709 in accordance with Shari'a principles. The *mudarib* may not guarantee the capital, save where loss arises by his fault (Art 696). The *rab al-mal* shall bear all loss, and any contrary provision is void, and the *mudarib* shall not bear any final loss (Art 704).

Further, the core provisions of UAE Contract law, in Part 1 of Book 1 of the Civil Code, provide that a contract is void if contrary to public order or morals: Arts 203 to 207: *Whelan* [2-0172] to [2-0181]. UAE public policy may require that IF agreements written under UAE law should be Shari'a compliant.

Any party to such a contract may rely on the voidness of that contract or a judge may so rule of his own motion: Art 210: Whelan [2-0187]. The Commentary confirms that a void contract has no existence save in form, and cannot be ratified: *Whelan* [2-0188].

STRUCTURED *MUDARABA*

The Agreements were no doubt structured in the knowledge of the obvious risk of challenge to their validity as a matter of Shari'a principles, UAE public policy and UAE law.

It seems likely that the Purchase Agreement, by which the *mudarib* provides his effective guarantee, was put in a separate agreement, governed by English law, precisely to take the Undertaking out of UAE law. It might be seen as a fire-break under English law between the *Mudaraba* Agreement with most of the provisions relating to the effective guarantee and the Sale Agreement by which the *mudarib* gives effect to that guarantee.

MULTI-JURISDICTION APPROACH

Dana Gas brought proceedings against the Trustee, the Delegate and certain related entities in various jurisdictions.

In the Sharjah Courts in the UAE, Dana Gas sought an order for the voidance of all of the Agreements and related security, an expert accounting of all sums paid and

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payable by Dana Gas to the Trustee and the sale of the *mudaraba* assets. It obtained an interim injunction to prevent the Trustee from taking relevant action in any jurisdiction.

In the BVI, it sought and obtained an interim injunction against a BVI subsidiary of Dana Gas effecting or registering any change in its shareholding pursuant to the exercise of any security over the shares in that subsidiary.

In England, it claimed declarations that the Undertaking under the Purchase Agreement was unenforceable because its performance in the UAE would be unlawful under UAE law, or the related obligations were void and unenforceable for mistake and were frustrated.

THE INTERIM INJUNCTION

Dana Gas sought an interim injunction in the Commercial Court to restrain the Trustee from giving notice of relevant events or from exercising any right under the Undertaking.

The injunction was first granted without notice. Dana Gas then argued for the continuation of the injunction on its primary ground that performance of the purchase obligations would be unlawful under UAE law, engaging the "*Ralli* principle" that a contract is unenforceable for illegality where performance would be unlawful in the place of performance.

As anticipated, the Trustee relied on the structure of the Agreements, and the distinction between the Purchase Agreement, under English law, and the Sale Agreement, under UAE law. The Purchase Agreement contained only an obligation to pay the fixed price for the *mudaraba* assets and an obligation to execute the Sale Agreement, neither of which was required to be in the UAE. The obligation to implement the Sale Agreement, in the UAE, arose under that agreement and not under the Purchase Agreement.

The Judge, however, rejected that distinction. He found it seriously arguable that the two agreements were parts of one process, with the price paid under the Purchase Agreement and the assets transferred under the Sale Agreement. It was the contractual occurrence of both that produced the effective guarantee for the certificate holders [56].

Once the Judge had so found, it followed that the performance of the Purchase Agreement included both the execution and implementation of the process. Given that Dana Gas was based in the UAE and that its Board would take and implement its relevant decisions in the UAE, he declined to take "too narrow a view" of performance so as to exclude any activity in the UAE [60]–[62]. There was therefore a serious issue of illegality on the *Ralli* principle [63].

The Judge further accepted that it was seriously arguable that the parties had made the Agreements under an operative mistake. They had assumed that the *Mudaraba* Agreement was lawful and enforceable under UAE law and that the purchase obligations could be lawfully performed. That assumption was fundamentally mistaken [69]–[70]. Dana Gas might even be required to pay for the return of those assets but receive no assets [67]–[68]. Performance was essentially different from that contemplated by the parties, and the Undertaking and purchase obligations accordingly void [69].

The Delegate's response was that Dana Gas had undertaken the risk that it might not be able to perform its obligations. The purchase obligations would be triggered even if, or indeed *because*, Dana Gas challenged the lawfulness of the Agreements. Dana Gas took the risk of then being required to pay for, but not receiving, the *mudaraba* assets.

The Judge rejected that argument because he did not accept that the obligations could be "sliced up" as argued by the Delegate so as to provide that the Trustee would be entirely protected from financial risk but still left holding on to the *mudaraba* assets [74]–[76].

CONCLUSIONS

This is a case of a *mudaraba* which raises serious issues of Shari'a compliance. The *rab al-mal* did not take *all* of the financial risk. Indeed it sought, by the *mudarib*'s Undertaking and the purchase obligations, to avoid taking *any* financial risk, and by taking a comprehensive security package, to avoid taking any risk *at all*.

It appears that those structuring and drafting the Agreements sought to mitigate the obvious Shari'a compliance risk by containing the potentially SNC and unlawful obligations in a discrete agreement written under English law to undermine any argument of illegality. As for performance of the purchase obligations, these could be settled by a number of ways at the option of the Trustee, so as to undermine any argument that the settlement would necessarily be contrary to the law of the place of performance.

The Commercial Court, however, took a robust approach on an interim basis in refusing to "slice up" the various obligations under the Agreements. It took a broad approach as to what is likely to be involved, and where, in the performance of the purchase obligations.

The Judge further listed the case for trial on an expedited basis before the end of October and therefore before both the expiry of the investment period under the *mudaraba* and before the Sharjah Courts are likely to rule on the issues of UAE law.

As in *Blom Bank*, the English courts have shown a willingness to engage with issues of compliance with Shari'a principles, albeit as codified in UAE law, in considering the validity of a contract under English law. In the short term, there is a risk that English law and courts become less attractive to IF parties, but in the longer term, there may be greater confidence in the integrity of IF contracts written under English law. ■

Further Reading:

- The application of Islamic finance principles under English and DIFC law [2014] 9 JIBFL 573.
- Shari'ah principles of liability for fraudulent misstatements in a prospectus [2016] 10 JIBFL 600.
- LexisPSL: Banking & Finance: examining the anatomy of Mudaraba Islamic financing.