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BRIEFING

ENFORCING COMPLEX ISLAMIC FINANCING ARRANGEMENTS UNDER ENGLISH LAW

FEBRUARY 2018

- ENGLISH HIGH COURT HOLDS THAT A POTENTIALLY NON-SHARI'A COMPLIANT FINANCING ARRANGEMENT STILL ENFORCEABLE AS A MATTER OF ENGLISH LAW REGARDLESS OF ANY SUCH NON-COMPLIANCE
- ENGLISH COURTS WILL DETERMINE QUESTIONS ABOUT WHETHER A CONTRACT IS ENFORCEABLE BY APPLYING GOVERNING LAW OF CONTRACT

Shari'a law compliant financing arrangements have become an increasingly significant part of the global financial landscape, allowing Islamic customers to access sources of finance which comply with their religious requirements but which also attract participants from the "traditional" interest-based banking world.

"SHARI'A LAW COMPLIANT FINANCING ARRANGEMENTS HAVE BECOME AN INCREASINGLY SIGNIFICANT PART OF THE GLOBAL FINANCIAL LANDSCAPE."

It is common place in large-ticket, multinational transactions wishing to attract non-Islamic as well as Islamic investors, for such arrangements to be documented primarily under English law. English law is highly developed and being based largely on a long-established system of binding precedent, provides relative certainty of outcome to investors, in the event of disputes. However, the interaction between the English law, any relevant local law, and the Shari'a elements of a transaction can be complex. In particular, there can be difficulties where the transaction proves not to be, or is claimed not to be, Shari'a compliant and/or contrary to local law, and therefore certain parties are unable to continue to participate in the transaction and/or assert that to be the case.

In the case of *Dana Gas PJSC v Dana Gas Sukuk Limited and Ors*[1] the English High Court was asked to consider just such a situation. The conclusions reached by Mr Justice Leggatt give useful guidance as to how the English courts will approach such matters, and will be viewed with interest by those involved in Islamic financing.

[1] [2017] EWHC 2928 (Comm)

The Transaction

In 2007 Dana Gas PJSC ("Dana Gas"), a publicly listed company incorporated in the United Arab Emirates ("UAE"), raised US$1bn of financing through the issue of various sukuk certificates (often referred to, somewhat erroneously, as "Islamic bonds"). This transaction was restructured in 2013, when new certificates with a face value of US$850,080,000 and due for redemption in October 2017 were issued.

"A MUDARABAH AGREEMENT IS AN AGREEMENT … WHICH IS INTENDED TO ALLOW FUNDS TO BE INVESTED BY ONE PARTY ON BEHALF OF OTHERS, IN A SHARI'A LAW COMPLIANT MANNER."

The proceeds of the new certificates (the "Mudarabah Assets") were transferred to Dana Gas Sukuk Limited (the "Trustee") to be invested on behalf of the investors under a Mudarabah agreement governed by UAE law, entered into between the Trustee and Dana Gas (as the general or managing partner). A Mudarabah agreement is an agreement – essentially a form of partnership agreement - which is intended to allow funds to be invested by one party on behalf of others, in a Shari'a law compliant manner, as Shari'a law prohibits many elements of traditional western financing, such as the payment of interest. The expectation was that the investment of the Mudarabah Assets would yield sufficient returns to fund the payments due under the certificates, with any excess to be held in a reserve account. If, when the certificates expired or were otherwise redeemed in full, there were any funds remaining in the reserve account, this surplus would be retained by Dana Gas, much like the "carried interest" in a partnership.

Alongside the Mudarabah agreement, Dana Gas also entered into an English law purchase undertaking with the Trustee. Under the purchase undertaking Dana Gas undertook to [re]purchase the Mudarabah Assets from the Trustee for a defined price (the "Exercise Price") if required to do so by the Trustee. The Trustee was entitled to serve notice requiring Dana Gas to [re]purchase in various circumstances, including where "it is or will become unlawful for either the Obligor or the [Trustee] to perform or comply with any or all of its obligations under the Transaction Documents". The controversy relating to using "purchase undertakings" in Shari'a compliant transactions goes back to 2008 when a leading Islamic scholar, Sh. Taqi Usmani, declared their use to be incompatible with the Shari'a – or at least structures based on partnership models – on the basis they do (or at least, arguably may) provide a "guarantee" of [re-]payment and hence, the key element of risk sharing by investors, was absent. This is particularly so, where the Exercise Price is simply equal to the entire face amount then due in respect of the certificates, rather than the market price of the relevant assets to be purchased.

Before entering into the transaction, Dana Gas obtained legal opinions confirming that the structure and the documents complied with UAE and English law and would constitute its binding obligations, and further, a fatwa was obtained to the effect that the structure was also Shari'a compliant.

The Dispute

In June 2017, Dana Gas announced that "due to the evolution and continual development of Islamic financial instruments and their interpretation" it had been advised that the transaction "is not Shari'a compliant and is therefore unlawful under UAE law" and commenced proceedings in the UAE and England.

In the English proceedings Dana Gas sought declarations that the purchase undertaking was unenforceable on the basis that the transaction was unlawful, invalid, or could not lawfully be performed in the UAE, either in full or in part. The question of the lawfulness of the transaction as a matter of UAE law was disputed,

and remains the subject of the UAE proceedings. However, after various procedural delays and issues, it was agreed that the English proceedings could be heard on the assumption that the transaction was unlawful as a matter of UAE law.

Dana Gas argued that the purchase undertaking was unenforceable under English law on the following grounds:

1. The obligation for Dana Gas to repurchase the Mudarabah Assets was conditional on the Trustee being able lawfully to transfer the Mudarabah Assets to Dana Gas under UAE law, which it could not do (the "Construction Argument");
2. The purchase undertaking was void for mistake because it was entered into by the parties on the basis of mistaken common assumption(s) that:
   a. The Mudarabah agreement was lawful and enforceable under UAE law; and/or
   b. Any sale agreement entered in to under the purchase undertaking would be valid under UAE law; and/or
   c. The Trustee had rights, benefits and entitlements in relation to the Mudarabah Assets which could be transferred under a sale agreement (the "Mistake Argument"); and
3. As a matter of English public policy the English courts will not enforce an agreement where to do so would require performance of an act which would be unlawful in another country (the "Public Policy Argument").

"THE HIGH COURT REJECTED ALL OF DANA GAS' ARGUMENTS, HOLDING THAT THE PROVISIONS OF THE PURCHASE UNDERTAKING WERE ENFORCEABLE AS A MATTER OF ENGLISH LAW, WHETHER OR NOT THE TRANSACTION WAS LAWFUL UNDER UAE LAW."

The Decision

The High Court rejected all of Dana Gas' arguments, holding that the provisions of the purchase undertaking were enforceable as a matter of English law, whether or not the transaction was lawful under UAE law.

Mr Justice Leggatt commented that "in general, questions about whether a contract is valid and enforceable are decided in the English courts by applying the law which governs the contract". As the purchase undertaking was expressed to be governed by English law, the law to be applied when determining whether the purchase undertaking was enforceable was English law, not UAE law.

The judge went on to hold that, since "it is perfectly lawful in English law to guarantee the return from an investment and to pay and receive compensation for the use of money", the prima facie position is that "the purchase undertaking is a valid and enforceable contract whatever view would be taken of its validity and enforceability if UAE law were applicable."

He therefore considered the merits of the Construction, Mistake and Public Policy arguments as a matter of English law.

The Construction Argument

The Construction Argument was dismissed by Mr Justice Leggatt in short order.

He held that, even if the required sale agreement would be unlawful as a matter of UAE law, which was disputed in any event, the obligation on Dana Gas to pay the Exercise Price to the Trustee was separate to, and not contingent upon, the Trustee transferring the Mudarabah Assets to Dana Gas. Therefore the fact that it might be unlawful for the Trustee to transfer the Mudarabah Assets to Dana Gas upon receipt of the Exercise Price did not render the obligation on Dana Gas to pay the Exercise

Price unenforceable. Interestingly, even under Shari'a principles, a purchase undertaking is regarded as a "wa'ad" – a unilateral promise which can be given independently of another contract and which also does not require consideration to flow to the promisor.

The judge went on to say that, contrary to Dana Gas' submissions, the purchase undertaking was clearly intended to protect the certificate holders from the risk that the Mudarabah transactions were invalid. Accordingly the circumstances at hand were specifically catered for, and it was clearly intended that the purchase undertaking should be enforceable in such circumstances.

The Mistake Argument

With regard to the Mistake Argument, Mr Justice Leggatt acknowledged that English law will, in certain circumstances, treat a contract as void as a result of a mistaken assumption on the part of the parties.

However, he emphasised that such circumstances are "wholly exceptional". Mr Justice Leggatt stated that this principle "can only apply if there is a gap in the contract" regarding "what is to happen if [the parties] turn out to have been mistaken about the matter in question". In other words, the risk that the assumption is wrong must not have been allocated under the contract. Further, even where there is such a gap, the mistake in question must be "sufficiently fundamental" as to render performance impossible or "the subject-matter of the contract essentially and radically different from… [that] which the parties believed to exist".

Mr Justice Leggatt held that, in respect of each of the assumptions identified by Dana Gas, the risk that they were mistaken was expressly allocated by the purchase undertaking. In particular, the judge held that the risk that the assumption that the Mudarabah agreement was valid and enforceable under UAE law was incorrect was expressly allocated to Dana Gas under the purchase undertaking because, as set out above, it entitled the Trustee to require Dana Gas to pay the Exercise Price in such circumstances. Accordingly the purchase undertaking would not be void if the assumptions proved to be mistaken.

The Public Policy Argument

Turning to the Public Policy Argument, Mr Justice Leggatt reiterated the general positon that:

"…the validity and enforceability of a contract governed by English law is not generally affected by considerations of whether the contract would be regarded as valid or whether its performance would or would not be lawful under the law of another country".

"THE PURCHASE AGREEMENT DID NOT REQUIRE THE PARTIES TO PERFORM ANY OBLIGATIONS IN A JURISDICTION IN WHICH IT WOULD BE UNLAWFUL TO DO SO."

He acknowledged that there is an exception to this rule where performance would be unlawful in the place of performance (i.e. if the contract is to be performed in a jurisdiction in which that performance would be unlawful). However, Mr Justice Leggatt did not accept that this was the case in relation to the purchase undertaking.

Mr Justice Leggatt held that the Purchase Agreement did not require the parties to perform any obligations in a jurisdiction in which it would be unlawful to do so. In regard to Dana Gas' obligation to pay the Exercise Price, this was to be performed by payment into an account held by the Trustee with Deutsche Bank in London. The

jurisdiction for performance of the obligation was therefore England, where performance would be lawful.

Addressing Dana Gas' argument that, as a matter of public policy, the English courts will not enforce a contract entered into for a purpose which is unlawful under the law of a friendly state, he held that this principle only applies where the object and intention of the contract is the performance of an act that is illegal in a friendly foreign country, in that friendly foreign country. It does not apply where the act is to be performed in a separate jurisdiction where it is lawful for it to be performed.

In this case Mr Justice Leggatt held that "there is nothing to indicate that the purchase undertaking has as its object and intention the doing of anything in the UAE which is alleged by Dana Gas to be unlawful under the laws of the UAE". Accordingly, the public policy principle was not engaged, and the court was free to enforce the purchase undertaking.

Conclusion

The decision in *Dana Gas* gives valuable guidance on how the English courts address the interaction between English law and the laws of other jurisdictions in the context of complex, multinational transactions such as Islamic financing arrangements. It also gives helpful clarity on the effect of mistakes in English law, and emphasises the courts' desire to uphold allocations of the risk of such mistakes agreed by the parties.

The decision is a helpful reminder of the complex issues that can arise in such transactions, the difficulties in utilising different legal systems with divergent underlying principles in the same transaction, and the importance of the careful allocation of risks as a result.

"THE DECISION IN *DANA GAS* GIVES VALUABLE GUIDANCE ON HOW THE ENGLISH COURTS ADDRESS THE INTERACTION BETWEEN ENGLISH LAW AND THE LAWS OF OTHER JURISDICTIONS IN THE CONTEXT OF COMPLEX, MULTINATIONAL TRANSACTIONS SUCH AS ISLAMIC FINANCING ARRANGEMENTS."

FOR MORE INFORMATION

Should you like to discuss any of the matters raised in this Briefing, please speak with one of the authors below or your regular contact at Watson Farley & Williams.

ANDREW SAVAGE
Partner
London

+44 20 7814 8217
asavage@wfw.com

NEALE DOWNES
Partner
Dubai

+971 4 278 2322
ndownes@wfw.com

NICK PAYNE
Senior Associate
London

+44 20 3036 9806
npayne@wfw.com

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