

Islamic Finance Update

The Dana Gas Case: Sanctity of English Law Contract Upheld, Notwithstanding Claims of Shari'ah Non-compliance

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Finance

Speed Read

This article looks at the recent English High Court decision in *Dana Gas PJSC v Dana Gas Sukuk Ltd & Ors* [2017] EWHC 2928.

Participants in the Middle East (and wider) Islamic finance markets held their breath during much of this year pending consideration by the High Court of the core issue of whether non-compliance with Shari'ah principles (the principles which sit behind the structure of an Islamic financing) and unenforceability as a matter of the law of the purported place of enforcement of English law governed contractual payment obligations (in this case, the United Arab Emirates (the "UAE")) would (or should) have any bearing on the enforceability of such obligations, as claimed by the issuer of a sukuk (an Islamic finance bond). There was an audible sigh of relief when the High Court upheld the sanctity of English law governed contractual obligations, irrespective of these claims.

The decision has not created any new English law precedent. However, it provides welcome clarity on the issues contemplated, for the purposes of sukuk and Islamic finance transactions generally. For many years, Islamic finance products entered into by Middle East-based entities have commonly governed certain documents containing payment obligations by English law. This was because of the perceived greater certainty of their enforceability, in light of nervousness from creditors about local laws. It is this general principle of enforceability that the High Court upheld and, in doing so, widespread uncertainty about the enforceability of a multitude of Islamic financings in place across the Middle East market has been seemingly abated. A different decision from the High Court could not only have had implications for creditor confidence in the Islamic finance market going forward, but also could have opened the floodgates for issuers to use the argument that their existing Islamic financings are not Shari'ah-compliant as a precursor to force creditors into financial restructurings on more advantageous terms.

It should be noted that the implications of the claims underpinning this case may still continue, as the sukuk issuer has announced that it will appeal the High Court judgment and the decision of the courts of the Emirate of Sharjah (in the UAE, the sukuk issuer's jurisdiction of incorporation) on whether the sukuk is enforceable as a matter of UAE law (which will have separate, although related, potential ramifications), is still pending.

Background: Shari'ah and the Laws of the United Arab Emirates

Shari'ah is derived from a number of sources, including the Quran, and is a non-codified body of law underpinning Islam generally and Islamic finance as a product. Because it is not a codified body of law, it is capable of development and subjective interpretation. In order to be considered Shari'ah-compliant an Islamic finance structure typically receives an opinion (*fatwa*) from a religious scholar (*mufti*) or recognised Shari'ah adviser. The capacity for subjective interpretation of Shari'ah means that the opinions of the specialist scholars and advisors on issues may vary, not least depending on which of the five Islamic schools of law (*madhabs*) that they belong to.

Shari'ah is one of the sources of UAE law, alongside the UAE's civil law statutory legal system. Because of its subjective and non-codified nature, the UAE courts have rarely relied on Shari'ah as a basis for determining cases involving commercial transactions. The UAE courts have, instead, relied on the published laws and decrees as primary sources of law. However, it is certainly possible that, if a UAE court decided to apply Shari'ah in respect of its interpretation of the enforceability of a document, such court could reach a different interpretation than it might otherwise, if it determined that such document did not comply with Shari'ah.

As a general note, in line with other law firms involved in the documentation of Islamic finance structures, we do not, and are not competent to, express any opinion on Shari'ah generally or more specifically as to whether any document, or the transactions contemplated therein, comply (or otherwise) with the teachings of Islam or Shari'ah.

Background: Islamic Finance Structures

The term "Islamic finance" refers to the network of financial institutions and commercial financing activities that conform to Shari'ah.

The following are the key prohibitions under Shari'ah, that are the key principles guiding Islamic finance structures:

- prohibition on usury or charging of interest (*riba*), with returns required to be based on sharing profit and loss;
- prohibition on uncertainty (*gharar*);
- prohibition on speculation (*maysir*); and
- prohibition on the use of or dealing with impermissible (*harem*) activities or commodities (such as alcohol).

For those familiar with Islamic finance transactions and structures, please read on. However, for readers wishing to gain a greater understanding of the basic concepts of Islamic finance and some of the most commonly used structures in Islamic finance, please see our accompanying note on [Common Islamic Finance Structures](#).

Background: The Case

Earlier this year, Dana Gas PJSC (“**Dana Gas**”), an Abu Dhabi Stock Exchange listed energy company, sent shockwaves through the Islamic finance markets when it announced the following (shortly after commencement of restructuring negotiations with investors in its sukuk, which was due for redemption at the end of October 2017):

“Due to the evolution and continual development of Islamic financial instruments and their interpretation, [it had] received legal advice that the Sukuk in its present form is not Shari’ah-compliant and is therefore unlawful under UAE law...”

Following this announcement, Dana Gas commenced legal proceedings in the English courts (together with separate actions in the courts of other jurisdictions, including in the courts of the Emirate of Sharjah).

Dana Gas alleged that:

- in light of changes in prevailing market practice in the Islamic finance market in the Middle East, its sukuk was no longer Shari’ah-compliant;
- therefore, the obligations it had entered into under the sukuk documentation were invalid and unenforceable under UAE law (where one of the pillars of the legal system is Shari’ah); and
- given such unlawfulness as a matter of UAE law, the English law governed purchase undertaking used in the sukuk structure (the “**Purchase Undertaking**”), which included Dana Gas’ core redemption payment obligation in the sukuk structure, was unenforceable as a matter of English law.

This latter claim, the focus of the case before the High Court, was based on Dana Gas’ position that:

- on a proper interpretation of the Purchase Undertaking, the obligation to pay was conditional upon a lawful transfer of assets under separate UAE law governed documents within the structure (which would not have taken place if the structure was unenforceable as a matter of UAE law);
- the Purchase Undertaking was void for mistake (on the basis that its obligations were based on an underlying transaction structure that was unenforceable); and
- the Purchase Undertaking was unenforceable on the grounds of English public policy.

On November 17, 2017, the High Court ruled against Dana Gas on all grounds. It should be noted that the High Court ruled on the case in the absence of Dana Gas and several of the leading sukuk creditor parties, as they were prevented from attending as a result of an anti-suit injunction granted by the courts of the Emirate of Sharjah.

Purely for the purposes of assessing arguments as to enforceability under English law, rather than as a finding in fact or law, the High Court assumed that Dana Gas’ argument was correct that the documents within the sukuk structure which are governed by UAE law were unenforceable as matter of UAE law.

Below, we touch on the areas of English law jurisprudence of most interest arising out of this High Court ruling, together with flagging some considerations for the drafting of Islamic finance documentation going forward.

The Judgment: Contractual Construction

The first argument presented by Dana Gas was that its obligation to pay the exercise price under the Purchase Undertaking was conditional upon the parties being able lawfully to transfer certain rights to assets to Dana Gas under a separate UAE law governed document (assumed by the High Court to be unenforceable under UAE law, as noted above). Dana Gas argued that if there was no valid transfer of assets (because the document which purported to effect the transfer was unenforceable as a matter of local law) no obligation to pay the exercise price could arise. The High Court ruled that, as drafted, the payment of the exercise price under the Purchase Undertaking was not conditional upon the transfer of assets under the UAE law governed documents and the exercise and the transfer were intended to be consecutive, rather than concurrent actions.

The High Court went on to state that, in its view, the Purchase Undertaking had not been structured in this way by accident and rather that it plainly reflected the intention of the parties.

The Judgment: Mistake

The second argument presented by Dana Gas was that the Purchase Undertaking was void for mistake, because the parties entered into it on the mistaken assumption that other linked documents within the structure were enforceable under UAE law.

The High Court ruling on this argument was based on the principle that the application of the doctrine of mistake was not dependent on the subjective views of the individual parties, but rather on an objective analysis of what those parties had previously contractually agreed (and, conversely, whether there was anything not expressly contractually agreed). If there was contractual agreement as to what would happen if a certain event occurred, then there would be no gap in the contractual framework and the doctrine of mistake could not apply. In the case at hand, the Purchase Undertaking included events of default for both “repudiation” and “illegality” where the consequences of these events triggered a requirement to pay the exercise price under the Purchase Undertaking.

The High Court concluded that, because the parties had expressly agreed at the outset that the risk of occurrence of these events lay with Dana Gas, the unenforceability of the UAE law governed documents within the structure, and any defect in title to the underlying assets, were not grounds for mistake under English law.

The Judgment: Conflicts of Law and Public Policy

Applying:

- the above-referenced underlying assumption that the documents within the sukuk structure which are governed by UAE law were unenforceable as matter of UAE law; and
- article 10(1) of the Rome I Regulation (Regulation No. 593/2008),

the position taken by the High Court was that, in general, English courts would apply the law which governs a contract when deciding on questions of validity and enforceability. As a result, the High Court would not enforce any contracts within the sukuk structure that were governed by UAE law.

However, applying the same principle, English law would determine whether or not the Purchase Undertaking was enforceable, as it was governed by English law.

The general principle (as established in the case of *Kleinwort, Sons & Co v Ungarische Baumwolle Industrie AG* [1939] 2 KB 678), the validity and enforceability of an English law governed contract is not generally affected by considerations of whether the contract would be regarded as valid, or whether its performance would be lawful under the laws of another country.

However, there are exceptions to this general principle. Dana Gas' final argument was that, as all of the obligations under the Purchase Undertaking had to be performed by Dana Gas in the UAE, the High Court was required to take into account whether or not the Purchase Undertaking was enforceable in the UAE. Underpinning this argument was Article 9(3) of the Rome I Regulation, which states that, "*effect may be given to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be or have been performed, in so far as those overriding mandatory provisions render the performance of the contract unlawful...*".

The High Court ruled against Dana Gas' argument on the basis that, under the sukuk structure, the transaction account from which payments were to be made was maintained in London. This meant that the place of performance of the payment obligations under the Purchase Undertaking was England. In light of this, the High Court ruled that Article 9(3) was not applicable and it did not need to take into consideration any overriding mandatory provisions of UAE law when ruling on the enforceability of the Purchase Undertaking as a matter of English law.

Practical Considerations for Future Transactions

We set out below some practical considerations for practitioners to bear in mind for documenting future Islamic finance transactions, with the object of seeking to safeguard against arguments of Shari'ah non-compliance:

- include a representation in the documentation from the obligor that the documentation is Shari'ah compliant and lawful and an undertaking from the obligor that it will not seek to challenge the Shari'ah compliant nature of the documentation;
- include the obligor's payment obligations in a separate document, governed by English or (where you have a UAE obligor) DIFC law;
- where possible have the payment obligation payable from an account located in England (or the DIFC) or otherwise owed to a person located in England (or the DIFC), so that the payment is found to be in England (or the DIFC);
- have the payment conditional only on the service of a notice by the obligee (not i.e. the transfer of any underlying assets); and
- clearly allocate the risk of invalidity, illegality and repudiation of the documentation to the obligor, so that occurrence of any such event triggers the obligor's payment obligation.

Meet the Team

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