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Legal Implications of Sukuk and “Shari’a Non-Compliance” under German Law

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Overview

- I. Introduction
- II. The legal structure of Sukuk under German Law
- III. “Shari’a-Risk” and Prospectus liability



Legal structure of Sukuk under German Law

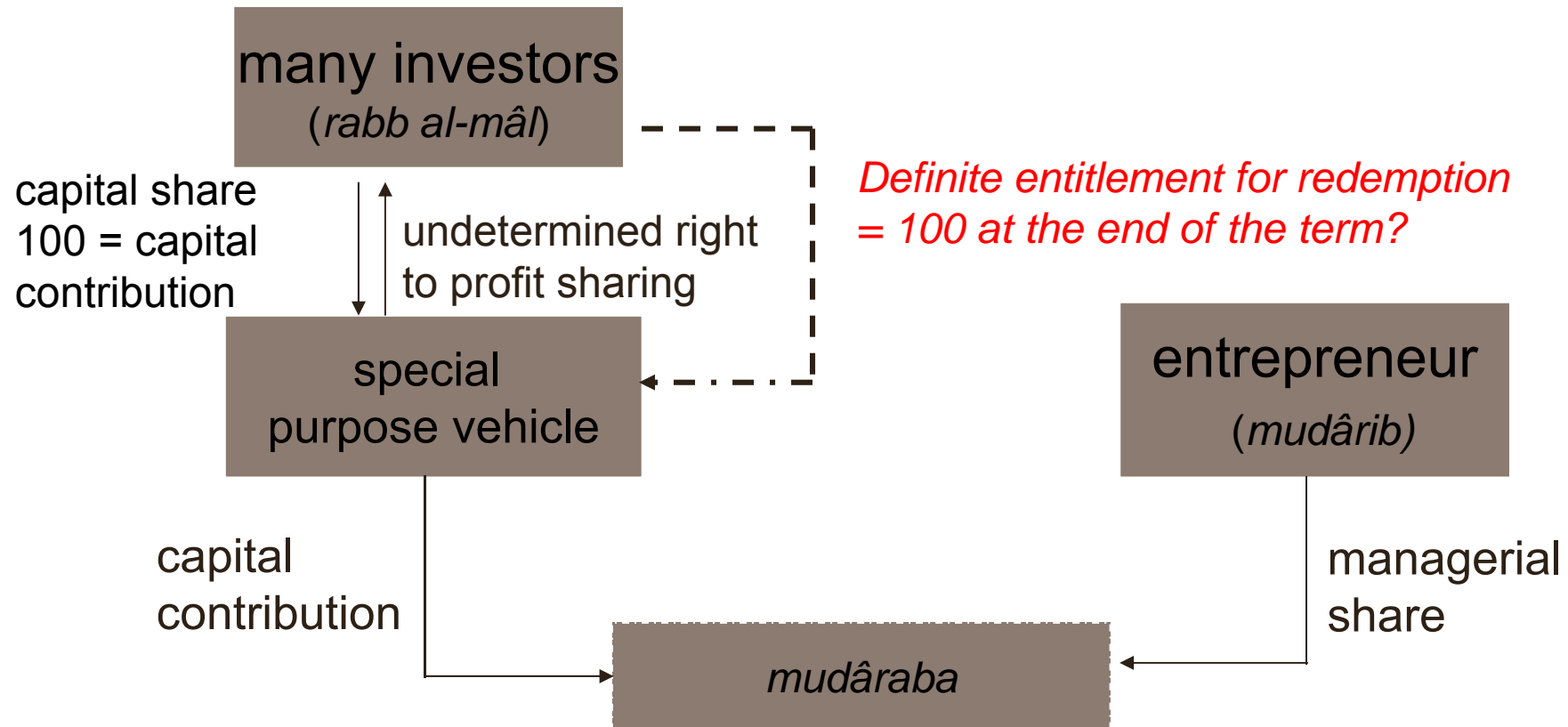
- (1) Sukuk-al-mudarabaha:
 - Issuing a Sukuk is exempt from regulatory authorization, SPV does not need a Banking-License
 - But Sukuk transaction can be an atypical loan when the investor receives interest-like profits at certain fixed dates
- (2) Sukuk-al-ijara:
 - Sale and lease back – but if there is no “true-sale”, the contract might be re-characterized as a loan



“The Risk of Shari’a-Non-Compliance“

- Example: In 2007, Sheikh Taqi Usmani declared that some Sukuk types were not in line with Shari’a principles. Subsequently, AAIOFI adapted and concretised its Shari’a standards.
 - This led to placement problems and difficulties in selling the Sukuk on the secondary market
- Shari’a compatibility is an “essential information” for the investor

The Shari'a-trap using the example of *Sukuk-al-mudârabâ*





Example Meridio Islamic Funds (Luxembourg)

- Offering circular Meridio Islamic Funds (2010) p. 10: “An independent Sharia Board and optional Sharia Advisor shall assess the Sharia-compliance of the Company ... “
- “It is assumed that investors and potential investors will obtain information independently and, based on statements by their own Sharia advisors or similar reliable sources, become convinced that the company or a subfund is not in violation of Sharia principles.”
- “There is ... a risk that the status of Sharia compliance may change over time. The Company assumes no liability with respect to such changes.”



“The Risk of Shari’a-Non-Compliance“

- Prospectus liability?
 - Yes, if the incompatibility with Shari’a principles is evident and foreseeable
 - Yes, if there is no information about the Shari’a-Compliance-System or Notice in the brochure mentioning common controversies concerning the issued Sukuk
 - No, if the opinion of the issuer on the Shari’a compatibility of the product is coherent with the view taken in one or more Islamic schools of law and proofed by a Shari’a Supervisory Board or a recognized organization



Conclusion

1. Sukuk can be structured under German law.
2. The issue of Sukuk certificates is exempt from regulatory authorization and supervision.
3. However, the underlying contractual agreements could be subject to regulatory authorization because of their classification as financial leasing or lending business.
4. Since there is no uniform interpretation of the Shari'a there is a risk that the Shari'a conformity of a product can be contested (Shari'a Risk).
5. It is not appropriate to shift the Risk of Shari'a-Non-Compliance entirely to the investors or the bank.
6. Prospectus liability is confined to extreme cases of obvious evasions of Shari'a principles or if there is no information about a Shari'a-Compliance-System.
7. An indemnification clause or disclaimer is acceptable as far as the classification by the Shari'a Board is a possible interpretation within the commonly accepted boundaries of Islamic law and if the investor gets the relevant information.