



Analysis of *Sukuk* Cross-Default Clause: A *Fiqh* Perspective

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Abstract

In recent time, there have been incessant *Sukuk* default cases which are posing a severe challenge to the growth of the nascent Islamic finance Industry. Institutions and principal officers in the industry are often concern about appropriate mechanisms that can protect the right and interest of the *Sukuk*-holders without violating *Shari'ah*-compliant risk. It is significant to note that there is a difference between *Sukuk* default and default event. *Sukuk* defaults happen when the obligor fails in fulfilling their financial obligations as indicated in the contractual agreement. Default event is various circumstances that can trigger *Sukuk* default. Default event can be in the form of credit risk and moral risk. Cross-default is an example of a default event that has attracted the attention of legal and *Shari'ah* scholars. Scholars and experts are considering the juristic status of cross-default mechanism that can be used to protect the right and interest of creditors by juxtaposing it with the principles of justice and equity in Islamic law. This paper aims to explore the legality and fairness of cross-default in Islamic jurisprudence. This study explains the concept of cross-default, how it works, review of what constitutes legality and morality of cross-default in Islamic legal theory. The study also employs the juristic analysis method to examine the opinions of contemporary scholars and expert of Islamic finance on the fairness of *Sukuk* cross-default.

Keywords: Cross-default, default *Sukuk*, contractual parties, Islamic jurisprudence.

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1. Introduction

Recent studies on legal and economic impacts of *Sukuk* investment show that default cases between contractual parties are happening in *Sukuk* market. A Creditor-Debtor relationship often leads to a disagreement due to default of promises or a failure to comply with required financial obligations (Ahmad Ali Yusuf Jaradat, 2006). Noticeably, there are two categories of creditors: (i) a group that imposes *riba* on debt; and (ii) another group that reject *riba* (interest/usury) on debt. The debtors tend to fulfil their obligation judiciously with those that impose interest. This happens due to their fear in facing the increase of the interest rate. Conversely, they often delay in paying their debts with those that reject interest (Gratzer, 1998). When there are no penalties, debtors seem more open in violating the creditors' rights by delaying payments or not paying them at all. Thus, those who do not take usury face troubles and difficulties when there is no *Shari'ah* compliance regulation and supervision (Oseni 2015).

The concept of cross-default (which is common in conventional practices) has been adopted in Islamic finance space to protect the interest of *Sukuk* investors and other stakeholders. In the cross-default practice, a clause is provided in the contractual agreement that automatically declares a debtor as a defaulter if he/she defaults in another loan (Misnen *et al.*, 2013).

The nature of cross-default depends on the contractual parties, although it has a similar mechanism of snowball effects. For instance, the contractual clause in a *Sukuk* investment may state that a downgrade in the rating of an obligor will trigger an automatic default in other financial obligation. Also, the said clause may stipulate that a default in a financial commitment (such as the settlement of credits or bank loans, bonds, and salaries of workers) can trigger an automatic default from the contractual agreement (Oseni, 2015).

Islamic finance and Islamic capital market have not made a serious connotation of *Sukuk* as an Islamic bond. It is pertinent to note that the term ‘Islamic bonds’ are a benchmark term used in relation to conventional practices of the bond. As such, the rating agencies tend to treat *Sukuk* similar with conventional bonds particularly in default situations (Oliver, 2017).

Although the issue of default in a debtor-creditor relationship has gotten a strong basis from the Islamic threshold; however, a cross-default remains a modern concept that is purely a *Muamalat* (Islamic transaction) issue and requires *ijtihad* (legal reasoning) whereby Muslim scholars have their rights to hold on to their different opinions. This study explores juristic positions mainly on the fairness of cross-default in Islamic financial transactions and *Sukuk* investment.

The study employs an analytical approach in accessing literature and secondary sources on the opinions of Muslim jurists from a *Fiqh* perspective. The researchers also consider the justification of fairness on the cross-default in Islamic jurisprudence and the argument of those that considered it unfair. The remaining parts of the study are discussed as follows: (i) the concept of default *Sukuk*; (ii) how cross-default works in *Sukuk* investments; (iii) legality and morality of *Sukuk* cross-default in Islamic jurisprudence; (iv) the discussion on cross-default clause, and lastly, (v) the conclusion.

2. The Concept of Default in *Sukuk*

The term default or ‘*takhallafa ‘an sadad*’ (Arabic term) means a failure to fulfil financial obligation either from a pool of expected profit or from the underlying asset (ISRA, 2010). ‘Default’ in Arabic term is ‘*Takhallafa*’ which derived from three letters ‘*kha, la, fa*’. It means ‘late, delay or come after’. It also refers to as ‘delay, to disagree over a term, or the inability to meet up with promises and agreement’ (Muhammad, 2005). Default also means ‘*Qaṣara*’ in Arabic language which indicates ‘to shorten a size or length of the volume of something, or a failure from financial obligation’ (Muhammad Rawas, 1985). It is also known as ‘*Taqṣir*’ (default) which shows ‘the state of experiencing financial shortfall and the failure to fulfil payment according to the law’ (Ahmad Mukhtar Umar, 2008).

It is fair to say that the term *Taqṣir* or *Takhallafa ‘an sadad* is referring to the same purpose in the financial sector. The basic distinction between a ‘default’ and an ‘insolvency’ is that a default is a general term used to indicate a failure to fulfil the obligation, while the insolvency is a specific term which means the debtor's inability to fulfil the debt obligation (Gratzer, 1998). Moreover, the default may show a general failure to pay a debt or fulfil financial obligation intentionally, while an insolvency is specifically showing the inability to repay because of a financial or an economic distress (Gratzer, 1998).

The concept of default (*taqṣir* or *takhallafa sadad*) has a basis under Islamic law. A default from a debt is considered under Islamic law as a concept which affects the personality of a debtor. For instance, the *hadith* about several companions who brought a corpse of a man to the Prophet (bless and peace be upon him) where he asked whether the deceased has any debt or not. The companions replied in affirmative. The Prophet (bless and peace be upon him) did not pray on the corpse; rather, he asked his companions to do so (Muhammad bin Ismail Al-Bukhari, 2002).

This *hadith* illustrates the significance of default relating to debts on the personality of a debtor. The debt is the right of creditor that hanging on the personality of the dead person. Ibn Hajar explicates the meaning of this *hadith* based on two others related *hadiths* of the Prophet (bless and peace be upon him). One of the related *hadith* shows that the Prophet (bless and peace be upon him) prayed on the corpse of a man whose debt was settled; and he (bless and peace be upon him) also prayed on the body of a man whose has a net-worth that shows he has nothing left to pay the debt.

Hence, this indicates that the Prophet (bless and peace be upon him) did not pray on the first person simply because he has some possession or money left behind to fulfil the debt and there is no evidence for his insolvency or inability to meet the obligation before his death (Ahmad bin Ali bin Hajar Al-Asqalani, 1986).

Similarly, the default from a promise is an act of violating Islamic ethical values. By doing so, the defaulter is violating a trust. This is as mentioned in the saying of the Prophet (bless and peace be upon him): “The signs of a hypocrite are three (even if he fasts and prays and claims to be a Muslim): when he speaks he lies, when he gives a promise he breaks it, and when he is trusted he is treacherous” (Muslim bin Hujaj, 2006).

This *hadith* emphasised on three main characteristics of a hypocrite: (i) the corruption of the speech happens when he lies when he speaks; (ii) the corruption of the intention happens when he breaks promises; and (iii) the corruption of the action happens when he betrays trust. Thus, when someone promises and intentionally defaults on the agreed terms, he analogously displays an act of hypocrisy. This is blameworthy in Islam (Al-Hafiz Zainuddin Abi Al-Faraj, 1996). The issue of a default on contractual promises in Islamic finance and *Sukuk* investment could be treated as a moral hazard to the entire Islamic finance industry (Ahmad Ali Yusuf Jaradat, 2006).

Oliver (2017) contends that default cases are common among conventional practices, although its occurrence in *Sukuk* investment is unexpected as it is presently posing a significant challenge to the future of the Islamic finance industry. The term default is an aftermath action arising from an event of failure to fulfil the contractual agreement between the involved parties. Some researchers have argued that the occurrence of default in Islamic finance is as a result of importing specific conventional structures into Islamic finance. Since Islamic finance is founded on Islamic philosophy of risk-sharing rather than risk transfer, importing non-*Shari'ah* structure into Islamic finance contracts and *Sukuk* structure could expose the market to a similar risk (Oliver, 2017).

Similarly, Nienhaus (2011) argued that the structuring of *Sukuk* is not a default-free. The concept of default from promises is a natural phenomenon in every human commercial transaction. The issue is usually left on the availability of a robust Islamic regulation to cater such default that arises between the contractual parties.

3. The Operation of Cross-Default Clause in *Sukuk*

‘Cross-default’ clause is a financial term which depicts the operation of a legal clause in a contract that a default by the *Sukuk* obligor under Agreement A will trigger an automatic default under Agreement B. It is a contractual clause mechanism that used to protect the interest and right of the creditor or *Sukuk*-holders in loans, debentures, bonds, derivatives, and *Sukuk* (Li and Lou, 2012). It is pertinent to clarify why cross-default clause emerged in *Sukuk* investment. *Sukuk* is an Islamic instrument which represents equal and undivided rights of ownership to an underlying asset (Beebee et al., 2017). Despite this standard definition of every *Sukuk* investment, *Sukuk* is still considered as an Islamic bond which has its benchmark on conventional bonds by using a coupon to represent its expected return. The cross-default clause is one of the prominent conventional instruments used as a clause in the contractual agreement. Such clause functions as an automatic trigger for a technical default on a financial obligation from one contract to another contract (Misnen et al., 2013).

For instance, the criteria of a rating agency on *Sukuk* investment, its obligor, and the performance of the business (such as the downgrade of rating) can be used as default events in triggering a cross-default clause. Thus, the role of rating agencies is very significant in the application of cross-default clause to protect the right of *Sukuk*-holders in default cases.

There are four common default events in the cross-default clauses. These cross-default events are: (i) the default event clause that is triggered by the declaration of insolvency, bankruptcy or reorganisation; (ii) the default event clause that is triggered by the failure to pay debt principal; (iii) the default event clause that is triggered by an inability to pay interest; and finally, (iv) the default event clause that is triggered by a violation of a covenant such as by using a *Shari'ah*-compliant issue to violate moral hazard. Such contractual clause is expected to consider the grace period for creditors to ensure fairness to the contractual party (Li and Lou, 2012).

The role of cross-default clause is not limited to the corporate offering. The sovereign or quasi-sovereign contracts may also refer to the cross-default clause if the said clause is included in the contractual agreement. For instance, the default of Saudi Arabia 1MDB that happened on the USD1.75bn 5.75% bond as issued in the year of 2012 by 1MDB Energy (Langat) Limited. The company has cross-defaulted in their financial obligation of USD50.3m interest payment that was due from the International Petroleum Investment Company (IPIC). The default of the Langat Notes consequently triggered other cross-defaults under 1MDB *Sukuk* MYR5bn 2039 and MYR2.4bn Bandar Malaysia Sdn Bhd (BMSB) *Sukuk* that are set to due on 2021 and 2024 respectively, which total up to MYR7.4bn (USD1.9bn) (Leslie, 2016).

The Langat's note default has the possibility of triggering material adverse effect clause on the MYR800m loan from the Social Security Organization (SOCISO) loan. Since the Langat's note issued is a sovereign *Sukuk*, the cross-default situation indicates the likelihood of the government assuming debt servicing obligations to 1MDB debt as given by explicit government guarantees on both 1MDB *Sukuk* and SOCISO loan (Leslie, 2016).

4. Legality and Fairness of Cross-Default Clause in Islamic Jurisprudence

The jurisprudential consideration on the cross-default clause is not challenging the effectiveness of the said clause mechanism in protecting the right and interest of *Sukuk*-holders and its legal enforceability before the court of law. Relatively, it is providing fairness and protection of rights of contractual parties without violating the rights of others. However, there are two essential opinions on this concept from a *Fiqh* perspective. There is an opinion that viewed the cross-default clause as a fair mechanism in its entire application, while the other opinion believes that the cross-default clause may be unfair if it is trampling upon the right of the obligor.

The first view opined that the cross-default clause is a *Muamalat* (Islamic transaction) clause that depends on *ijtihad* (legal reasoning). The *Sukuk*-holders have rights to protect their interests as long as it is agreed between the parties. It must be done without any duress. Alternatively, the parties must agree to its implication during the cause of structuring the *Sukuk* (Busari, 2019). Such a situation is similar to the penalty clause. Ibn Taymiyyah (728H) suggested that a penalty clause (*shartu jazai*) is a contemporary commercial terminology used to protect the right and interest of the contractual party in a business contract (Ibn Taimiyyah, 2004). This clause is considered under the Islamic jurisprudence as *Muamalat* (Islamic transaction) in nature which makes it permissible and lawful. This is especially when there is an evidence that shows a violation of a fundamental Islamic principle (Ibn Taimiyyah, 2004). A penalty clause in the Islamic financial contract is usually applied as a deterrent that uses to ensure the protection of contractual parties' right. This is permissible under the Islamic jurisprudence because it is a means to forestall the event of chaos and manipulation arising from the violation of the contractual terms between the parties (Busari, 2019). It is said that "Muslims are bound by their conditions except for a condition that prohibits what is lawful or makes lawful what is prohibited" (Muhammad bin Isa Abu Isa, 1998).

The second view depends on an assumption. It considers that the creditor or obligor in the default event is assumed to default in his/her obligation because of the failure in others. For instance, someone who cannot stand as a witness according to Islamic jurisprudence may be disqualified to be a judge. This is due to the violation of certain ethical values and behaviours, such as telling lies. Even though he may still tell the truth in the court but due to certain features that are surrounding him (such as he does not pray regularly and telling lies) may automatically disqualify him to be a competent witness in the court because he is considered not trustworthy (Zaidan, 1989).

Islamic law requires a witness in the court of law to be a just person. According to a *hadith*, the Prophet (bless and peace be upon him) said, "I have made injustice forbidden for myself and have made it prohibited upon you, do not be unjust to others!" (Muslim bin Hujaj, 2006). The *Qadi* (or a judge) has the right to accept or reject the witness based on his/her background information and attributes of the witness which can be used to accept or disqualify the witness before the court. It is also a requirement for witnesses to be free from the characteristic of a betrayer.

This position is evident from a *hadith* reported by Abu Dawud about a person that was disqualified from being a witness. On this regards, the Prophet (bless and peace be upon him) said: “Bearing a witness is not permissible for a betrayer, both male and female” (Muhammad bin Isa Abu Isa, 1998). Consequently, in the event of interdiction on the debtor, some Muslim jurists opined that the *Qadi* should sell out personal properties of the debtor if he refuses to settle the debt. A default from a financial obligation is considered as a violation of others’ right (Ahmad Ali Yusuf Jaradat, 2006).

Besides, one of the primary objectives of *Shari’ah* is to protect wealth. It is important to note that the protection of wealth is a necessity for the present and future generation. No individual, group, or nations can be self-sufficient from the need of wealth in their daily and regular affairs. Muslim scholars identified it as one of the five primary objectives of *Maqasid Al-Shari’ah (Al-Kuliyyah Al-khamsah)* (Shabir Ahmad Maulawi Ahmad and Muhammad Tahir Mesawi, 2016).

Ibn Ashur (2016) also suggests that the objective of the Lawgiver (Allah) relating to wealth is to enhance Muslims, to make them secure economically, and to protect their honour and dignity. Ibn Ashur further argues that the objective of the Lawgiver in the protection of wealth includes multiplying wealth through trading and investment, acquiring wealth from lawful means. The objective also indicates that wealth earned by Muslims must also free from ambiguous sources, properly stored from theft, and the wealth should be used to establish future needs. Another reason for the protection of wealth as discussed by Ibn Ashur is an act of prohibition from the act of a *safih* (overspending) if there are indications such action will protect the wealth of investor (Ibn Ashur, 2016). Abdul-Aziz (2009) also explains that contemporary Muslims need to understand the significance of protecting wealth in trading and investment as one of the primary objectives of *Shari’ah*. This is why the cross-default clause is necessary for modern investment. The primary objective of the cross-default clause is to detect the mismanagement and incapacity of a fund manager which may trigger an event that leads to the protection of investors’ rights from being violated. The cross-default clause seems essential particularly in a sophisticated investment like *Sukuk*.

Custom and norms are influential factors under Islamic jurisprudence, especially in *Muamalat* (Islamic transaction). The cross-default clause is a norm and an acceptable trend among the stakeholders of *Sukuk* investment which is used as a mechanism to protect the right of *Sukuk*-holders (Busari, 2019). Ibn Taymiyyah emphasised in his work titled *Majmu’ah Fatawa* that “the consideration of custom and norms in a financial transaction is like the verbal norm” (Ibn Taimiyyah, 2004).

It is also compulsory to protect wealth, especially when it involves a huge amount such as millions of dollars. For example, the International Islamic Liquidity Management manages over USD3 billion in *Sukuk* investments which are also related to taxpayers' money and assets owned by different countries (Busari, 2019). Thus, the protection of wealth is essential to be considered here, especially to avoid any violation of public wealth.

Public wealth is a contribution from individual earnings. Thus, it is necessary to provide safety measures to protect individuals’ wealth and collectively to secure such wealth from any violation and corruption (Ibn Ashur, 2016). On this regard, Allah said in Al-Quran, “And do not give the weak-minded your property, which Allah has made a means of sustenance for you” (Al-Quran, Surah Al-Nisa’: 5). Ibn Kathir (1997) explains that in this verse, Allah warns people to be careful in deciding and selecting their fund managers for their wealth. It is also a part of the higher objectives of *Shari’ah* in protecting and preserving wealth. It indicates that it is necessary to choose a person who understands about managing wealth as the fund manager.

The *Sukuk* contract is purely transaction-based. Based on a contrast opinion regarding the cross-default clause, the contractual parties in the *Sukuk* transaction are known to each other, and thus such contract should not be connected with another independent transaction. Moreover, Ibn Kathir emphasised that Allah wants creditors to be patience with debtors that have a genuine reason for defaulting their financial obligations (Ibn Taimiyyah, 2004; Ibn Kathir, 1997).

5. Discussion on Cross-Default Clause in Sukuk

The fundamental ethos of cross-default clauses in the *Sukuk* contractual agreement is to allow the issuer /obligor to be able to restore or refrain from the event of default (on the separate contract) before a cross-default declaration. Cross-default clause in *Sukuk* contract is an effective mechanism that *Sukuk*-holders may use to encourage the obligor to fulfil his/her contractual agreement. The cross-default clause makes the creditor honour the repayments of regular coupon or proper fulfilment of the purchase undertaking agreement (Chen, 2019).

Although cross-default clauses are used to encourage the obligor to make repayment on time, the said clause may trigger a negative domino effect. The creditor's legal experts usually have to advise his/her client on the appropriate negotiation and mitigating factor for the cross-default clause. For instance, the creditor can limit the cross-default clause to credit maturity that is longer than one year. The creditor can also limit contracts that will be counted under the cross-default clause by excluding a debt that is likely to fall under a bad-debt or any disputed debt in a good faith (Childs *et al.*, 1996).

The contractual parties of *Sukuk* may use cross-default clauses to protect the right and interest of *Sukuk*-holders. *Sukuk* issuer/obligor is declared cross-defaulted because of defaults arise from another financial obligation, or because of a downgrade from the rating agency, or in the event of insolvency or bankruptcy.

According to a study conducted by Busari (2019), when a *Sukuk* is defaulted and it triggered a cross-default clause, it is considered fair since it is a part of the agreement to protect interests of the *Sukuk*-holders. Busari (2019) noted that Muslim scholars have no reason to worry about the cross-default clause in *Sukuk* investment because the *Sukuk* is bound by English law and not *Shari'ah*. The essence of *Shari'ah* in *Sukuk* is just to ensure the *Sukuk* is structured in compliance with Islamic financial contract.

Majority of Muslim scholars consider that the cross-default clause in *Sukuk* is fair because the right of *Sukuk*-holders should be protected. Moreover, *Sukuk* agreement is *Muamalat* based and it permits the cross-default clause made based on the agreement between the contractual parties as approved by their *Shari'ah* boards (Busari, 2019).

However, it is pertinent to highlight the significance of cross-default clause to the fundamental philosophy of the Islamic capital market like *Sukuk*. The *Sukuk* in the current market is categorised as a debt. Such a cross-default clause is one of the instruments that can be used to protect the interest of the lender (*Sukuk*-holders) to ensure repayment of the debt. The cross-default clause can equally be harmful to the creditor if the parties do not consider whether the said clause is enforceable or not. The cross-default clause can also trigger a breach of the fiduciary duty of the board of directors because it grants the debtors unlimited right to accept and allocate contractual agreements (Lumempouw, 2018).

It seems to the researchers that the fairness of cross-default clause in *Sukuk* is justified based on the intent to protect wealth and rights of contractual parties from any violation. Moreover, *Sukuk* is a sophisticated investment that requires sufficient protection for the source of funds. Capital intensive investors are usually concerned about the guarantee and certainty around their investment. Finally, the underlying intent of the cross-default clause in *Sukuk* is basically to serve as a deterrent to obligors in handling the contractual *Sukuk* agreements.

6. Conclusion

The term cross-default clause is borrowed from conventional financial contracts which declares a debtor as a defaulter of one financial obligation due to his/her default from another financial commitment. There is no doubt that *Sukuk*-holders need to be protected and the cross-default clause is a very useful tool in ensuring such protection. The cross-default clause should comply with *Shari'ah*. Therefore, the contractual parties should consider the juristic opinions in applying the cross-default clause by ensuring its compliant with

Shari'ah principles. The contractual agreement should accommodate such clause that can strike a balance for all interests of the parties. The limitation of this study is that it is doctrinally based and as such future research should explore the legal analysis and implication of the concept of cross-default clause in *Sukuk* contract. There is also a need to explore the Islamic jurisprudence for the possible *Shari'ah* based deterrent clauses that will evenly protect the contractual parties and the entire *Sukuk* market. Finally, quantitative analysis is important to be considered in the future research relating to the effectiveness of cross-default clauses in the *Sukuk* market.

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