



# Evaluating *Sukuk* Default Factors: A Case Study on Dana Gas *Sukuk* in the UAE

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## Abstract

In the last couple of years, the Islamic finance industry was rocked by several *sukuk* defaults, the most prominent among them being Dana Gas *Sukuk*. These defaults led to hordes of questions related to *Shariah* governance, unstandardized legal documentation, *Shariah* non-compliant structure, lack of intent and transparency, incongruence in governing laws, and a lack of regulatory support. This paper assesses Dana Gas *Sukuk* by conducting a qualitative analysis to determine the circumstances that led to the failures of this *sukuk*. Using secondary sources this paper employs a content analysis method and scrutinizes the *sukuk* understudy with a special focus on its structure, governance mechanism, and legal jurisdiction. Thus, the study suggests standardizing the legal documentation and *Shariah* interpretation of the Islamic capital market, as it would reduce the risk of *Shariah* non-compliance and remove all the uncertainty and ambiguities and would help to avoid such *sukuk* default. Finally, it can be asserted that an attempt is made to offer some recommendations that hopefully will avert similar defaults in the future and help the Islamic finance industry to achieve greater standardization and clarity.

*Keywords:* *sukuk*, *Shariah* governance, *Shariah* non-compliant, governing laws, legal documentation

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## 1. Introduction

The global *sukuk* players are actively participating in the issuance of *sukuk* and many Islamic countries and corporates as well as western countries like the UK, Hong Kong, South Africa, and other affiliated corporates like Goldman Sachs have successfully debuted in the Islamic capital markets. As per the [International Islamic Financial Market \(IIFM\) Sukuk Report \(2021\)](#) Global *sukuk* issuance has expanded by 19.84 percent or USD 145.702 billion in 2019 to USD 174.641 billion in 2020. This implies that short-term issuances rose by almost 44.50 percent whereas long-term issuances expanded by about 12%. New *sukuk* issuances from Power Holding Public Limited Pakistan, Oman Sovereign Sukuk, ICDPS Sukuk Limited and others provided the market prodigious impetus in 2020 ([IIFM, 2021](#)).

However, repercussions and shockwaves have rocked the Islamic finance industry in the past decades, latest being when Dana Gas declared its *mudarabah sukuk* as *Shariah* non-compliant instrument asserting that “Due to the evolution and continual development of Islamic financial instruments and their interpretation, the company has recently received legal advice that the *sukuk* in its present form is not *Shariah*-compliant and is therefore unlawful under the UAE law. As a result, a restructuring of the current *sukuk* is necessary to ensure that it conforms to the relevant laws for the benefit of all stakeholders” ([Dana Gas, 2017](#)). To rub salt in the wound, Dana Gas declined to repay the overdue coupons once claimed by the investors and Deutsche Bank AG, the *Sukuk*'s Principal Paying and Exchange Agent. Dana Gas went even further, by declaring that the prior profit payouts should be restored to them due to the invalidity of *sukuk* ([Hekmatyar, 2018](#)).

Hence, the aim of this research is to evaluate the issuance of Dana Gas *Sukuk* in the United Arab Emirates and, afterward, qualitatively analyze to find the factors that caused the default of this *sukuk* issuance. The research tends to focus on the legal framework of *sukuk* market of United Arab Emirates only as the financial

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market of this jurisdiction is predominant and mature. The study differs from the past studies on Dana Gas Sukuk in the sense that it encompasses the regulatory challenges of both jurisdictions and highlights the reasons of failure of this peculiar *sukuk*. Nevertheless, the study is significant as it will contribute to the body of knowledge and aims to recommend some strategies and procedures to avoid such default and repercussions to the Islamic capital market. Similarly, the research would also assist the Islamic banking and finance community to understand the nature, structure, and governance framework of Islamic capital market of this jurisdiction. Therefore, the evaluation of such a case shall fulfil the gap and enable the *sukuk* market to evolve further and become more resilient for similar future occurrences.

## 2. Literature Review

### 2.1 Definition of Sukuk

*Sukuk* is a Shariah-compliant substitute to a traditional bond and has witnessed tremendous development in the last few decades and it is demonstrating a bright future ahead. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) describes *sukuk* as: "... certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity" (AAOIFI, 2017).

In a simple sense, *sukuk* are documents or certificates that indicate the holding of an asset. It confers shareholders a portion of the asset, as well as the profits and potential risks accompanying from such investment. The structure of *sukuk* can be relied on the tenets of exchange contracts such as "*ijarah*, *murabahah*, *istisna*" and partnership contracts (e.g., "*musharakah* and *murabahah*") (Yean, 2009).

In the same context, the Islamic Financial Services Board (IFSB) describes *sukuk* as follows: "*Sukuk* (plural of *sakk*), frequently referred to as Islamic Bonds, are certificates each of which represents the holder's proportional undivided ownership right in tangible assets, or pool of predominantly tangible assets, or a business venture."

### 2.2 Sukuk Development

As early as 1978, efforts to introduce a *Shariah* compliant bond-like security were undertaken by Jordan, whereupon the government authorized Islamic bank of Jordan to launch *muqaradah* bonds. As a result, the *muqaradah* bond Act was enacted in 1981. Similarly, in Pakistan, a peculiar law termed as the "*mudarahab* flotation and control ordinance of 1980" was enacted. Notwithstanding, either of these initiatives has yielded any notable results.

The Malaysian government was the first to successfully incorporate Islamic bonds in 1983, with the introduction of "Government Investment Issues" (GII) - originally named as "Government Investment Certificates" (GIC). Due to the sluggish pace of development the IFIs were unable to build an active market for such instruments. Furthermore, the development of an asset securitization in traditional markets has established a paradigm that could be applied to Islamic assets as well. It was not until the late 1990s when Bahrain and Malaysia have introduced a well-versed framework of an asset-backed security in the shape of *sukuk*. This structure attracted the attention of investors and borrowers and was deemed a prospective tool to evolve Islamic capital markets (Iqbal, 2011). However, The Gulf countries did not step into the capital markets up until 2016, when oil prices had fallen to less than US\$50 per barrel. It was then when Abu Dhabi came back to the bond markets after 9 years to offset a US\$10mn deficit. The results were staggering; the order book was oversubscribed by more than three times for a US\$5mn bond. This success was noted and carried on by Saudi government when they issued a US\$9bn *sukuk* in 2017. The Gulf council realized if they wanted to diversify their economies, capital markets are the key. The global *sukuk* players are accumulating with good pace and many Islamic countries and corporates as well as western countries like the UK, Hong Kong, South Africa and other affiliated corporates like Goldman Sachs have successfully debuted in the Islamic capital markets. Despite the Middle East's sociopolitical instability, Arab nations have maintained their *sukuk* pace; Saudi Arabia leads, followed by Qatar, Bahrain, and the United Arab Emirates. They mostly concentrated on the Eurobond market, apart from Bahrain, which has a thriving local *sukuk* market. The Gulf is a US Dollar economy, although they have their local currency, it is pegged to the US dollar (Drum, 2021). The majorities are issued in US dollar and are listed in London Stock Exchange being home to most of the listed international

*sukuk*. In addition, the number of *sukuk* issuers and industry players seems not to be influenced by the recent *sukuk* default cases nor has it affected the confidence of local and global investors, notably Dana gas, Investment Dar Sukuk from Kuwait, and the Golden Belt from Saudi.

### 2.2.1 Types of offerings

Generally, there are three levels at which capital market offering may be made in a country, though of course, different jurisdictions have different rules. The three broad levels of offering distribution are:

- a) Exempt offering: The offering is not approved by the regulatory authority, but the regulator instead exempted the need for an approval subject to certain conditions. In this case, the regulator may restrict the marketing of the offering to a very limited number of qualifying (institutional) investors only.
- b) Private placement: The offering is approved for restricted marketing. This could carry the advantages of lower disclosure requirements, no listing requirement, shorter time to gain approval and lower costs, but the disadvantage is that the offering would only be marketed to a limited number of qualifying (institutional) investors.
- c) Public offering: The offering is approved for unrestricted marketing to and subscription by the public. Typically, this would be for high quality offering by well-established entities. There would be an onerous disclosure obligation, a listing requirement, a longer approval timeline, greater public security (e.g., on *sukuk* structure), higher legal costs (legal due diligence may be required) and higher marketing costs.

### 2.3 Developing Capital Markets

Developing capital markets is a long-term project. The traditional capital markets of today are the result of years of adaptation, which has enabled them to cope with the remarkable rate of innovation seen in recent decades. Islamic capital markets may learn from and benefit from the conventional markets' extensive expertise to accelerate their own development. Today's capital markets are part of a complex system that includes various components such as the status of the regulatory regime, the quality of supporting institutions, the design of incentive and corporate-governance systems, as well as market microstructure and behaviors. Other elements that influence the formation of an efficient capital market include the market's breadth, which is defined by the product variety, the availability of credible performance standards, market participant culture, and the degree of interaction with external markets. The primary obstacles to the establishment of Islamic capital markets are explored in the next section.

Many Muslim developing countries, like many of their non-Muslim counterparts, are heavily in debt. Only the six Gulf Cooperation Council nations have positive budgetary balances among the 57 OIC countries. The remaining 51 OIC countries have budget deficits. The World Bank/IMF classifies 19 of these 51 nations as Heavily Indebted Poor Countries (HIPC). The fact that government spending outnumbers government receipts is a frequent feature of emerging economies. It usually arises because of a need to support development. As things stand today, there are two major issues with this. First, the budget deficit is usually filled via interest-based borrowing. Second, governments must borrow in foreign currency because domestic capital accumulation is typically insufficient. Even if the borrowing is done through the issuing of bonds, the bonds must be denominated in foreign currency to minimize necessary yields. Two things happen because of such compulsion. As a result, the economy becomes leveraged and exposed to exchange rate risk, making it sensitive to such dangers.

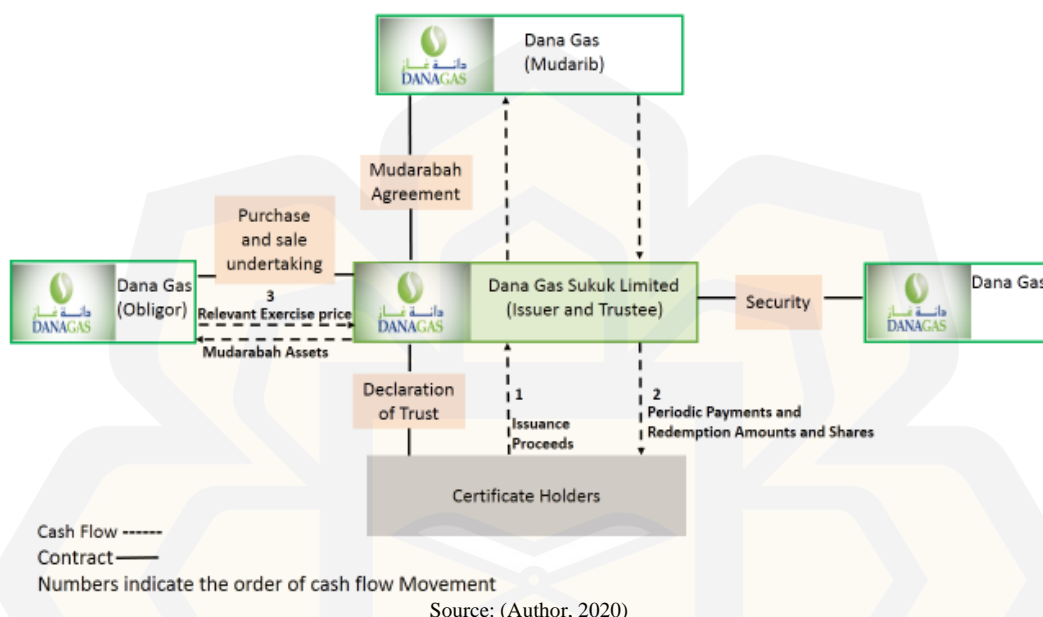
### 2.4 Dana Gas Sukuk

The original issuance issued in 2007 was about to be restructured at the Sharjah headquartered Dana Gas Sukuk Ltd on May 8th, 2013, when their shareholders approved of restructuring the already issued US\$1bn *sukuk* and decided to re-issue a dual tranche *sukuk* amounting to US\$850mn maturing in 2017. It was riskier back in the day as the share price of the company was already down by 59 fills (16.06 Us Cents) (Islamic Finance News, 2018). One could say that Dana Gas did not want to dilute the equity ownership, hence they defaulted, but back on this at a later stage. The tranches were split into two, a US\$450mn ordinary *sukuk* and a US\$450mn convertible *sukuk* at 7% and 9% respectively. The certificates were traded on the Irish Stock exchange, while the arrangers were "JP Morgan Securities Ltd., Citigroup Global Markets Limited and Barclays Bank plc (the 'Joint Lead Managers')" accompanied by the Deutsche Trustee Company Limited as a delegate.

### 2.4.1 Structure of Dana Gas Sukuk

The Figure below illustrates the structure and contractual relationships between the contracting parties of Dana Gas Sukuk. As it is obvious that only Dana Gas<sup>1</sup> (SPV) is involved in this transaction where it is acting as an Issuer, Trustee, Purchaser, *Mudarib* (entrepreneur) and Obligor. It can be realized in the following figure (Figure 1):

Figure 1: Modus operandi of Dana Gas Sukuk.



Cash flow of the structure:

1. Investors fund the trustee and issued *sukuk*.
2. The trustee then gets into a *mudarabah* contract with the *mudarib* (entrepreneur) to manage the residual capital and also to invest in *Shariah* compliant products as per the investment plan laid out. The *mudarib* (entrepreneur) consented to manage a ledger account as the “Reserve Account” in its books, designated in U.S. dollars.
3. The obligor acquired the Trustee's rights, advantages, and entitlements to the *mudarabah* assets in the requisite fraction from the Trustee on "as is" basis at the related exercise price, following the Trustee's delivery of a notice under the Purchase Undertaking (the "Exercise Notice") on the terms and subject to the conditions of the Purchase Undertaking.

Hence, it can be stated that on October 31, 2007, the Trustee and Dana Gas (“in its capacity as *mudarib*”) (entrepreneur) signed a *mudarabah* contract (the "Original *mudarabah* Agreement") in which the *mudarib* (entrepreneur) invested US\$1,000,000,000 (the "Initial *Mudarabah* Capital") in definite *mudarabah* assets (the "Initial *Mudarabah* Assets") in consistent with an investment scheme laid down in the original *mudarabah* contract. On the due date, the *mudarib* (entrepreneur) delivered 14.992 per cent of the primary *Mudarabah* Funds (indicating US\$149,920,000 of the initial *Mudarabah* Assets) to Dana Gas (in its independent capacity), and the Trustee and the *mudarib* (entrepreneur) consented to modify and reaffirm the initial *mudarabah* contract. Dana Gas employed 100 percent of the revenues to maintain the residual balance of the initial *mudarabah* capital, which reflected the residual balance of the Initial *Mudarabah* Capital at the due date, which

<sup>1</sup> Dana Gas PJSC is a publicly traded natural gas company, based in Sharjah, United Arab Emirates. Incorporated and listed on the Abu Dhabi Securities Exchange in 2005.



was US\$850,080,000, in line with the aspects of the *mudarabah* contract an investment strategy that allows specific investments to be initiated in a handful of *Shariah* compliance undertakings, namely (without restriction) some investments in Dana Gas's commercial operations.

### 2.5 Verdict from the English High Court

The Purchase Undertaking (governed by English Law) which lays out Dana Gas's payment rights within the *sukuk*, was found to be legal and binding in line with its provisions, and Dana Gas was ordered to make the requisite payments to its creditors who acquired the *sukuk*.

The English High court held:

1. As stated, the disbursement of exercise price within the "Purchase Undertaking" was not contingent on the delivery of assets under UAE law regulated instruments, and the execution and transfer were aimed to be sequential rather than contemporaneous procedures.
2. The notion of misunderstanding will only arise if the contract had a gap in it. There would have been no shortfall in the agreement if the parties had explicitly or impliedly consented on the occurrence of some specific incidences, and the concept of misunderstanding will not arise in those scenarios. In this case, the counterparties had explicitly acknowledged that the illegality and invalidation of the "Mudarabah Agreement and Sale Agreement" would lead to the dissolution of *sukuk*, and as consequence, the *Sukuk* Trustee would have the power to release an exercise statement triggering the "Purchase Undertaking". Dana Gas would be obligated to reimburse the "Exercise Price" for the *sukuk* when the exercise notification is released under the provisions of the "Purchase Undertaking". Since the provisions *sukuk* explicitly cater for a circumstance in which the existence and enforcement of "Mudarabah Agreement and Sale Agreement" are being questioned, since there is no gap in the contract, the English High Court resolved that the notion of misunderstanding would not apply in this case.
3. In this *sukuk* structure, under the "Purchase Undertaking" England was the jurisdiction to execute the payment responsibilities, because the accounts for the *sukuk* transactions were maintained by the "Sukuk Trustee with Deutsche Bank in London". Therefore, the High Court declared that while determining the applicability of the "Purchase Undertaking under English law", it did not need to consider any prevailing requisite provisions of the UAE law (Trowers & Hamblins, 2018).

### 2.6 Sharjah High Court rulings

Since the legality of the contract was non-exclusive jurisdiction of the English courts. In December 2017, the Sharjah court agreed to Dana Gas's appeal to participate in the UK high courts proceedings on the defaulted *sukuk*. The decision is basically an appeal against the English court's rulings that *sukuk* issuance is valid under English law. Two months post the appeal when the English court again overruled Dana Gas's attempt to overturn the decision, Sharjah Court of First instance orders the Gas company to suspend the enforcement in the UAE of judgments issued by the English court of justice. It ordered to refer all the UK judgments to the UAE courts for the determination of their eligibility of enforcement in the country and orders to continue proceedings and submit all defenses.

In May 2018, with the expectations to resolve the legal challenges in the UK and the UAE, a delegation was set up to represent the securities owners, comprising BlackRock Inc. and Goldman Sachs Group Inc., to discuss a new agreement with Dana Gas. It is reported that the committee has consented to reform the *sukuk* structure, giving the creditors two choices: (1) withdraw the *sukuk* at 90.5 US cents per dollar of face value, or (2) rollover the present *sukuk* into a new three-years *sukuk* with a yield of 4% annually and finally in 2018 August Dana Gas ended all the litigations in UK and UAE (Trowers & Hamblins, 2018). The corporation saved US\$21 million by purchasing back US\$133 million of its *sukuk* in the marketplace at a discount and by saving future profit rates on *sukuk* that was purchased back. Dana Gas saves an additional of US\$8 million by retaining the profit rate at 4% per annum, boosting the overall savings to US\$29 million, in contrast, to one year saving of US\$35 million saved "at the time of the restructuring" (Khan, 2019).

## 2.7 Reasons for default

As stated below, the causes of default are split into the internal causes and external causes.

### 2.7.1 Internal causes

- It is vital that the *sukuk* structure of Dana Gas is centered on the law of UAE. Whereas the English law regulates the “Purchase Undertaking Agreement”. As the agreement implies that following the investment plan the funds received by the trustee should be invested by Dana Gas Limited. According to the Dana Gas agreement, the revenue earned by *mudarabah* assets will be distributed periodically between Dana Gas PJSC (*mudarib*) (entrepreneur) and the trustee (*rab-al-mal*) in a ratio of 99 percent to 1 percent. Nevertheless, assuring a confirmed profit in a *mudarabah sukuk* to any of the contracting parties is a breach of Shariah principle. As a result, the method of purchase undertaking employed was inconsistent with Shariah standards (Busari, 2019).
- It is investigated that the mechanism of dividend payout of Dana Gas Sukuk was imitating to some extent to the traditional bond output, contradicting to the standards of AAOIFI and UAE (Hekmatyar, 2018).

### 2.7.2 External causes

- It is cited that the liquidity constraints induced by late payments from Egypt and Iraq's Kurdistan provinces was one of the causes for Dana Gas Sukuk default (“UAE's Dana Gas Misses”, 2012). Whereupon 729 million dirhams were remained unpaid from Egypt gas supplies and 1.2 billion dirhams in the Kurdistan province (“UAE's Dana Gas won't”, 2012).
- Finally, it can be asserted that the absence of an effective regulatory framework from both a legal and *Shariah* aspects have led to this instability. Since then, the UAE has a fragmented Shariah compliance structure in place for Islamic finance industry. Article 6 of the UAE Islamic banking law declares “that each Islamic Bank (IB), financial institution and Investment Company should establish its own Shariah Supervisory Authority to ensure that its transactions and practices conform to Islamic law. It also states the establishment of Higher Shariah Authority to supervise Islamic Banks, financial institutions and investment companies”. Art. 5, Federal Law No. 6 of 1985. (Hamza, 2013). In fact, the Higher Shariah Authority was not in place by that time, and Shariah Supervisory Boards (SSBs) are undertaking the obligation of *Shariah* governance (Hamid, 2015). Similarly, the governing laws and jurisdictions are primarily split amongst English and UAE law. “The Declaration of Trust, the Agency Agreement, the Purchase Undertaking, the Sale Undertaking, the Security Agreement, the Security Agency Agreement, the Ordinary Certificates and the Exchangeable Certificates are governed by English law and subject to the non-exclusive jurisdiction of the English Courts. Whereas the *Mudarabah* Agreement, the UAE Share Pledges and the UAE Mortgage were governed by the laws of the UAE” (Hekmatyar, 2018).

## 3. Research Methodology

To accomplish the objectives of this research the study applies a qualitative method by using the library research and content analysis approach. From the library research, the study employs comparative and content analysis methods. In this essence, the secondary data was collected through different sources like, English law, the law of UAE, verdicts of English court, articles, books, websites, and academic writings and then compare and analyze them using analytical methods. The research analyzes the issuance of Dana Gas Sukuk in UAE to discover the factors that caused the default of this *sukuk*. Furthermore, the research also tries to urge the IFIs practitioners and academicians to comprehend the nature, structure, and governance framework of Islamic capital market of this jurisdiction (Mohtesham, 2021; Hai, 2021).

#### 4. Finding and Discussion

There were many repercussions and shockwaves around the Islamic finance industry, since then, most *sukuk* issuance come with warranties to prevent obligors from declaring non-*Shariah* compliance. As the case with any default, if standardization of Islamic products would have been in place, we would not be seeing this day. Where standardized *Shariah* interpretations would eliminate the likelihood of someone arguing that something is not *Shariah* compliant, and this would help to prevent such dilemmas in the first place.

Furthermore, to remove the uncertainty and ambiguity the market urgently requires standardized legal documentation. As Dr. Mohamed Damak, the global head of Islamic finance at S&P Global Ratings asserts that this would make the rating agencies life easier in rating *sukuk*. The intricacy of mixing English law and local law for the *Shariah* products at times creates conflict as is seen in the Dana Gas. Further, the UAE has a decentralized version for *Shariah* compliance matters in Islamic finance industry. Article 6 of the UAE Islamic banking law declares “that each Islamic Bank (IB), financial institution and Investment Company should establish its own *Shariah* Supervisory Authority to ensure that its transactions and practices conform to Islamic law. It also states the establishment of Higher *Shariah* Authority to supervise Islamic banks, financial institutions and investment companies”. Art. 5, Federal Law No. 6 of 1985 (Hekmatyar, 2018; Hamza, 2013). Hence, this form of decentralized version for *Shariah* compliance matters in Islamic finance industry may cause to many repercussions in the industry and hinder the growth of IFIs across the globe.

#### 5. Conclusion and Recommendation

Based on the above deliberation the study aims to recommend some strategies and procedures to avoid such defaults and repercussions to the Islamic finance industry. Thus, the study aims to make the following recommendations:

1. The study finds that there is dire need to standardize the *Shariah* interpretation of *sukuk* structures used in the Islamic capital market. As the standardized *Shariah* interpretation would reduce the risk of non-*Shariah* compliance and would help to avoid *sukuk* defaults. Moreover, to eliminate the suspension and ambiguity, the market imminently requires standardized legal documentation. Thus, the likelihood of standardizing the *Shariah* interpretation and legal documentation can be accomplished by the *Shariah* scholar’s and legal council’s considerable collective efforts of the region. The role of AAOIFI in this recommendation would be vital, as the AAOIFI *Shariah* standards on *sukuk* will provide a comprehensive guidance to the UAE’s ICM.
2. Decentralized version of *Shariah* compliance matters in Islamic finance industry may cause many issues and hinder the growth of IFIs in the region. Thus, seminars, forums and round table discussions should be held amongst the *Shariah* scholars of the region to centralize the *Shariah* compliant matters and harmonize the *Shariah* rulings of Islamic finance industry. Since seminars and forums will enhance the understanding of *Shariah* scholars with regards to the development, and regulatory requirements of Islamic capital market of the province. These efficient platforms will assist in identifying the rulings that can be centralize in the UAE.
3. The study also suggests that the regulators should reshape their organizations and practices in ways that explicitly and effectively safeguard transparency throughout the *sukuk* insolvency process and protect equally all creditors’ rights in cross-border insolvencies. Without these legislative initiatives, jurisdictions would inevitably see that the confidence of foreign investor is eroded further, which in time will slow the modernization of their economies and jeopardize long-term growth. The study further suggests that a detailed review needs to be done by the regulator with regards to the *sukuk* legal framework and the local regulatory requirements as in most cases *sukuk* documents in relation to sale and purchase of assets of the underlying *sukuk* assets are governed of the local laws and the overall *sukuk* documentation is governed by the English law.
4. As far as the process of documentation is concerned the research highlights the need for care by banks and their lawyers to ensure that offering documentation fully describes the scope of the role that the institution agrees to perform in the transaction and the need to draft disclaimers to encompass acts and omissions in carrying out all the constituent elements of that role.
5. Finally, default in a financing structure is not new to any financial industry but at times what gets disappointing is the wrong expectation from the parties regarding a financial structure. The challenge of structuring a *sukuk* is quite evident that from credit perspective it needs to behave

like a debt instrument irrespective even though if it is structured in an equity or profit-sharing format. In this *sukuk* default also a message was quite clear and that is even though it was a *mudarabah sukuk* and there was a genuine market condition in the form of financial crisis still the payment obligation of the partner (i.e., the client) was enforced. Few industry participants consider this to be an act of misrepresentation, but the fact of the matter is all the parties including the investors are made aware of their rights, obligations, and risk in the *sukuk*. This approach is taken not to misrepresent but under the current challenge of finding a suitable *sukuk* structure because at times the client does not have enough assets to match the issuance size of the *sukuk* and in such scenarios a *mudarabah* avenue is ventured into. The study here suggests that sufficient assets need to be identified and an easy access should be provided to *sukuk* issuers so that they can have smooth issuance of *sukuk*.

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