

# Dispute Resolution in the Restructuring of Defaulted Sukuk: An Empirical Investigation in Malaysia

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The objective of the study is to empirically investigate the dispute resolution in the restructuring of defaulted corporate sukuk in Malaysia. Under Malaysia law system, the disputing parties may resolve their business dispute through the court or various Alternative Dispute Resolution (ADR) mechanisms. ADR includes negotiation, mediation and arbitration mechanisms. The finding suggests that the disputing parties may utilise a combination of dispute resolution mechanisms to restructure the defaulted sukuk. The negotiation tends to be used as the first option, followed by the court trial or mediation. The finding implies that the disputing parties should consider any possible dispute resolution method under the jurisdiction where a sukuk is structured to resolve the defaulted sukuk.

**Key words:** *Sukuk default • Sukuk restructuring • Dispute resolution in Islamic Finance.*

## Introduction

As the largest sukuk issuer, Malaysia has experienced 35 default cases of corporate sukuk for the period of 2002-2018 or contributes more than 80% of total default events in the global sukuk market.<sup>1</sup> These cases involved a defaulted amount of more than eight billion Malaysian Ringgit. This has an impact on the reputation of Malaysia as the hub for global

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<sup>1</sup> Data was compiled from Rating Agency Malaysia Berhad (RAM), Malaysian Rating Corporation Berhad (MARC), Bond Pricing Agency Malaysia (BPAM), Islamic Finance Information Services (IFIS), Islamic Financial Services Board (IFSB), and International Islamic Financial Market (IIFM)

Islamic finance (Ab Majid et al., 2011) and may undermine the credibility of sukuk itself and Islamic finance more generally (McNamara, 2010; Wilson, 2013).

An event of default may lead to a dispute between sukuk holders and sukuk issuers due to conflict of interest between both parties. Therefore, the disputing parties should seek any possible resolutions to restructure the defaulted sukuk. However, Kalantar and Delaney (2010) and Baker (2011) argue that the restructuring of defaulted sukuk may face some challenges due to Sharia, legal and regulatory issues in the jurisdiction where a sukuk is structured. Moreover, they argue that in many Islamic jurisdictions, unlike in the conventional one, bankruptcy or insolvency law is less developed and relatively untested. Since sukuk defaults are largely unprecedented, the restructuring is likewise a new frontier of the Islamic finance industry as well as academic interest.

The above situation motivates the study to empirically investigate the dispute resolution in the restructuring of defaulted corporate sukuk in Malaysia. The rest of this paper is organised as follows. Section 2 elaborates various sukuk restructuring methods which are argued in accordance with Sharia. It is followed by Section 3 and 4 which elaborates litigation and types of alternative dispute resolution in Malaysia, respectively. Section 5 describes data and methodology of this study. Cases of sukuk default and its restructuring process is discussed in Section 6 and 7, respectively. The last section, Section 8, provides an overall conclusion.

### **Sukuk Restructuring Approaches**

In an insolvency situation, a sukuk issuer may face two choices, either restructuring or liquidation. Restructuring, from the conventional market experience, is a preferable alternative to liquidation, which is more expensive to both creditors and debtors (Bris et al., 2006; Bakar, 2012). The objective of restructuring is not only to provide a sukuk issuer with additional time to recover and meet their obligations, but also to ensure a fair treatment for sukuk holders (Kalantar and Delaney, 2010; White, 2012).

Among early academic literature on the sukuk restructuring studies, Khnifer (2010c) proposed three restructuring modes that were argued in accordance with Shariah, namely rescheduling, hair-cut and debt-for-equity swaps. In a rescheduling mode, the sukuk holders would come to an agreement to reschedule the financial obligations of the issuer by extending maturity for the same, lower or usually higher rate of coupon. Another mode is known as a 'hair-cut' whereby the creditors may agree to make a discount on their investment to get an early settlement. Alternatively, the creditors may agree to convert some or all of the debt in exchange for equity of the company under a 'debt-for-equity swaps' mode.

However, Bakar (2012) argued that these modes might be not suitable for all types of sukuk due to unique structures and characteristic of each type of sukuk. Further, Bakar (2012) explained the proposed restructuring approaches from two perspectives: its underlying assets and its underlying contracts. From the underlying asset perspective, asset-backed structure gives right to the investors to claim only from the asset, but not from the originator or issuer. Meanwhile recourse of asset-based sukuk is only limited to the originator or issuer. This perspective is in agreement with the opinion of Aini and Rafisah (2011) and Khnifer (2010b and 2010c).

From the underlying contract perspective, Bakar (2012) and Khnifer (2010c) argued that the hair-cut approach is permissible being applied to debt-based sukuk such as a payment of purchase price under *murabahah* and *istisna'* contracts as well as a rental payment under *ijarah* contract. Further, the rescheduling approach is permissible when being applied on *ijarah* but is not accepted on the sale-based contract if the extension of maturity is followed by an increase in the purchasing price. However, in the context of Malaysia, Bakar (2012) argued many of the debt-based sukuk have been restructured by creating a set of contracts to retire the existing sukuk and to create a new contract with new profit rates and maturity to set-off all outstanding payments. As for sukuk *mudarabah* and *musyarakah*, any restructuring initiative pertaining to a new project line, duration and profit-sharing ratio is possible. However, the hair-cut approach will not be accepted since it implies a capital guarantee for the sukuk investors.

Although the restructuring approaches are argued in accordance with Shariah, its application faces problems due to each legal jurisdiction where a sukuk is restructured has different regulations and rules regarding default (Khnifer, 2010a and 2010d). Since the sukuk market is part of the Malaysian capital market, the Security Commission of Malaysia (SCM) regulates sukuk issuance. So far, there is no regulation that specifically regulates the restructuring of defaulted sukuk. However, SCM has issued the Guidelines on Sukuk of 2014 (hereafter Sukuk Guidelines 2014), which contains articles that can be used as a basis for the restructuring. These articles are stated in Paragraph 17 of the Sukuk Guidelines 2014 regarding the revision to principal terms and conditions. These articles allow revision on profit rate as well as maturity date of a sukuk. It means that the proposed sukuk restructuring approaches have a regulatory foundation in the Malaysia legal jurisdiction. Next, the discussion elaborates the restructuring of defaulted sukuk from the legal perspective.

### **Litigation of Islamic Finance Dispute in Malaysia**

Litigation or resolution through the courts is the most well-known method of disputes resolution. Since Malaysia applies dual law systems, there are two court systems; the civil court and the Shari'a court systems. The law of commerce and business, including Islamic

finance, fall under the civil court jurisdiction. Meanwhile, Shari'a court has limited jurisdiction which is only over Muslims and personal matters such as succession, testate and intestate, family law, gift, *waqf* and the determination of Islamic law and Malay custom (Markom and Ismail, 2009).

Besides the court, there is an authority body that plays an important role in the litigation of Islamic finance dispute, namely Shari'ah Advisory Council (SAC). The primary role of the SAC is to ensure any institution carrying on Islamic banking and finance does not contravene the Shari'a principles. The SAC is established under the Central Bank of Malaysia (CBM)<sup>2</sup> and accorded with the sole Shari'a authority in Islamic banking and finance in Malaysia. Other Islamic financial institutions shall refer the resolutions of SAC, and its ruling according to such reference shall be binding upon them. However, in the early development, the SAC's resolutions have no binding effect on the court since the legislation<sup>3</sup> only requires the court to take it into consideration in the decision. This situation has resulted in the refusal of the court judges to follow the SAC's resolutions. Therefore, the Central Bank of Malaysia Act (CBMA) 2009 amended the previous legislation by expressly providing that the SAC's resolutions are binding on the court and arbitrator. Since that time, the SAC's resolutions shall be referred and have a binding effect on the litigation of Islamic finance dispute in Malaysia (Oseni and Ahmad, 2011).

To serve disputes in Islamic finance specifically, the Kuala Lumpur High Court introduces a *Muamalat* Bench, which is placed under the High Court Commercial Division. The objective of the Bench is to encourage a sort of expert determination of Islamic finance disputes albeit through adjudication. Through the Bench, the two court systems can be gradually integrated into one (Markom and Ismail, 2009).

### **Alternative Dispute Resolution in Malaysia**

As an alternative to the litigation, the disputing parties in case of defaulted sukuk may resolve the dispute through Alternative Dispute Resolution (ADR) mechanism. The ADR is a range of processes for amicable settlement of disputes outside the formal court procedure or litigation where a neutral third party intercedes to resolve the dispute (Oseni and Ahmad, 2011). Among the types of ADR practiced are negotiation, mediation and arbitration (Abdul Manaf et. al., 2012). Negotiation is an agreement between two or more parties to reach compromise. It may be conducted directly between the parties or involve the third party as a facilitator. Mediation is a flexible resolution process in which a neutral person (the mediator) actively and confidentially assists disputing parties in working towards a negotiated

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<sup>2</sup> For the first time the SAC was established by the CBM on 2 August 1996 as implementation of the provision in the Banking and Financial Institutions Act (BAFIA) 1996.

<sup>3</sup> The Central Bank of Malaysia Act (CBMA) 2003

agreement of a dispute or difference. In arbitration, the disputing parties submitted their claims into the third party (the arbitrator) to reach a fair determination.

If sukuk holders prefer to use negotiation approach, they can negotiate their claims to the issuer directly in a sukuk holder meeting. The meeting may be facilitated by the issuer or the sukuk trustee. As an alternative to the meeting, the sukuk holders may appoint the trustee to conduct an indirect negotiation. However, the power and authority of the trustee to represent the Sukuk holders' interest is limited both by the authority as set out in the sukuk documentation and by the constraints placed on it due to the particular sukuk structure itself (El-Khatib, 2012).

If the negotiations have been deadlocked, the disputing parties may use mediation or arbitration approaches. Several institutions in Malaysia provide services on resolving Islamic finance dispute through mediation or arbitration. Oseni and Ahmad (2009 and 2012) argue the institutional framework for ADR in Islamic finance in Malaysia includes the following bodies:

#### ***Kuala Lumpur Regional Centre for Arbitration***

Kuala Lumpur Regional Centre for Arbitration (KLRCA) is a dispute resolution body established under the Asian-African Legal Consultative Organization (AALCO) in 1978. It provides institutional support as well as a convenient venue for domestic and international arbitrations. In 2007, it introduced the Rules for Arbitration of Islamic Banking and Financial Services to encourage the use of arbitration for disputes in Islamic financial services. The rules provide flexibility in the conduct of proceedings of the arbitration and give wide discretion to the parties in choosing their arbitrators, conciliator and panellist as well as choosing the place of dispute resolution and the applicability of the procedural rules.

#### ***Financial Mediation Bureau***

The Financial Mediation Bureau (FMB) established in 2005 as a result of the merger between the Banking Mediation Bureau and Insurance Mediation Bureau. The FMB is an independent initiative body consisting of banks and financial institutions in Malaysia as the members and supervised by the Central Bank of Malaysia. The FMB provides dispute resolution services to the members and its customers for a free, fast and efficient way.

#### ***Malaysian Mediation Centre***

The Malaysian Mediation Council (MMC) was established by The Bar Council of Malaysia on 5 November 1999. The MMC is expected to be a world class mediation centre in

Malaysia. The MMC provides mediation services, assistance and advice on how to get the other side to use a mediation approach if one party has shown interest. It also provides mediation training for those interested in becoming mediators, accreditation of trained mediators and maintains a panel of mediators. The effort of the MMC has been complemented by the Practice Direction on Mediation (PDM), which was issued by the Chief of Justice of Malaysia on 16 August 2010. The PDM gives the civil court a suitable framework to explore every amicable process of dispute resolution before proceeding for court adjudication. All court referrals are made to a mediator appointed from the list of neutrals furnished by the MMC, except otherwise provided by the disputing parties.

### ***Shari'ah Advisory Council of the Central Bank of Malaysia***

The Shari'ah Advisory Council (SAC) of the Central Bank of Malaysia may also be considered as an institution that provides ADR besides its primary services in performing statutory functions. The ADR functions are served through two mechanisms, first, the published rule of the SAC must be taken into consideration by the court or arbitral tribunal in any proceedings relating to Islamic financial business, and it has binding effect. Second, if there is a reference to a Shari'a issue from the court or arbitral tribunal, SAC ascertains the Islamic law on such a matter and issue a ruling which is considered in the final judgment or award of the court or arbitral tribunal respectively. Through these two mechanisms, SAC may perform its function as a dispute avoidance and dispute resolution body.

### ***Corporate Debt Restructuring Committee***

The Corporate Debt Restructuring Committee (CDRC) is a pre-emptive measure by the Malaysian Government to provide a platform for corporate borrowers and their creditors to work out feasible debt resolutions without having to resort to legal proceedings. The CDRC was first established during the 1998 financial crisis with the main objective being to provide an alternative platform to distressed corporate borrowers to resolve debt obligations with their creditors in an effective and efficient manner. Companies seeking to settle their debt obligations through CDRC must fulfil the following broad criteria: (i) Aggregate indebtedness of RM30 million or more; (ii) At least two financial creditors; (iii) Not in Receivership or Liquidation; (iv) Experiencing difficulties in servicing their debt obligations but may not have already defaulted, provided they meet criteria (i) & (ii), or any company listed on Main Market or ACE Market of Bursa Malaysia that has already been classified as a PN17<sup>4</sup> or GN3<sup>5</sup> company's respectively.

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<sup>4</sup> PN17 stands for Practice Note 17/2005 and is issued by Bursa Malaysia to assign companies in main market that are in financial distress

<sup>5</sup> GN3 stands for Guidance Note 3 and is issued by Bursa Malaysia to assign companies in ace market that are in financial distress

### ***Data and Methodology***

The study investigates the defaulted corporate sukuk in Malaysia for the period 2002-2011. Events of default are based on the rating published by credit rating agencies (CRA) in Malaysia namely the Rating Agency Malaysia Berhad (RAM) and the Malaysian Rating Corporation Berhad (MARC). Meanwhile, information on the restructuring of defaulted sukuk is gathered from various sources, such as RAM, MARC, Bursa Malaysia, Central Bank of Malaysia, State and Federal Court, and local news media.

The dispute resolution approach was chosen by disputing parties and was compiled into two broad categories, namely the court resolution and Alternatives Dispute Resolution (ADR). The court resolution consists of trial and negotiation under protection (protection). Negotiation under protection is included in the court resolution since the Malaysian law allows the court to grant a protection (Restraining Order) to debtor or sukuk issuer to restrain any actions or proceedings against them. During the restraining order period, sukuk issuer may propose a restructuring scheme and negotiate the defaulted sukuk to its investors. Meanwhile, the ADR approach consists of negotiation, mediation and arbitration methods. It is possible for the disputing parties to use more than one dispute resolution method in the restructuring or negotiation. Selected default cases are discussed to give a brief overview of the restructuring process of several defaulted sukuk in Malaysia.

### ***Defaulted Corporate Sukuk in Malaysia***

There are 35 events of default in the Malaysian corporate sukuk market for the period 2002-2018. The list of defaulted sukuk is presented in Appendix A. From overall default events, 28 sukuk is rated by the Malaysian Rating Corporation Berhad (MARC) while the rest by the Rating Agency Malaysia Berhad (RAM). The types of defaulted sukuk are dominated by *murabahah* (31 sukuk), following by *musyarakah* (2 sukuk) and *ijarah* (2 sukuk). Domination of *murabahah* structure is reasonable since such the structure also dominated sukuk issuance in the Malaysian capital market.

The Appendix A shows that the initial long-term rating of defaulted sukuk is ranging from BBB to A2 (RAM rating) and A<sub>ID</sub> to AA<sub>ID</sub> (MARC rating), which are a classified investment grade sukuk.<sup>6</sup> Typically, an investment grade sukuk is expected to have low default probability or take a long time to default. However, according to the RAM's default study (2012), issuers with an initial rating of A and AA (in both Islamic and conventional market) contribute almost 31% of total default events over period 1992 until 2011. Interestingly, the

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<sup>6</sup> According to MARC investment grade consist bond or sukuk with rating from BBB to AAA, while non-investment or speculative grade consist bond or sukuk with rating from D to BB.



highest default events concentrate in initial rating BBB which contributes about 39% of total default events.

Based on the RAM's data, Johor Corporation (JCorp) sukuk is recorded as the first defaulted sukuk in the Malaysia capital market. The JCorp, a Johor State Government-owned Corporation, issued sukuk under *murabahah* principles amounting to MYR500 million in January 1999 and defaulted after three years in June 2002. Meanwhile, the sukuk of Sistem Lingkaran Lebuhraya Kajang Sdn Bhd (SILK) amounting to MYR2.1 billion is considered as the largest defaulted sukuk in the history of the Malaysian capital market so far. From perspective of time to default, sukuk of Pesaka Astana (M) Sdn Bhd is the shortest default events. The company issued MYR140 million of sukuk in April 2004 and assigned to default status in September 2005.

### ***Restructuring of Defaulted Sukuk in Malaysia***

As discussed in the previous sections, the disputing parties may resolve their dispute through the court or various dispute resolution alternatives or combination of both. The combination of method chosen by the disputing parties is presented in Table 1.

Table 1 shows that 17 of the 34 companies successfully resolve their disputes through only one dispute resolution method. The rest resolve it through at least two methods. This finding implies that disputing parties should not stick to one method but may use multiple resolution methods simultaneously to resolve the disputes. Furthermore, the negotiation (including negotiation under court protection) tends to be used as the first method to resolve their dispute. The court trial or mediation would become the next option if the negotiation becomes deadlocked. Interestingly, there no parties use arbitration to settle disputes. A possible explanation for this phenomenon is that the disputing parties perceive arbitration as more expensive, slower, less efficient, and less flexible than litigation.<sup>7</sup>

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<sup>7</sup> For more discussion on this issues please visit <http://www.skrine.com/an-overview-of-the-reasons-for-arbitrations-popularity-in-malaysia>

**Table 1:** Combination of dispute resolution in restructuring of defaulted sukuk

No	Issuer	The court resolution		Alternatives Dispute Resolution			Final Resolution
		Trial	Negotiation Under Court	Private Negotiation	Mediation	Arbitration	
1	ABI Malaysia Sdn Bhd			✓			n.a.
2	ACE Polymers (M) Sdn Bhd	✓		✓	✓		Liquidated
3	Ambang Sentosa Sdn Bhd		✓	✓	✓		Restructured <sup>1</sup>
4	BSA International Bhd			✓			n.a.
5	Dawama Sdn Bhd			✓			Restructured
6	Enlotech Holding Bhd	✓		✓	✓		Restructured
7	Europlus Corporation Sdn Bhd		✓	✓	✓		Restructured <sup>1</sup>
8	Evemaster Bhd			✓			Restructured
9	Hyalon Corporation (M) Sdn Bhd			✓			Restructured <sup>2</sup>
10	Inress Sukuk Bhd			✓			Restructured
11	Intelbest Corporation Sdn Bhd			✓	✓		Restructured <sup>1</sup>
12	Jana Niaga Sdn Bhd			✓	✓		Restructured
13	Johor Corporation				✓		Restructured <sup>3</sup>
14	Malaysian International Tuna Port Sdn Bhd			✓			n.a.
15	Malaysian Merchant Marine Bhd			✓			Restructured
16	Maxisegar Sdn Bhd		✓	✓	✓		Restructured <sup>1</sup>
17	Memory Tech Sdn Bhd			✓			Restructured <sup>4</sup>
18	Moccis Trading Sdn Bhd			✓			Restructured
19	M-Trex Corporation Sdn Bhd			✓			n.a.
20	Nam Fatt Corporation Bhd	✓		✓	✓		Liquidated
21	Oilcorp Bhd	✓		✓	✓		Restructured
22	Oxbridge Height Sdn Bhd			✓			Restructured <sup>5</sup>
23	Paradym Resources Industries Sdn Bhd			✓			n.a.
24	Perak-Hanjoong Simen Sdn Bhd			✓			Restructured
25	Peremba Java Holdings Sdn Bhd	✓		✓			Liquidated
26	Perspektif Perkasa Sdn Bhd	✓	✓	✓	✓		Liquidated <sup>1</sup>
27	Pesaka Astana (M) Sdn Bhd	✓		✓			Redeemed
28	PSSB Ship Management Sdn Bhd			✓			Restructured <sup>6</sup>
29	Sistem-Lingkaran Labuhava Kajang Sdn Bhd			✓			Restructured
30	Stenta Films (M) Sdn Bhd			✓			Restructured
31	Straight A's Portfolio Sdn Bhd	✓		✓	✓		Liquidated
32	The Royal Mint of Malaysia Sdn Bhd			✓			n.a.
33	Tracoma Holdings Bhd	✓	✓	✓	✓		Restructured
34	Vastalux Capital Sdn Bhd	✓	✓				Liquidated
35	Alam Maritim Resources Bhd				✓		Restructured
<b>Total</b>		<b>10</b>	<b>6</b>	<b>32</b>	<b>13</b>	<b>0</b>	

<sup>1</sup> Restructured by its holding company Talam Corporation Berhad

<sup>2</sup> Restructured through a acquisition by Recron (Malaysia) Sdn Bhd

<sup>3</sup> Mediated by Corporate Debt Restructuring Committee (CDRC) of Malaysia

<sup>4</sup> Restructured by its holding company Megan Media Berhad Holdings Berhad

<sup>5</sup> Restructured by its holding company Renewed Global Sdn Bhd

<sup>6</sup> Restructured by its holding company PSSB Strategic Holdings Sdn Bhd

The following discussion elaborates three selected cases to provide a brief overview of the restructuring process of defaulted sukuk in Malaysia.

### ***Sistem Lingkaran Lebuhraya Kajang Sdn Bhd (SILK) Sukuk***

Sistem Lingkaran Lebuhraya Kajang Sdn Bhd (SLIK) is a special purpose company which holds the 36-years concession of privatised highway namely the Kajang Traffic Dispersal Ring Road (KRR). The owner of SILK is Sunway Infrastructure Berhad (Sunway Group). SILK's core business is to implement and complete construction of the KRR. To finance land costs and the construction of the 37-km long ring road, SILK issued Bai' Bithaman Ajil Islamic Debt Securities (from now on referred as the SILK Sukuk) amounting RM2.01 billion on 23 August 2001. Malaysian Rating Corporation Berhad (MARC) has assigned a long-term Islamic debt rating of A<sub>ID</sub> (A, Islamic Debt Security) to the SILK Sukuk. MARC has reaffirmed the A<sub>ID</sub> rating for three consecutive years (2002-2004) to reflect the perceived high demand for the KRR.

However, in reality, the traffic volume at all the four tolls is consistently and significantly below the initial traffic projections. Therefore, SILK appointed a consultant to review the traffic projection and a financial adviser to review the financial position due to weak traffic volume. Due to this situation, MARC has downgraded the rating to BB<sub>ID</sub> on 9 September 2005 and subsequently to B<sub>ID</sub> on 20 September 2006. The consultant identified few problems and provided a new traffic projection. Based on such projection and the toll rate increments scheduled in the Supplemental Concession Agreement, the company's funds are expected insufficient to cover the Sukuk redemption.<sup>8</sup> Therefore, Sunway Infrastructure Berhad (SunInfra) as the owner of SILK proposed a restructuring scheme to the Sukuk holders. The detail restructuring process of the SILK sukuk is presented in Appendix B.

SunInfra proposed a 'haircut' mode of restructuring to the sukuk holders on 18 September 2006. Under such restructuring mode, SunInfra offered an early cash settlement of RM740 million as full and final settlements to all liabilities and obligations under the outstanding sukuk (Proposed Settlement). However, the Proposed Settlement was not approved by the Sukuk holders during the Extraordinary General Meeting (EGM) held on 12 October 2006. Further, SunInfra appointed Affin Investment Bank Berhad (Affin Investment) to make another restructuring proposal. Afterwards, Affin Investment on behalf SunInfra proposed a new settlement (Affin Proposal) to the Sukuk holders on 2 August 2007. The Affin Proposal consists of two restructuring options. The first option offers to convert the existing sukuk into a new *mudharabah* based sukuk. The second option offers to be paid by cash. Finally, the majority of sukuk holders approved the first option in the EGM held on 17 August 2007. Based on the EGM results, 65.87% of the existing sukuk holders was restructured by subscribing to *mudharabah* sukuk (amounting to approximately RM541.5 million), and the remaining 34.13% was paid by cash (amounting to about RM210.7 million). To implement the restructuring agreement, SILK through Manfaat Tetap Sdn Bhd, SILK's wholly owned

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<sup>8</sup> The first redemption of RM150 million will due on 22 August 2007

subsidiary and represents a special purpose vehicle, issued *mudharabah* sukuk amounting RM 752,236,660 to refinancing the existing sukuk. Such *mudharabah* sukuk has features which allow the repayment obligations of SILK to vary with the actual traffic volumes generated by the highway and it provides for a profit rate payable to the investors in a manner which allows investors to share in the excess revenue of the highway. The restructuring process was complete on 25 January 2008.

The SILK sukuk is one example of the defaulted case which successfully restructured through private negotiation. The negotiation took more than two years since the first proposal submitted to the sukuk holders on 18 September 2006 until the restructuring completed on 25 January 2008. The restructuring of SILK sukuk is also considered as a new method of restructuring in which the original sukuk converted into a new sukuk structure.

### ***Tracoma Holding Bhd (Tracoma) Sukuk***

Tracoma Holding Bhd (Tracoma) is known as one of the leading local automotive component manufacturers. Tracoma's core business is manufacturing and supply of metal-based and tubing parts components for a local brand such as Proton and Perodua as well as foreign brands such as Toyota, Honda, Nissan, Hyundai and Volvo. To finance its business expansion, Tracoma issued Bai' Bithaman Ajil Islamic Debt Securities (starting now referred as the Tracoma sukuk) amounting to RM100 million on 28 January 2005. The Tracoma sukuk was assigned an initial rating to A<sub>ID</sub> by Malaysian Rating Corporation Berhad (MARC). However, MARC placed it in a negative outlook on 3 October 2006 due to Tracoma's delay to deposit the monthly built up in the Profit Service Account (PSA) required for the future profit payments which due in January 2007. At the same time, the domestic automobile industry faced negative outlook due to weak industry fundamental. This situation is further aggravated by tightening hire purchase loans, higher interest, depressed used car prices and reduction in demand due to rising petroleum prices. The sluggish outlook affected most of the local automotive parts and components manufacturers including Tracoma as their businesses are closely linked to the local automakers. Therefore, MARC downgraded Tracoma's Sukuk in three consecutive reviews for the period 2007-2008. The downgrade reflects Tracoma's tight liquidity position and limited financial flexibility due to weak cash flow generation.

Due to tight liquidity position, Tracoma requests to vary the six scheduled monthly payments to build up the Principal Service Reserve Account (PSRA) to redeem the first series of the sukuk amounting to RM50 million which matured on 28 January 2009. However, Tracoma failed to redeem it even though the sukuk holders have approved the request. Therefore, MARC downgraded the sukuk rating to D<sub>ID</sub> (default) due to the missed principle payment. Tracoma started to renegotiate its defaulted sukuk by calls for a sukuk holders meeting to

propose a rescheduling and restructuring program (RRP). The sukuk holders approve the RRP which includes extending the maturity and repayment schedule in the third meeting on 16 January 2010. MARC assigned the restructured sukuk to C<sub>ID</sub>. However, MARC was downgraded to D<sub>ID</sub> and withdrew the rating four months later due to Tracoma's proposed further changes on it. On 3 March 2010, Bursa Malaysia Securities Berhad (Bursa) placed Tracoma's listing status under PN17 for failure to submit the audited accounts as stipulated under the Bursa regulations. In order to anticipate this situation, Pacific Trustee Berhad (Trustee) on behalf sukuk holders identified Tracoma's assets and appointed Monitoring Accountant (MA) and Independent Financial Advisor (IFA) to oversee the operations of Tracoma. The detail restructuring process of the Tracoma sukuk is presented in Appendix C.

Tracoma filed a Restraining Order (RO) to the High Court to restrain all further proceedings in any actions or proceedings against Tracoma and its subsidiaries. The High Court granted the RO for 18 months from 30 November 2010 until 8 June 2012. The RO then extended for six months from 9 June 2012 until 8 December 2012. Under the High Court protection, Tracoma tried to restructure their sukuk including invite strategic investor and filed Debt Restructuring Scheme (DRS) under the Corporate Debt Restructuring Committee (CDRC). However, all the restructuring efforts were not successful, and Tracoma delisted from the Bursa. The trustee on behalf sukuk holders declared an event of default on 31 November 2012 and appointed a law firm to take immediate relevant actions against Tracoma. The law firm sent a letter of demand on the underlying of the Sukuk to Tracoma and its subsidiaries after the High Court decided that Tracoma would not able to extend the RO. The trustee appointed a consultant to sell the underlying asset and used the proceeds to recover the Sukuk. Restructuring of Tracoma sukuk is an example for dispute resolution combination of negotiation, mediation, and the court's trial and protection.

### ***Vastalux Capital Sdn Bhd (Vastalux) Sukuk***

Vastalux Sdn Bhd (VSB) is a company wholly owned by Vastalux Energy Sdn Bhd (VEB). The VSB's core business is an upstream sector of the oil and gas industry. VSB was awarded two contracts by Petronas Carigali Sdn Bhd (PCSB) and one contract by Murphy Sarawak Oil Co Ltd (Murphy). In order to financing the contracts, VSB issued sukuk amounting RM100 billion through a special purpose vehicle namely Vastalux Capital Sdn Bhd (Vastalux Capital). The sukuk was issued under the principle of *Musyarakah Mutanaqisah* (diminishing *musyarakah*) in which the three contracts were used as the underlying assets. The sukuk was issued on 23 December 2005 and assigned an initial rating of AA-1S by Malaysian Rating Corporation Berhad (MARC). The rating has reaffirmed for three consecutive years (2007-2009).

VSB faced trouble when PCSB suspend the contracts in January 2010. This situation is aggravated by the deterioration in VSB's liquidity position as a result of pending of claims on the completed works due to purported changes in the scope of works on a major contract. Some VSB's suppliers filed winding-up petitions to the court due to VSB failed to settle its obligations. VSB filed a Restraining Order (RO) to the High Court to restrain all further proceedings in any actions or proceedings against VSB. VSB was granted a RO by the High Court to propose a Debt Restructuring Scheme (PDRS) to its unsecured creditors. However, the PDRS was rejected by the creditors. Actually, this situation had no significant effect on the sukuk holders since the sukuk was secured by the proceeds of the contracts payment that received in a special revenue account. As the secured creditors, the sukuk holders have priority on the utilisation of the special revenue account. Therefore, VSB redeemed RM21.04 million of RM25 million of the outstanding sukuk on 10 December 2010 prior to the final redemption date on 23 December 2010. However, the remaining balance of RM3.96 million cannot be settled since the High Court issued winding up order on VSB at 16 December 2010. Eventually, the remaining balance was settled under liquidation process. The detail restructuring process of the Tracoma sukuk is presented in Appendix D.

## **Conclusion**

Under Malaysia law system, the disputing parties in case of defaulted sukuk may resolve their dispute in the court or out of the court through various Alternative Dispute Resolution (ADR) mechanisms such as negotiation, mediation and arbitration. The study suggest that the disputing parties may use more than one or combination of dispute resolution method to restructure the defaulted sukuk. The negotiation tends to be chosen as the first option to resolve the dispute followed by court trial or mediation. The findings imply that the disputing parties should consider any possible dispute resolution methods available in the jurisdiction where a sukuk is structured to resolve the defaulted sukuk.

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## APPENDIX A

### The list of defaulted corporate sukuk in Malaysia for the period 2002-2011

No	Issuer	Type of Sukuk <sup>#</sup>	Issuance Date	Date of Default	Rating Agency	Initial Rating*	Issuance Size <sup>§</sup>
1	Johor Corporation	MIDS	25-Jan-1999	27-Jun-2002	RAM	BBB3	240
2	Moccis Trading Sdn Bhd	BaIDS	11-Dec-2000	03-Jun-2003	RAM	BBB3	50
3	Hualon Corporation (M) Sdn Bhd	BaIDS	17-Apr-1997	21-Nov-2003	RAM	A2	140
4	Perak-Hanjoong Simen Sdn Bhd	BaIDS	15-Nov-2001	30-Nov-2004	MARC	AA+ <sub>ID</sub>	694
5	ABI Malaysia Sdn Bhd	BaIDS	30-May-2003	24-Aug-2005	MARC	A <sub>ID</sub>	80
6	Pesaka Astana (M) Sdn Bhd	BaIDS	01-Apr-2004	30-Sep-2005	MARC	A+ <sub>ID</sub>	140
7	Europlus Corporation Sdn Bhd	MUNIF/BaIDS	03-Oct-2000	10-Mar-2006	MARC	MARC-2 <sub>ID</sub> /A <sub>ID</sub>	600
8	Maxisegar Sdn Bhd	BaIDS	22-Feb-2001	10-Mar-2006	MARC	A <sub>ID</sub>	390
9	Perspektif Perkasa Sdn Bhd	MUNIF	24-Jul-2003	10-Mar-2006	MARC	MARC-3 <sub>ID</sub>	188
10	Ambang Sentosa Sdn Bhd	BaIDS	28-Jul-2003	28-Jul-2006	MARC	A+ <sub>ID</sub>	986
11	Peremba Jaya Holdings Sdn Bhd	MUNIF/MMTN	14-Jan-2005	16-Apr-2007	MARC	MARC-2 <sub>ID</sub> /A <sub>ID</sub>	200
12	Memory Tech Sdn Bhd	BaIDS	28-Oct-2005	07-Jun-2007	RAM	A2	320
13	The Royal Mint of Malaysia Sdn Bhd	MMONIF	12-Nov-2004	08-Jun-2007	RAM	P2/A2	55
14	Paradym Resources Industries Sdn Bhd	MCP/BaIDS	17-Jul-2004	13-Jun-2007	MARC	MARC-2 <sub>ID</sub> /A- <sub>ID</sub>	80
15	Sistem-Lingkaran Lebuhraya Kajang Sdn Bhd	BaIDS	23-Aug-2001	23-Aug-2007	MARC	A <sub>ID</sub>	2010
16	ACE Polymers (M) Sdn Bhd	BaIDS	15-Sep-2004	14-Sep-2007	MARC	A <sub>ID</sub>	70
17	Stenta Films (M) Sdn Bhd	MUNIF	19-Sep-2003	20-Sep-2007	MARC	MARC-3 <sub>ID</sub>	90
18	Jana Niaga Sdn Bhd	MUNIF	04-Nov-2004	15-Nov-2007	MARC	MARC-2 <sub>ID</sub>	100
19	Intelbest Corporation Sdn Bhd	BaIDS	28-Feb-2005	29-Feb-2008	MARC	A+ <sub>ID</sub>	160
20	BSA International Bhd	MCP/MMTN	19-Oct-2004	28-May-2008	RAM	P2/A3	130
21	Evermaster Bhd	MMONIF/BaIDS	30-Dec-2003	31-Dec-2008	MARC	MARC-2 <sub>ID</sub> /A <sub>ID</sub>	90
22	Tracoma Holdings Bhd	BaIDS	28-Jan-2005	29-Jan-2009	MARC	A <sub>ID</sub>	100
23	Englotech Holding Bhd	MMTN	26-Sep-2005	27-Mar-2009	MARC	A <sub>ID</sub>	50
24	Oxbridge Height Sdn Bhd	MUNIF/MMTN	29-Apr-2005	06-Apr-2009	RAM	P1/A1	154
25	M-Trex Corporation Sdn Bhd	MCP	08-Mar-2005	21-May-2009	MARC	MARC-2 <sub>ID</sub>	60
26	Ingress Sukuk Bhd	Sukuk Ijarah	09-Jul-2004	13-Jul-2009	MARC	A+ <sub>ID</sub>	160
27	Oilcorp Bhd	MUNIF/MMTN	07-Oct-2004	07-Oct-2009	MARC	MARC-2 <sub>ID</sub> /A <sub>ID</sub>	80
28	Malaysian International Tuna Port Sdn Bhd	BaIDS	17-May-2007	18-Nov-2009	MARC	A+ <sub>ID</sub>	240
29	Straight A's Portfolio Sdn Bhd	MUNIF	13-Apr-2007	11-Dec-2009	MARC	MARC-1 <sub>ID</sub>	200
30	PSSB Ship Management Sdn Bhd	BaIDS	15-Dec-2004	15-Dec-2009	MARC	AA <sub>ID</sub>	40
31	Malaysian Merchant Marine Bhd	BaIDS	28-Nov-2003	02-Apr-2010	MARC	AA <sub>ID</sub>	120
32	Nam Fatt Corporation Bhd	MCP/MTN	10-Feb-2006	06-Apr-2010	MARC	MARC-1 <sub>ID</sub> /A+ <sub>ID</sub>	250
33	Vastalux Capital Sdn Bhd	Sukuk Musyarakah	23-Dec-2005	23-Dec-2010	MARC	AA- <sub>IS</sub>	100
34	Dawama Sdn Bhd	Sukuk Musyarakah	27-Apr-2009	29-Apr-2011	MARC	A+ <sub>IS</sub>	140
35	Alam Maritim Resources Bhd	Sukuk Ijarah/MTN	06-Jul-2007	07-Jul-2017	MARC	AA- <sub>IS</sub>	500

Note:

\* Please refer to website of RAM and MARC for details on rating definition

§ in MYR million

# BaIDS = *Bai' Bithaman Ajil* Islamic Debt Securities

MUNIF = *Murabahah* Underwritten Notes Issuance Facility

MMONIF = *Murabahah* Multi-Option Notes Issuance Facility

MIDS = *Murabahah* Islamic Debt Securities

MCP = *Murabahah* Commercial Paper

MMTN = *Murabahah* Medium Term Notes Facility

Source: RAM and MARC

## APPENDIX B

### The restructuring process of Sistem Lingkaran Lebuhraya Kajang Sdn Bhd (SILK) Sukuk

		Negotiation			Mediation		
		-----			-----		
<b>RESTRUCTURING PROCESS</b>		SILK appointed consultant to review the traffic projection and appointed adviser to review the financial position due to weak traffic volume (29/08/2005)	Sunway Infrastructure Berhad (SunInfra) proposed a cash settlement of RM740 million to sukuk holders as full and final settlement to the outstanding Sukuk (18/09/2006)	Sukuk holders rejected the proposal in the Extraordinary General Meeting (EGM) on 12/10/2006	Affin Investment on behalf of SunInfra proposed settlement (Affin Proposal) of the outstanding Sukuk (2/08/2007)	Sukuk holders approved the Affin Proposal in the EGM on 17/08/2007	65.87% of the existing sukuk holders was restructured by subscribe to sukuk mudharabah (amounting RM541.5) and the remaining 34.13% was paid by cash (amounting RM210.7 mil). The restructuring complete at 25/01/2008
		2001	2002-2004	2005	2006	2007	2008
<b>RATING MIGRATION</b>		Sukuk was issued (23/08/2001) and assigned an initial rating of A <sub>10</sub> by MARC (8/08/2001)	Affirmed to A <sub>10</sub> for three consecutive years i.e. 15/01/2003, 26/02/2004 and 2/11/2004	Downgraded to BB <sub>10</sub> (9/09/2005)	Downgraded to B <sub>10</sub> (20/09/2006)	Downgraded to D and withdrawn the rating (23/08/2007)	

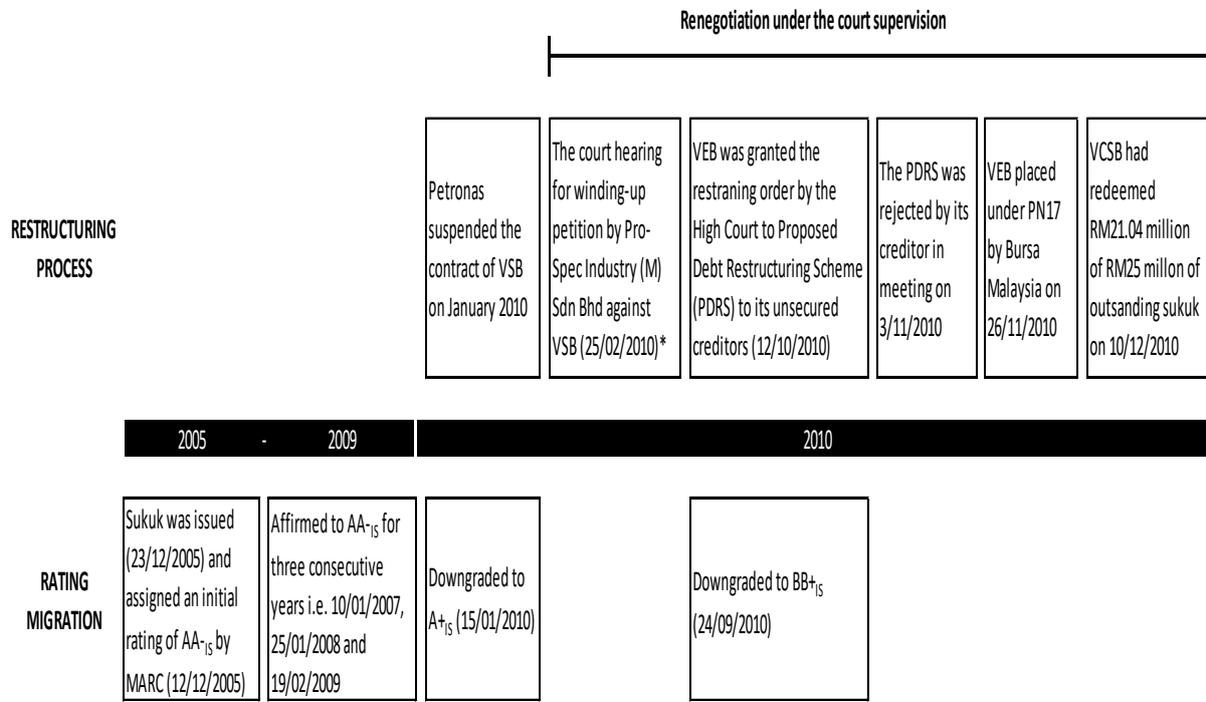
## APPENDIX C

### The restructuring process of Tracoma Holdings Bhd (Tracoma) Sukuk

		Private renegotiation								
RESTRUCTURING PROCESS										
	2005	2006	2007	2008	2009	2010				
	<p>Tracoma requests to reschedule build-up of the principal service reserve account (PSRA) and then approved by Sukuk holders</p> <p>THB called sukuk holders meeting to proposed a rescheduling and restructuring program (RRP) on 29/08/2009 and continued on 30/10/2009</p> <p>Sukuk holders approved THB's RRP on 16/01/2010</p> <p>THB assigned under Bursa Malaysia Practice Note 17 (PN17) on 2/03/2010</p> <p>Trustee identified the THB's assets and appointed Monitoring Accountant (MA) &amp; Independent Financial Advisor (IFA) to oversee the operations of THB (4/05/2010)</p>									
RATING MIGRATION	Sukuk was issued (28/01/2005) and assigned an initial rating of A <sub>10</sub> by MARC (29/11/2004)	Affirmed to A <sub>10</sub> (7/04/2006); Placed negative outlook (3/10/2006)	Downgraded to BBB <sub>+</sub> <sub>10</sub> (26/02/2007)	Placed to negative outlook (25/07/2008); Downgraded to BB <sub>+</sub> <sub>10</sub> (31/07/2008) and to B <sub>10</sub> (30/10/2008)	Downgraded to C <sub>10</sub> (23/01/2009) and to D <sub>10</sub> (29/01/2009)	MARC assigned rating of C <sub>10</sub> to restructured BalDS (2/11/2009)	Updated rating of C <sub>10</sub> (5/03/2010)	Reinstated to D <sub>10</sub> and withdrawn the rating (15/07/2010)		
		Renegotiation under court's protection								
RESTRUCTURING PROCESS										
	2010		2012							
	The High Court granted the Restraining Order (RO) for a period from 30/11/2010-8/06/2012	THB defaulted to serve the semi-annual profit payment due on 28/01/2012 and proposed restructuring plan	THB entered MOU with Yasmin Group to involved in the restructuring plan (23/03/2012)	The High Court granted extension of the RO for a period from 9/06/2012-8/12/2012	THB proposed Debt Restructuring Scheme (PDRS) under Corporate Debt Restructuring Committee (CDRC) on 1/07/2012	CDRC terminated the PDRS on 28/07/2012	Yasmin Group decided not to proceed the MOU (4/10/2012)	Sukuk holders declared an Event of Default (31/11/2012) and appointed a law firm to take immediate relevant actions	THB was delisted from Bursa Malaysia (4/11/2012)	The law firm filed an application to set aside the RO (7/12/2012) and the court decided that THB would not able to extend the RO
RATING MIGRATION										
		Final resolution								
RESTRUCTURING PROCESS	The law firm served Letters of Demand to THB and its subsidiaries (20/12/2012)	Sukuk holders appointed consultant to sale THB's assets (30/12/2012)	The proceed of the sale of assets was used to recover sukuk (as per 30/04/2013)							
RATING MIGRATION	2012			2013						

## APPENDIX D

### The restructuring process of Vastalux Capital Sdn Bhd (Vastalux) Sukuk



\* This petition was followed by another winding-up petitions by several companies for a period until December 2010.

(continued...)

