Islamic Finance and the United States Bankruptcy Courts: The Future of *Sukuk* Certificate Holders' Rights and the Importance of Considering *Shari'ah* Precepts in the Bankruptcy Process

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I. INTRODUCTION

The Islamic finance industry is one of the fastest growing financial sectors worldwide, with an estimated annual growth rate of 10-15%.[1] Total global investment in Islamic financial products is close to one trillion dollars, with some experts predicting investment will reach two trillion dollars in the next five years.[2] Most major international banks

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1. Press Release, Thomson Reuters, Islamic Finance Centre Launched by Thomson Reuters on the Westlaw Business Global Legal Platform (July 29, 2009), http://www.thomsonreuters.com/content/press_room/legal/466588.

2. McKean James Evans, *The Future of Conflict Between Islamic and Western Financial Systems: Profit, Principle and Pragmatism*, 71 U. PITT. L. REV. 819, 819 (2010); Andrew Sheng, *Is Islamic Finance the New Challenge to Wall Street?*, CHINA POST, Nov. 7 2010, http://www.chinapost.com.tw/commentary/the-china-post/special-to-the-china-post/2010/11/07/278933/p1/Is-Islamic.htm.

have developed Islamic finance divisions, and countries around the world are beginning to court Islamic finance revenue through regulatory changes.[3] The global legal industry has played a major role in the meteoric rise of Islamic finance, with major international law firms participating in the issuance of a number of innovative new Islamic financial products for clients in both the Western and Muslim worlds.[4] The legal profession's role in the industry has become so prominent that in 2009, Thomson Reuters partnered with the Islamic Financial Standards Board to launch an Islamic Finance Centre on their Westlaw Business Global Legal Platform, which is designed specifically for lawyers working on *Shari'ah* compliant deals.[5]

However, the rapid growth of the Islamic finance industry has left serious questions regarding the potential legal treatment of complex Islamic financial products in the various jurisdictions where they are issued. This is especially true in the United States, where a well-developed legal and regulatory system appeals to Islamic finance issuers and investors. However, the absence of clear legal precedent on judicial treatment of Islamic financial instruments and an increase in Islamaphobia often keeps the industry wary of pursuing high profile deals.[6] Therefore, court decisions about the treatment of Islamic financial products in the coming years will substantially affect the growth of this lucrative industry in the United States.

One crucial area of U.S. jurisprudence that remains uncertain for Islamic finance is how *Shari'ah* compliant financial products will be treated in bankruptcy, an area where Western courts could potentially find themselves issuing rulings that conflict with *Shari'ah* law.[7] This Comment seeks to shed some light on this important area and to show

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3. Suresh R.I. Perera, *Sukuks—The Emerging Trend in Islamic Finance*, ISLAMIC FIN. TODAY (May 2008), http://www.sailanmuslim.com/news/*sukuk*s-the-emerging-trend-in-islamic-finance-suresh-r-i-perera-llb-attorney-%E2%80%93-at-law-director-tax-regulatory-kpmg-ford-rhodes-thornton-co/. England, Singapore, and Malaysia are examples of countries that have enacted legislation designed to court Islamic finance. *Id.*

4. *Id.* For purposes of this Comment, the Islamic or Muslim world refers to the territory from North Africa through the Levant to Turkey, down through the Arabian Peninsula, into Iraq, Iran, Pakistan, up through Central Asia, across India and Bangladesh, and down through Malaysia, Singapore, and Indonesia. Ayman H. Abdel-Khaleq & Christopher F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in* Sukuk *Offerings*, 7 CHI. J. INT'L L. 409, 415-16 (2007).

5. *See* Press Release, Thomson Reuters, *supra* note 1.

6. *Lost in America,* ISLAMIC BUS. & FIN. (Apr. 2011), http://www.cpifinancial.net/v2/magazine.aspx?v=1&aid=2676&cat=IBF&in=63.

7. Although *sukuk* are designed to be subject to the law of the jurisdiction in which they are issued, in the bankruptcy context it could be beneficial to present evidence of *Shari'ah* when establishing the limits of the bankruptcy estate.

that U.S. bankruptcy courts can take *Shari'ah* precepts into consideration while maintaining the rights of creditors in bankruptcy, drawing in part on the lessons learned from the bankruptcies of Catholic dioceses in the wake of sexual abuse lawsuits in 2004. These cases reveal that when dealing with Islamic financial instruments involved in a default, as long as the twin bankruptcy principles of equity and justice are preserved, U.S. bankruptcy courts can successfully achieve an equitable result for all the stakeholders involved, while respecting the precepts of *Shari'ah* and the rights of Islamic investors.[8]

II. INTRODUCTION TO *SHARI'AH*[9]

Shari'ah, which translates to "the path" in Arabic, is the holy law of Islam.[10] It is primarily derived from two sacred texts, the *Qur'an* and the *Sunna*. The *Qur'an* is the Islamic holy scripture, composed of revelations received by the Prophet Mohammad from the archangel Gabriel from 610 A.D. to 632 A.D.[11] The *Sunna* contains the prophetic example set by the Prophet Mohammad, revealed through a compilation of his sayings and conduct.[12] The *Sunna* describes what the Prophet promoted, allowed, and prohibited in a narrative form known as *Hadith*.[13] In any *Shari'ah* inquiry, the first step is to look to these two texts to see if the behavior is expressly condoned or prohibited.

However, *Shari'ah* not only encompasses the "black letter" law of the Muslim faith, but also the methodology through which Muslim jurists apply legal reasoning to religious texts to derive the law in accordance with divine will, a process known as *ijtihad*.[14] Through this process, Islamic jurists have supplemented the fundamentals provided in the *Qur'an* and the *Sunna* with centuries of scholarly interpretation embodied in two secondary sources of Islamic law, *ijima* and *qiyas*.[15] *Ijima* refers to the consensus of Islamic scholars and jurists on certain

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8. Jonathan C. Lipson, *When Churches Fail: The Diocesan Debtor Dilemmas*, 79 S. CAL. L. REV. 363, 368-69 (2006).

9. This Comment does not purport to explain fully subjects as extensive and complex as the nature and interactions of Islamic finance and *Shari'ah* law. Instead, it will attempt to provide the reader with the basic principles necessary to understand the rest of this Comment. It is important to remember that there are varying interpretations of *Shari'ah* law and Islamic financial principles throughout the world, and different sects of Islam may adopt different interpretations.

10. Abed Awad & Robert E. Michael, *Iflas and Chapter 11: Classical Islamic Law and Modern Bankruptcy*, 44 INT'L LAW. 975, 976 (2010).

11. *Id.* at 977.

12. *Id.*

13. *Id.*

14. *Id.* at 978. *Ijtihad* translates to "to exert, strive and/or endeavor." *Id.*

15. Evans, *supra* note 2, at 821; Awad & Michael, *supra* note 10, at 978.

issues, and *qiyas* are analogous reasoning to the higher sources of Islamic law when an unfamiliar issue arises.[16] Over time, the varying interpretations of the sources of *Shari'ah* developed into four different Sunni[17] schools of Islamic jurisprudence, known as *madhaheb*, each with its own interpretation of what is permitted.[18] This means that today there is ongoing debate between, and sometimes within, the various schools about what is acceptable and what is prohibited.

In the fourteenth century, the development of the *Shari'ah* jurisprudential system was interrupted by the incursion of the Ottoman Empire, and later the various European colonial powers, into the Muslim Caliphates.[19] These incursions led to the imposition of various legal systems on the Muslim world. The European colonial occupation in particular left a permanent mark on the legal systems of many Muslim countries, and today the various national legal systems of the Arab world frequently contain elements of European common and civil law in addition to *Shari'ah* principles.[20] However, today most countries that belong to the Organization of the Islamic Conference have legal systems that are partially, if not fully, influenced by *Shari'ah* law.[21]

Whether or not *Shari'ah* law is codified in the jurisdiction where they live, most Muslims will try to follow *Shari'ah* precepts whenever possible.[22] In fact, Islamic historians will point out that the *Shari'ah*'s boundaries are fluid, since the expansion of Islam into new lands is ongoing.[23] However, when Muslims move into Western jurisdictions, complying with *Shari'ah* can become challenging. This is especially true in the financial sector, where *Shari'ah* precepts frequently conflict with

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16. Awad & Michael, *supra* note 10, at 978.

17. *Id.* at 975 n.*. The two main denominations of Islam are Sunni and Shi'a, with eighty-seven to ninety percent of Muslims worldwide belonging to the Sunni denomination. *Id.*

18. *Id.* at 977. The surviving schools in Sunni law are *Hanafi*, *Maliki*, *Shafi'i*, and *Hanbali*. *Id.* at 978.

19. *Id.* at 979.

20. *Id.* Two excellent examples of this mix of European legal influences with law are Egypt and Pakistan, both of which apply *Shari'ah* law mixed with British common law influences. Abdel-Khaleq & Richardson, *supra* note 4, at 416.

21. Abdel-Khaleq & Richardson, *supra* note 4, at 416. Most of the conservative states in the Arab world have legal systems entirely governed by *Shari'ah* law, with Saudi Arabia being an excellent example. *Id.* A complete list of the member states in the Organization of the Islamic Conference can be found on the organization's Web site: Organisation of Islamic Cooperation, MEMBER STATES, *available at* http://www.oic-oci.org/member_states.asp. *See generally* ISLAMIC LAW AND THE CHALLENGES OF MODERNITY (Yvonne Haddad & Barbara Stowasser eds., 2004) (describing the process of restoring *Shari'ah* into Arab constitutional law and the impact of the current modernization and legal reform on women).

22. Abdel-Khaleq & Richardson, *supra* note 4, at 415.

23. *Id.*

the Western financial system, and give and take on both sides is necessary to achieve economically acceptable solutions.[24]

III. *SHARI'AH* AND ISLAMIC FINANCE

From its inception, *Shari'ah* contained many precepts that dictated how Muslims should handle their financial affairs. For the most part, these precepts revolved around the ideals of charity and compassion, which were considered "divine compulsions."[25] One of the overriding goals of *Shari'ah* is to protect the poor in society from the wealthy, especially moneylenders, who frequently took advantage of impoverished Muslims in the early days of the religion.[26] Some of the financial precepts proscribed by *Shari'ah* to achieve this goal are a prohibition on earning interest on debt, known as *riba*; a prohibition on taking excessive contractual risk, known as *ghirar*; and a requirement that Muslims own the assets that earn income.[27] As economic globalization increased, and Muslims immigrated in increasing numbers to non-*Shari'ah* jurisdictions, these prohibitions severely limited their ability to invest and raise money in Western capital markets.

Of the above three precepts, the prohibition on charging or receiving interest on debt (*riba*) has proven the most challenging for modern Islamic finance to overcome. The *Qur'an* specifically prohibits charging interest, reading "[t]hose who consume usury (riba) shall not rise from the dead. . . [t]his is because they allege that commerce is the same as usury (riba). But God has made commerce licit and usury illicit . . . . God annuls usury and augments free gifts."[28] While all Muslim scholars agree that the prohibition on *riba* exists in the *Qur'an*, there is an ongoing debate in Islamic financial circles over the exact meaning of *riba*, and therefore, the extent to which collecting interest is prohibited.[29] The most commonly held view is that the prohibition on *riba* is a complete prohibition on charging or paying interest.[30] Supporters of this view point out that *Shari'ah* does not recognize the time value of money, or the idea of money as being capable of storing

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24. *See* Evans, *supra* note 2, at 836-37 (arguing that where the increased costs of developing Islamic financial instruments that comply with Western financial systems reduce the cost-effectiveness of maintaining *Shari'ah* principles, rational actors will chose the most economically efficient compromise).

25. Awad & Michael, *supra* note 10, at 981.

26. *Id.* at 978-79.

27. Evans, *supra* note 2, at 822-23.

28. Awad & Michael, *supra* note 10, at 981 (alterations in original) (citation omitted).

29. *Id.* at 982.

30. Evans, *supra* note 2, at 822.

value in itself (although, interestingly, *Shari'ah* does recognize the time value of tangible assets).[31] Additionally, without interest increasing a debt, the debtor will have a lifetime to pay it off, which fits with *Shari'ah*'s focus on compassion and aid for the impoverished members of society.[32] Thus, the prohibition on interest prevents compounding debt that can quickly leave a debtor at the mercy of his creditors.

Islamic financial institutions in countries wholly or partially governed by *Shari'ah* law are usually regulated and restricted by the legal system. However, in many ways it is easier for them to operate, since property, tax, and bankruptcy laws in these jurisdictions will generally follow *Shari'ah* to some degree.[33] Yet, as the Muslim world and the Western world become increasingly intertwined, Islamic financial principles have increasingly come into conflict with the Western financial system. One of the main areas of conflict has been the inability of Muslim investors to issue and hold conventional Western loans and bonds.[34]

IV. INTRODUCTION TO *SUKUK*

In the wake of World War II, many Muslim countries regained their independence, and traditional *Shari'ah* values experienced a resurgence. In the 1970s and 1980s, the current Islamic finance industry arose in the form of Islamic banks and investment houses that operated according to *Shari'ah* principles, with religious advisory boards to ensure religious compliance.[35] The prohibition on interest and holding Western bonds quickly became problematic for Islamic financial institutions and investors looking for diversity and liquidity.[36] In response, the Islamic finance movement began to experiment with new financial structures that complied with *Shari'ah*, while providing risk and returns comparable to Western bonds. This innovative process continues today and has produced a number of transactional structures that have been approved by *Shari'ah* scholars.[37] Most of these structures are some derivation of

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31. Awad & Michael, *supra* note 10, at 983.

32. *Id.*

33. Abdel-Khaleq & Richardson, *supra* note 4, at 416.

34. NATHIF J. ADAM & ABDULKADER THOMAS, ISLAMIC BONDS: YOUR GUIDE TO ISSUING, STRUCTURING, AND INVESTING IN *SUKUK* 5 (2004).

35. *Id.* at 1.

36. *Id.* at 10.

37. Abdel-Khaleq & Richardson, *supra* note 4, at 411-12. Examples of these structures are *murabaha* (cost plus financing), *ijara* (lease-buyback), *musharaka* (partnership), *mudaraba* (sweat capital), *wakala* (investment agency), and *istisna'a* (construction/engineering and procurement contract). However, not all of these structures are accepted by all schools of *Shari'ah*. *Id.*

the partnership model, or sale-leasebacks, with the investor and borrower both sharing in the profit, loss, and risk of the venture under a prearranged agreement.[38] The most successful of these financial instruments have been hybrid structures of debt and equity known as *sukuk*, which are approved by many religious scholars and Islamic finance organizations as being *Shari'ah* compliant while providing returns comparable to Western bonds.[39]

The term *sukuk* comes from the plural form of the word *saak*, which means title or investment certificate.[40] The term arose in the seventh century when Muslim soldiers were paid in certificates representing certain commodities.[41] Today, the term *sukuk* refers to investment certificates based on or backed by ownership rights in certain assets, which also entitle the certificate holder to payments based on the income of those assets. *Sukuk* transactions may come in many forms, with the most common being a sale-leaseback transaction known as *ijarah*.[42] To put it in the simplest terms possible, in an *ijarah* transaction, an asset or group of assets is transferred from its owner to another party in exchange for payment based on the assets' performance. Payment is made on a regular schedule over a predetermined period, allowing the *sukuk* certificate to provide many of the same characteristics as bonds.[43] All *sukuk* issuances are made with the help of a *Shari'ah* board of advisors, which eventually will issue, or help to obtain, a *fatwah* (similar to a legal opinion) assuring Muslim investors that the securitized assets comply with *Shari'ah* law.[44] The *fatwah* must be issued before the *sukuk* can be issued.[45] To ensure the *sukuk*'s success, both "the assets underlying the *sukuk* and the offering company must be *Shari'ah*-compliant."[46] Among other requirements, the underlying assets, the issuing company, or its subsidiaries may not be engaged in *Shari'ah* prohibited industries like gambling, the sale of pork products, interest-

38. Evans, *supra* note 2, at 824. Evans makes the analogy that Islamic financing frequently resembles the Uniform Partnership Act more than article 9 of the U.C.C. on secured transactions. *Id.*

39. *Id.* at 827.

40. *Id.*

41. *Id.*

42. *See* ADAM & THOMAS, *supra* note 34, at 7-8 (providing a comprehensive explanation of the various structures used in *sukuk* issuances).

43. *Id.* The rate of return on a *sukuk* certificate may not be directly linked to a "prime rate," like the London Interbank Offered Rate (LIBOR), that is interest based, but a well-structured *sukuk* with reliable underlying assets can generate a profit-based return that replicates those rates. Abdel-Khaleq & Richardson, *supra* note 4, at 412.

44. Abdel-Khaleq & Richardson, *supra* note 4, at 411.

45. *Id.*

46. *Id.* at 417.

charging finance, overly speculative or risky activity, or have high debt ratios.[47] It also means that *sukuk* issuances can quickly become expensive, since significant due diligence must be done, and only a few *Shari'ah* scholars have the financial experience required to serve on a *sukuk* religious advisory board, so their services are in high demand.[48]

Sukuk are frequently referred to as "Islamic bonds," and are sometimes formatted in compliance with bond regulations in the countries where they are issued.[49] However, this classification is misleading. In reality, *sukuk* are a hybrid of debt and equity, with the certificate holder possessing both an ownership interest in the underlying assets and an ownership interest in the stream of income that the assets produce.[50] Most *sukuk* are created by transferring certain assets from an originator to a series of trusts or special purpose vehicles, which then issue the *sukuk* certificates to the investors and make payments to them based on the performance of the underlying assets.[51] This sale-leaseback is classified as an *ijara* transaction and has been used in most corporate[52] *sukuk* issuances to date.[53] Although the *ijara* structure (and variations from it) has proven to be the most popular so far, there is speculation that the trend may be shifting to other *Shari'ah*-compliant financial structures.[54]

Sukuk are also distinguishable from Western bonds from an investment perspective. Western bonds are usually unrelated to the value of any particular underlying asset, while one of the primary *Shari'ah*

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47. *Id.* The prohibition on investing money with institutions that also engage in interest earning activities can be problematic, and many investment and traditional banks open Islamic branches to avoid comingling "Islamic" funds with funds that are connected with interest activities. *Id.*

48. Farmida Bi, *Banking & Finance: Sukuk Succour*, LAWYER (June 11, 2007), http://www.thelawyer.com/banking-and-finance-*sukuk*-succour/126433.article.

49. Evans, *supra* note 2, at 827.

50. Abdel-Khaleq & Richardson, *supra* note 4, at 412.

51. Michael J.T. McMillen, *Contractual Enforceability Issues: Sukuk and Capital Markets Development*, 7 CHI. J. INT'L L. 427, 428 (2007).

52. While corporations have issued the majority of *sukuks* to date, sovereign entities have been responsible for some of the largest *sukuk* issuances. The Malaysian government began to issue them in the 1980s, and they were later adopted by a large number of countries in the Arab world that had previously been forced to borrow in international markets rather than locally because of the prohibition on trading debt and interest-backed securities. Interestingly, in 2004, the province of Saxony-Anhalt, Germany, was the first Western government to issue a *sukuk*, raising 100 million euros. Abdel-Khaleq & Richardson, *supra* note 4, at 413.

53. *Id.* at 412. In practice, there are two main categories of *sukuk* issuances, asset-backed and asset-based. Asset-backed *sukuk* are based on the credit of the issuer instead of a particular set of assets. While the certificates are supposed to correspond to an ownership interest in an asset, the ultimate credit provider is usually a sovereign entity. McMillen, *supra* note 51, at 428.

54. *See* Abdel-Khaleq & Richardson, *supra* note 4, at 414.

requirements of *sukuk* is that the certificates correspond to an actual ownership interest in the income producing assets.[55] Additionally, Western bonds generally offer either a fixed rate of return or a rate of return tied to a particular interest reference rate, like the London Interbank Offered Rate (LIBOR). However, payments made to *sukuk* certificate holders are generally calculated with reference to a comparable interest rate but provide a rate of return based on the performance of the securitized assets.[56]

Modern forms of *sukuk* have not been accepted by all Islamic scholars, some of whom regard *sukuk* as sham transactions that conform with the structural requirements of *Shari'ah* while abandoning the underlying principles.[57] The practice of paying asset managers incentives to achieve returns that mirror interest-based returns has been especially criticized.[58] There are also geographic divisions of opinion; many Islamic scholars in the Arab world criticize the less conservative standards adopted by Islamic scholars in Malaysia, which allow *sukuk* to be backed by pools of *Shari'ah* compliant debt.[59] Other scholars have encouraged transactions that are similar to partnerships, arguing that such transactions are more compliant with *Shari'ah* because risk is shared and there is no assurance of earning guaranteed income.[60] This debate over *sukuk* is ongoing within the Islamic finance and religious communities today.

Another obstacle to the development of *sukuk* has been the lack of a cohesive international governance system regarding their issuance and structure. With no cohesive governance structure for *sukuk* issuances, and few Muslim scholars with the financial acumen and religious knowledge necessary to approve an issuance, it can be difficult to get a *sukuk* to market. However, that is beginning to change. A major breakthrough occurred in 1988, when the Fiqh Academy of the Organization of the Islamic Conference issued a ruling stating that, subject to proper legal documentation,

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55. ADAM & THOMAS, *supra* note 34, at 5; Evans, *supra* note 2, at 823. Many *Shari'ah* scholars stress that one of the key factors legitimizing Islamic finance under *Shari'ah* is that the funding must be for the production or lending of real assets. ADAM & THOMAS, *supra* note 34, at 5.

56. Evans, *supra* note 2, at 828.

57. *Id.* at 829.

58. *Id.*

59. Abdel-Khaleq & Richardson, *supra* note 4, at 412.

60. *Id.* Some *sukuk* pay predetermined returns while others require profit sharing and even loss sharing. McMillen, *supra* note 51, at 429.

> any collection of assets can be represented in a written note or bond; and that this bond or note can be sold at a market price provided that the composition of the group of assets, represented by the security, consists of a majority of physical assets and financial rights, with only a minority being cash and interpersonal debts.[61]

While Fiqh Academy rulings are not considered binding law, they are influential on most Islamic financial institutions.[62] After the Fiqh Academy ruling, the Accounting and Auditing Organization for Islamic Financial Institutions issued a set of standards for *sukuk*, defining them as "certificates of equal value put to use as common shares and rights in tangible assets, usufructs, and services or as equity in a project or investment activity."[63] The standards also emphasized that *sukuk* were not debt, but fractional ownership interests in assets.[64] In the wake of these decisions, the Islamic Financial Services Board began working to develop an effective model legal infrastructure for *sukuk*, which should reduce costs and legal uncertainty for *sukuk* issuers.[65]

One of the most appealing aspects of *sukuk* for both Muslim and Western investors is that *sukuk* can be traded on certain markets, subject to applicable securities laws.[66] To date, *sukuk* appear on a number of specialized exchanges throughout the world.[67] Additionally, bankers in major global financial centers like London and New York are increasingly participating in *sukuk* issuances.[68] However, the development of *sukuk* markets has been hindered by the difficulties involved in obtaining ratings for *sukuk* offerings from the major credit ratings agencies.[69] One of the main reasons the major international rating agencies are reluctant to rate *sukuk* offerings is the difficulty of obtaining "satisfactory legal opinions" on a variety of enforceability issues, including bankruptcy remoteness and whether the assets have been transferred in a true sale.[70] It is clear is that many Islamic jurisdictions would require considerable legal reform before such satisfactory legal

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61. ADAM & THOMAS, *supra* note 34, at 4-5.
62. *Id.* at 4.
63. McMillen, *supra* note 51, at 428.
64. *Id.* at 429. The standards also provide fourteen eligible asset classes for *sukuk* issuance. *Id.*
65. Evans, *supra* note 2, at 827-28.
66. Abdel-Khaleq & Richardson, *supra* note 4, at 414.
67. *Id.* at 414-15.
68. *Id.*
69. McMillan, *supra* note 51, at 431-32. The "big three" credit rating agencies are Standard & Poor's, Moody's Investor Service, and Fitch Ratings.
70. *Id.*

opinions can be issued.[71] Because *sukuk* transaction costs are already high, standardizing transactions to reduce risk is highly desirable for issuers.[72] Therefore, in the near future, most *sukuk* will likely be issued in Western jurisdictions that have extensively developed securities, bankruptcy, and tax laws, such as the United States.[73] However, when issuing *sukuk* in these jurisdictions, questions often arise regarding to what extent *Shari'ah* and *Shari'ah* compliant transactions can be enforced, since *Shari'ah* is not incorporated into the secular law.[74]

V. THE OBSTACLES TO ISSUING *SUKUK* IN WESTERN JURISDICTIONS

As mentioned above, an increasing number of *sukuk* will likely be issued in Western jurisdictions in the coming years. While the legal systems of these jurisdictions are often well suited to *sukuk* issuances and provide more legal certainty than less developed jurisdictions, the proliferation of Islamic finance in the West has been somewhat hampered by political opposition, especially in the United States. The United States and many European countries have experienced a backlash against all things *Shari'ah* related in the wake of the September 11 terrorist attacks and the ongoing wars in Iraq and Afghanistan.[75] In the United States, this backlash has manifested itself in claims that *Shari'ah* is incompatible with the United States Constitution and in calls from high-ranking politicians for federal laws to prevent *Shari'ah* from being recognized in any U.S. court.[76] Critics have also suggested that the trillion-dollar Islamic finance industry is actually a front to funnel funds to terrorist organizations.[77] To date, these calls have been largely ignored by U.S. courts. For example, on January 14, 2011, a Michigan district court rejected a claim filed by a U.S. Marine veteran alleging that the U.S. government had violated the Constitution by allowing American International Group (AIG) to use federal bailout money to fund its Islamic insurance business.[78] However, at the state level, there have been movements against recognizing the practice of *Shari'ah* in any form,

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71. *Id.* at 433.
72. *Id.* at 436.
73. *Id.* at 433.
74. *Id.* at 432.
75. Abdus Sattar Ghazali, *American Muslims Ten Years After 9/11*, AM. MUSLIM PERSPECTIVE (Sept. 6, 2011), http://www.amperspective.com/?page_id=1740.
76. *Islamic Finance Faces Political Hurdles in U.S.*, REUTERS, Oct. 29, 2010, *available at* http://www.*sukuk*.me/news/articles/73/Islamic-finance-faces-political-hurdles-in-US.html.
77. *Id.*
78. Murray v. Geithner, 763 F. Supp. 2d 860, 871, 875 (E.D. Mich. 2011).

including in the courts.[79] Members of the U.S. Islamic finance community are concerned that if the movement against Islamic finance in the United States gains momentum, Islamic investors could begin to take their business elsewhere.[80] In this tense environment, every U.S. court decision that touches on Islamic finance and *Shari'ah* law is watched closely by both the legal and financial industries, since a negative decision could lead to serious losses of revenue or even destroy the emerging industry's prospects in the United States.

VI. *SUKUK* AND BANKRUPTCY IN THE UNITED STATES: *IN RE EAST CAMERON PARTNERS*[81]

The recent bankruptcy case *In re East Cameron Partners* provides an excellent example of the tensions that can arise when Islamic finance instruments meet the U.S. legal system. When the East Cameron Gas *sukuk* was issued in 2006, it was lauded as the first *sukuk* backed by assets located in the United States.[82] The assets securitized were royalties from federal oil leases off the coast of Louisiana. The assets were transferred by the originator, East Cameron Partners, LP, through a true sale to a special purpose vehicle (SPV)[83] located in the United States, which in turn transferred them to an offshore SPV, a Cayman Islands LLC, which issued the *sukuk* certificates.[84] The funds ultimately flowed back to East Cameron Partners, a U.S. oil and gas company that owned

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79. *See id.*; *see also* Tim Lockette, *Legislation Would Ban Islamic Law in Alabama Courts*, ANNISTON STAR, Mar. 4, 2011, http://www.annistonstar.com/view/full_story/12157691/article-Legislation-would-ban-Islamic-law-in-Alabama-courts.

80. *Islamic Finance Faces Political Hurdles in U.S.*, *supra* note 76.

81. *In re* E. Cameron Partners, L.P., 2008 Bankr. LEXIS 3918 (Bankr. W.D. La. 2008); *see In re* E. Cameron Partners, L.P., 2008 U.S. Bankr. Ct. Motions 51207 (Bankr. W.D. La. 2009).

82. Abdel-Khaleq & Richardson, *supra* note 4, at 422. Most *sukuk* issued in the Muslim world have been supported by assets located in jurisdictions where *Shari'ah* law is incorporated at least to some degree. *Id.* at 415.

83. Special purpose vehicles, or SPVs, are frequently used in asset securitization transactions to ensure bankruptcy remoteness from the issuer. They can take a variety of legal forms, including trusts, LLCs, and corporations. In a typical "multi-tier" securitization transaction, an issuer (sometimes called an originator) transfers the assets to a subsidiary SPV in a "true sale." The "first-tier" SPV then transfers the assets to a second SPV to make them even more remote from the originator. The second SPV then issues the securities, or debt instruments. *See generally* Kenneth N. Klee et al., *Asset-Backed Securitization, Special Purpose Vehicles and Other Securitization Issues*, American Bar Association Continuing Legal Education, ALI-ABA Course of Study, SJ082 ALI-ABA 55, June 10-12, 2004.

84. Abdel-Khaleq & Richardson, *supra* note 4, at 423. The ability to sell royalty ownership interests in oil and gas rights is one factor that makes oil and gas law a unique match for *sukuk* issuances. *See generally* Christopher F. Richardson, *Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field*, 42 TEX. INT'L L.J. 119 (2006-2007) (describing how U.S. oil and natural gas law is an excellent match for *sukuk* issuances).

and operated the leases producing the royalties.[85] From the beginning, the structure of the transaction was designed to ensure the bankruptcy remoteness of the Cayman Islands LLC. The Cayman Islands LLC exclusively possessed an interest in the royalties from the leases and did not take part in the drilling or production.[86] The *sukuk* investors bore the risk that the oil and gas reserves could be insufficient to support the *sukuk*, along with the risk of a natural disaster affecting production.[87] Additionally, the transaction was structured to try and ensure that the sale of the royalties would be considered a true sale of a real property interest under Louisiana state law, a technique used to ensure bankruptcy remoteness.[88] By conveying the royalty interest as a true sale the deal was more secure from both a *Shari'ah* and a bankruptcy perspective.[89] To reduce the risks related to the *sukuk* and the issuer, the transaction contained a number of risk reducing aspects, like reserve accounts, security interests, and *Shari'ah* compliant hedges.[90]

When it was issued, the East Cameron Gas *sukuk* was praised as a breakthrough in Islamic finance. Not only was it the first *sukuk* backed by assets located in the United States and the first issued by a U.S.-based company, but it was also a truly international effort. Banks in London and Beirut underwrote and coordinated the issuance, and legal assistance was provided by lawyers in Dubai and Houston, Texas.[91] The *fatwah* approving the structure was issued by two *Shari'ah* scholars, one in the United States and one in Bahrain.[92] The *sukuk* certificates were purchased by both Islamic and Western investors.[93] The issuance was classified under U.S. securities laws as a Regulation S international offering and a Regulation D domestic private placement.[94] Additionally,

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85. Abdel-Khaleq & Richardson, *supra* note 4, at 423. To avoid invalidation of the deal due to East Cameron Partners' debt burden, the funds raised through the *sukuk* were used to eliminate the company's outstanding debt, leaving it with a *Shari'ah* acceptable debt equity ratio. *Id.*

86. *Id.*

87. *Id.* at 423-24. One of the risks associated with the *sukuk* was East Cameron Partners' cost to repair the damage to their facilities from Hurricanes Katrina and Rita in 2005. Blake Goud, *Courting Disaster, Islamic Business and Finance*, CPI FIN. (Apr. 10, 2010), http://www.cpifinancial.net/v2/Magazine.aspx?v=1&aId=2330&cat=IBF&in=52.

88. Abdel-Khaleq & Richardson, *supra* note 4, at 423.

89. *Id.*

90. *Id.* at 424.

91. *Id.* at 422-23.

92. *Id.* at 424.

93. *Id.* at 422.

94. *Id.*

the East Cameron Gas *sukuk* was one of the first *sukuk* issuances to be rated by Standard & Poor's.[95]

Then, in October of 2008, the *sukuk* originator, East Cameron Partners, LP, filed for Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the Western District of Louisiana located in Lafayette, Louisiana.[96] As the proceedings neared, East Cameron Partners, LP, attempted to wrap the royalty rights owned by the *sukuk* holders into the bankruptcy estate. The originator's argument was that the *sukuk* transaction was actually a secured loan instead of a true sale.[97] Resolution of this issue was crucial from both a U.S. bankruptcy law and a *Shari'ah* perspective. For bankruptcy purposes, if the transaction was deemed a true sale, the *sukuk* certificate holders would have the sole proprietary rights to the underlying royalty interests, like owners.[98] However, if the transaction was deemed a secured loan, then the *sukuk* certificate holders would only have contractual rights to the assets, putting them in the same position as Western bondholders, and they would have to take their place in line with the other creditors.

From a *Shari'ah* perspective, the issue was crucial. Debate over whether *sukuk* certificates represented debt or equity had been ongoing in Islamic financial circles for years. Opponents of *sukuk* had consistently taken the position that they were sham transactions disguising ownership of debt as equity interests, and therefore did not comply with *Shari'ah*. To comply with *Shari'ah*, the *sukuk* certificates in the East Cameron Gas *sukuk* issuance had to represent an undivided ownership interest in the royalties, as had been indicated by the *fatwah* and the marketing materials.[99] However, the extent to which a Western court would actually uphold *sukuk* certificate holder's ownership rights had never been tested. Now the issue was finally going to come before a Western court, although the U.S. Bankruptcy Court for the Western District of Louisiana in Lafayette, Louisiana was about as far from *sukuk*'s origins in the ancient Muslim Caliphates imaginable. Resolution

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95. Mohammed Khnifer, *When Sukuk Default—Asset Priority of Certificate-Holders vis a vis Creditors*, OPALESQUE ISLAMIC FIN. INTELLIGENCE (Sept. 2, 2010), http://www.opalesque.com/OIFIArticle/81/*Sukuk*_Default_Asset_Priority429.html. The East Cameron Gas *sukuk* was rated poorly at CCC+ because the energy deposits were undeveloped when the *sukuk* was issued. Standard & Poor's divides *sukuk* into two ratings categories based on whether they are asset-backed, and therefore rated based in the ability of the underlying assets to meet the special purpose vehicle's obligations, or asset-based, and therefore rated based on the credit worthiness of the originator. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. Abdel-Khaleq & Richardson, *supra* note 4, at 424.

of this case was an opportunity to settle some of the legal uncertainty surrounding *sukuk* and to set important precedent in the bankruptcy area; the court's holding could promote or hinder the issuance of more *sukuk* in the United States.

However, the case was complicated because the East Cameron Gas *sukuk* structure appeared to have a weakness. Another level of transfer to a third SPV independent of the first two should have been made to further guarantee the separation of the *sukuk* assets from the bankruptcy estate.[100] As this issue came to light, a source close to the case was quoted as saying: "In their desire to deliver products (*sukuk*) that resemble credit instruments (like bonds), originators have sometimes blurred the distinction between credit and equity . . . . [T]he originator spent a lot of time on the matter of credit enhancements (protecting banks) and very little time on protecting investors' rights."[101] With this weakness in mind, proponents of *sukuk* in the United States were bracing themselves for a negative result.

On March 31, 2010, the bankruptcy judge issued an order accepting the transfer of the royalty interests from East Cameron Partners, LP, to the *sukuk* issuer as a true sale, making the certificate holders the owners of the royalty interests.[102] The decision was granted in part because the certificate holders had relied on the transfer of the royalty interest being a true sale when they invested in the *sukuk*.[103] This meant that the *sukuk* holders got full ownership of the royalty interests without having to "line up" with the other creditors.[104] Although this was a positive result for the *sukuk* certificate holders, overall the decision was a disappointment for the Islamic finance community because of the legal means the court used to resolve the issue.

The court could have held that the *sukuk* certificate holders were owners with an undivided interest in the assets. However, the court instead treated the certificate holders as third party buyers.[105] Although the *sukuk* certificate holders argued that they were the true owners of the royalty interests, the court chose to resolve the issue under Section 363 of the U.S. Bankruptcy Code,[106] titled "Use, sale, or lease of property,"

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100. Khnifer, *supra* note 95.

101. *Id.* (internal quotation marks omitted).

102. *Id.*

103. *Id.*; *see also Islamic Finance: Restructuring Proof? Ask East Cameron*, WESTLAW BUS. CURRENTS, Aug. 25, 2009, http://currents.westlawbusiness.com/Article.aspx?Id=19d743af-7982-4a2a-ac22-a66c2ee87de8&cId=&src=&sp=.

104. Khnifer, *supra* note 95.

105. *Id.*

106. 11 U.S.C.S. § 363 (2010).

which permits a bankruptcy court to approve the sale of the assets of a business without obtaining a vote from the creditors and equity holders of the debtor.[107] In the wake of the case, commentators have speculated that one reason the East Cameron Gas *sukuk* holders prevailed was that the *sukuk* structure was asset-backed instead of asset-based, and that if it had been asset-based, the *sukuk* holders would have been lumped in with the other creditors.[108] In other words, although the *sukuk* structure had not been as remote from bankruptcy as possible, the structure was saved by the fact that the SPV owned the royalty assets at arm's length, and did not rely on the credit worthiness of East Cameron Partners, LP, to support the issuance.

VII. WHY *SUKUK* CERTIFICATE HOLDERS SHOULD BE PERMITTED TO INTRODUCE *SHARI'AH* PRECEPTS IN BANKRUPTCY PROCEEDINGS

In re East Cameron Partners went a long way towards eliminating the legal uncertainty surrounding *sukuk* issuances in the United States. However, the resolution of the *sukuk* certificate holders' ownership interests as a sale under § 363 left open the issue of to what extent *Shari'ah* precepts will be taken into account in the bankruptcy context. This Part of the Comment will show that although it would be difficult, if not impossible, to allow *Shari'ah* law to control entirely in the bankruptcy context without violating the Establishment Clause of the U.S. Constitution[109] (Establishment Clause), as courts of equity, bankruptcy courts can still take *Shari'ah* precepts into account as evidence when doing so is necessary to achieve an equitable result. This is especially true in a situation like *In re East Cameron Partners*, where the *sukuk* certificate holders did not voluntarily choose to submit themselves to the bankruptcy court, but were forced to intervene in the proceedings as stakeholders to defend their ownership rights. In such situations, failing to take *Shari'ah* considerations into account could raise constitutional concerns under both the Free Exercise Clause[110] and the Establishment Clause, as well as interfere with the proclamations of

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107. Goud, *supra* note 87. Assuming that the leases are still valuable, the *sukuk* certificate holders should be able to recover their investment. *Id.*

108. *Id.*; Khnifer, *supra* note 95; *see* sources cited *supra* note 53 and accompanying text.

109. U.S. CONST. amend. I ("Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.").

110. *Id.* The Free Exercise Clause generally refers to the portion of the amendment that reads: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof . . . ." *Id.*

Shari'ah scholars. Considering the political rhetoric already surrounding the application of *Shari'ah* law in U.S. courts, these issues must be handled delicately to ensure that all the stakeholders in such a bankruptcy case are treated equitably and fairly.

The bankruptcy context is sometimes unique in that bankruptcy courts are courts of equity, and in order to achieve justice for the parties involved, they are permitted to "expand the search for applicable principles beyond the usual sources of law and look for equitable principles to clear the muddy waters" within the limits of the U.S. Bankruptcy Code.[111] To fulfill this goal, the U.S. bankruptcy code attempts to balance the interests of all the affected parties in reaching equitable solutions.[112] While the freedom given to bankruptcy courts to achieve the most equitable result possible initially appears to lend support to applying *Shari'ah* precepts in the bankruptcy context when doing so would help achieve an equitable result for *sukuk* certificate holders, the Supreme Court of the United States' current position on religion likely does not support allowing religious considerations.[113]

Supreme Court decisions from the 1960s and 1970s describe religion in glowing terms as "the holiest of endeavors, pervasive and life-directing, filled with mystery, and bearing a transcendental quality" and therefore "[in need of protection] as a unique and fragile phenomenon of the deepest meaning."[114] During this period, religious liberty under the Free Exercise Clause and the separation of religion and government under the Establishment Clause were given significant weight.[115] However, in the 1980s, the Supreme Court began to treat religion under "neutral principles" of law, viewing it as being comparable to any other preference or point of view, and promoting equal treatment of religious and nonreligious institutions.[116] This "formal neutrality" approach has prompted some legal scholars to argue that the Supreme Court's current position, which "de-emphasizes the sacral qualities of religion," does not permit arguments for the application of religious law in the bankruptcy context.[117] However, other scholars have argued that refusing to take

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111. Christina M. Davitt, *Whose Steeple Is It? Defining the Limits of the Debtor's Estate in the Religious Bankruptcy Context*, 29 SETON HALL LEGIS. J. 531, 533 (2005) (citing Ellis v. Sec'y of State of Ill., 883 F. Supp. 291, 293 (N.D. Ill. 1995)).

112. Veryl Victoria Miles, *Assessing Modern Bankruptcy Law: An Example of Justice*, 36 SANTA CLARA L. REV. 1025, 1035 (1996).

113. Angela Carmella, *Constitutional Arguments in Church Bankruptcies: Why Judicial Discourse About Religion Matters*, 29 SETON HALL. LEGIS. J. 435, 438-39 (2005).

114. *Id.* at 438.

115. *Id.*

116. *Id.* This treatment has been dubbed "formal neutrality." *Id.* at 441.

117. *Id.* at 438.

religious law into account entirely risks leaving the Free Exercise Clause and the Establishment Clause devoid of meaning.[118]

While the application of *Shari'ah* law in a *sukuk* bankruptcy has never been addressed in the bankruptcy courts, the debate over the role of religion in bankruptcy arose simultaneously in multiple bankruptcy jurisdictions in 2004, when the Roman Catholic dioceses of Portland, Oregon; Tucson, Arizona; and Spokane, Washington filed for Chapter 11 bankruptcy in the face of massive tort judgments against them for sexual abuse.[119] These dioceses were all organized as corporations under state law, with the bishop holding title to all the assets of the various parishes including churches and schools. However, under canon law, the diocese and parishes are each considered distinct juridic persons, and the bishop is not considered to have legal title to the parish assets.[120] During the bankruptcy proceedings, the three dioceses each argued that under canon law, the bishop could not wrap the assets of the parishes and schools into the bankruptcy estate and that the bankruptcy courts should respect the churches' structure under canon law.[121] In support of their position the dioceses argued that canon law should replace civil law, a position supported by some commentators, "especially when ecclesiastical and financial decisions are inextricably connected."[122] However, since the dioceses had made a voluntary choice to be organized as corporations under state law and had also made the voluntary choice to submit to bankruptcy, it was doubtful that the bankruptcy courts would apply canon law against the creditors' wishes.[123]

In the end, the bankruptcy courts in the Spokane and Portland cases held that the parish assets were part of the overarching corporate form of the dioceses and therefore wrapped up in the bankruptcy estates.[124] However, the bankruptcy court in Tucson confirmed a creditor-approved reorganization plan that was partially based on canon law. The plan explicitly stated that under canon law, the parishes were to be treated as

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118. *Id.* at 440.

119. *See id.* at 435; *see also In re* Catholic Bishop, 329 B.R. 304 (Bankr. E.D. Wash. 2005) (Spokane); *In re* Roman Catholic Archbishop, 335 B.R. 842 (Bankr. D. Or. 2005) (Portland); *In re* Roman Catholic Church of the Diocese of Tucson, No. 04-bk-04-04721-JMM (Bankr. D. Ariz. May 25, 2005).

120. Lipson, *supra* note 8, at 385. Canon 1256 states that property is owned by the parishes, not the diocese, and that both are separate juridic persons.

121. Carmella, *supra* note 113, at 436.

122. *Id.* at 436 n.2 (citing Melanie DiPietro, *The Relevance of Canon Law in a Bankruptcy Proceeding*, 29 SETON HALL LEGIS. J. 399, 422 (2005) ("[C]anon law may be controlling on the merits.")).

123. Carmella, *supra* note 113, at 436.

124. Lipson, *supra* note 8, at 367-68, 385.

separate legal entities from the diocese, and therefore parish property was not part of the bankruptcy estate.[125] In its motions, the diocese of Tucson laid out the canon law structure and described how the parishes own their property even though the title remains with the bishop. The argument compared canon law to similar aspects of the civil law of trusts. Specifically, the diocese analogized that its relationship with its parishes was one of trustee to beneficiary.[126] Permitting this analogy allowed the bankruptcy court to come to an equitable decision in what has been dubbed a "middle way" without yielding entirely to church law or putting full title to all the assets in the diocese.[127] While these three decisions established competing precedent in religious bankruptcy case law, they also revealed a number of potential constitutional issues that would arise in the *sukuk* bankruptcy context.

It is important to note that in a *sukuk* bankruptcy, it generally is not the SPV holding the securitized assets that will go into default, but the *sukuk* originator (the company that issues the *sukuk*). The defaulting *sukuk* originator or its creditors will then try to wrap the *sukuk* assets into the bankrupt estate, which is what East Cameron Partners, LP, tried to do in the East Cameron Partners case.[128] This puts the *sukuk* certificate holders in the position of stakeholders intervening in the proceedings, and not debtors or creditors.[129] A useful analogy is to compare the *sukuk* certificate holders to the parishioners in the Catholic bankruptcy cases who were intervening to maintain control of their places of worship. The *sukuk* certificate holders, like the parishioners, did not make a voluntary decision to submit themselves to the bankruptcy court, but were forced to do so to defend their interests.

Additionally, both the *sukuk* certificate holders and the parishioners found themselves in a position where an adverse decision by the bankruptcy court could "substantially burden[]" their ability to exercise their religion in violation of the Religion Clauses of the First

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125. *Id.* Notably, the diocese's creditors were all in favor of this plan. *Id.*

126. Carmella, *supra* note 113, at 440-41.

127. *Id.*

128. Because of the prohibition on risk, and emphasis in being backed by assets, Islamic financial instruments are fairly resilient to default. In 2009, International Financial Services London released a report saying that Islamic banks had been largely protected from the global financial crisis, and that because of their proliferation in the British economy, the English markets had benefitted from their resilience. Evans, *supra* note 2, at 835.

129. Remember that the general consensus among scholars is that if the originator of an asset-based *sukuk* went into default, the certificate holders would be treated like ordinary bondholders. However, the East Cameron Gas *sukuk* was an asset-backed *sukuk*, and no asset-based *sukuk* has ever been tested in the bankruptcy context. *See* Goud, *supra* note 87.

Amendment.[130] In the Catholic bankruptcy context, if the parish assets were held to be part of the bankrupt estate, the assets could be sold off to satisfy creditors, depriving the parishioners of a place of worship. In the *sukuk* context, holding that the *sukuk* certificates are equivalent to debt instruments that receive interest (i.e., holding that they are comparable to Western bonds) would imply that the *sukuk* issuance did not comply with *Shari'ah*. Such a holding would of course be contrary to the *fatwah* approving the *sukuk* issuance and would imply that by holding the *sukuk* certificates, the Islamic investors had been in violation of *Shari'ah*.

Further complicating the potential role of *Shari'ah* in the bankruptcy context is the realization that every accommodation of Free Exercise of religion under the First Amendment raises a potential Establishment Clause issue.[131] The Supreme Court has addressed this relationship and has established that there must be "play in the joints" between the competing clauses.[132] In the *sukuk* context, this means that if a bankruptcy court tied the *sukuk* assets into the debtors estate, the certificate holders could potentially argue that the decision "substantially burdened" their exercise of religion under both the Free Exercise clause and the Establishment Clause. These arguments would be further strengthened by the fact that, unlike the dioceses in the church bankruptcy cases, the *sukuk* certificate holders never voluntarily submitted to the bankruptcy process, which was a strong argument against applying canon law in the church bankruptcy cases.[133] However, if the bankruptcy court allowed *Shari'ah* considerations to apply, creditors could potentially argue that their rights had been violated under the Establishment Clause, because *Shari'ah* law would be giving religious actors (the *sukuk* certificate holders) an economic benefit that is not available to other actors who are similarly situated (the other creditors).

The best solution from both a constitutional and equitable point of view is to allow religious beliefs to be permitted as evidence in a bankruptcy proceeding. This view was espoused by at least one scholar during the church bankruptcies as allowing the bankruptcy court to take significant religious considerations into account while upholding the constitutional rights of all the parties involved.[134] Such evidentiary considerations could be easily integrated into the bankruptcy process.

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130. Lipson, *supra* note 8, at 365 (internal quotation marks omitted).
131. *Id.* at 367-68.
132. *Id.* (internal quotation marks omitted).
133. Carmella, *supra* note 113, at 436.
134. *See* Carmella, *supra* note 113.

U.S. bankruptcy courts generally apply the U.S. bankruptcy code, and the state property law applicable to a particular case.[135] The Supreme Court has recognized that unless there is a significant "countervailing concern, perhaps including religious liberty," bankruptcy courts should look to state law to determine what property law controls in a bankruptcy case.[136] However, within that framework, bankruptcy courts remain free to create their own procedural rules, including presumptions and burdens of proof, consideration of evidence, and weight of evidence.[137] In this context, bankruptcy courts could allow considerations of *Shari'ah* law precepts as evidence when evaluating the claims of *sukuk* certificate holders. In the event a bankruptcy court allowed evidence of *Shari'ah* precepts, the door would be opened for two potential arguments for *sukuk* certificate holders.

The first argument available to the *sukuk* holders would be along the lines of the East Cameron Gas holding, arguing that they purchased the assets via a true sale from the bankrupt originator and that the assets were held by a legally separate entity from the originator. *Shari'ah* precepts regarding *sukuk*, and the *fatwah* in particular, could be introduced as evidence to show that the *sukuk* certificate holders believed that they held an ownership interest in the underlying assets and that the bankrupt *sukuk* originator had marketed the certificates as such. The success of this argument would likely depend on the strength of the *sukuk* structure, and how arm's length the asset transfers and operation of the *sukuk* assets were from the originator. The East Cameron Gas bankruptcy has already provided valuable guidance in this area. If there had been a third tier SPV, and thus three different transfers, it would have been significantly easier to separate the assets from the originator in the bankruptcy proceeding.[138] Thus, with the East Cameron case as precedent, this argument will be a hard one for a bankrupt *sukuk* originator to overcome.

The second evidentiary argument that could be made in the *sukuk* default context is a constitutional one, which could have two components depending on the context. The *sukuk* holders could first argue that by treating them as creditors, the bankruptcy court would be holding that

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135. Lipson, *supra* note 8, at 368. Although the dioceses in the Catholic Church bankruptcies argued for applying canon law, there is little support in the Restatement (Second) of Conflict of Laws that would allow choosing any source of law besides bankruptcy law and state law. *Id.*

136. *Id.* at 384 (citing Raleigh v. Ill. Dep't of Revenue, 530 U.S. 15, 16 (2000); Butner v. United States, 440 U.S. 48, 55 (1979)).

137. Lipson, *supra* note 8, at 368.

138. Khnifer, *supra* note 95.

they had violated *Shari'ah* law, contrary to the *fatwah* saying they had not. Furthermore, the *sukuk* certificate holders could argue that by forcing them to accept the same bankruptcy remedies as the Western bondholders, the court had substantially burdened their ability to practice their religion under the Free Exercise Clause by forcing them to accept *Shari'ah*-prohibited debt instruments.

Alternatively, or contemporaneously with the Free Exercise Clause argument, the *sukuk* holders could argue that by wrapping the *sukuk* assets in with the rest of the bankruptcy estate and declaring them creditors of the originator the court was violating the Establishment Clause, especially by appointing a bankruptcy trustee to manage the *sukuk*. This argument would require showing that by interposing a state actor into a religion-based bankruptcy estate, the court was violating the Establishment Clause.[139] While these constitutional arguments would have had a good probability of success under the Supreme Court jurisprudence of the 1960s and 1970s, it is questionable whether they would succeed today.[140] However, given the recent success of the East Cameron Gas *sukuk* holders and the willingness of the bankruptcy court to allow a bankruptcy plan based on canon law in the Diocese of Tucson Bankruptcy, it seems that such arguments might be accepted, especially if the *sukuk* certificate holders pushed to have *Shari'ah* precepts considered as evidence, instead of trying to apply religious law outright.

VIII. CONCLUSION

As the Islamic finance industry continues to grow, more and more *sukuk* certificate holders may find themselves intervening to defend their ownership rights in United States bankruptcy courts. To these Muslim stakeholders, making financial choices that comply with *Shari'ah* law is a vital part of their faith, and an adverse decision from a U.S. bankruptcy court could have a devastating impact on both the individual *sukuk* certificate holders and the growing Islamic finance industry in the United States. Luckily, the *In re Roman Catholic Church of the Diocese of Tucson* and *In re East Cameron Partners* decisions have shown that U.S. bankruptcy courts can balance the interests of the creditors and the religious stakeholders by permitting evidence of religious precepts when defining the bankruptcy estate. By failing to allow such considerations, bankruptcy courts risk violating the First Amendment rights of both the

139. *See generally* Lipson, *supra* note 8, at 365-66.

140. *Id.* It is important to remember that the Diocese of Tucson's reorganization plan, based on canon law, had the support of its creditors. *Id.*

religious stakeholders and the other creditors. Therefore, in the wake of *In re East Cameron Partners*, the Islamic finance industry and Muslim investors in the United States and abroad can remain hopeful that the United States courts will continue to uphold *sukuk* certificate holders' rights and allow *Shari'ah* precepts to be admitted as evidence in bankruptcy proceedings.