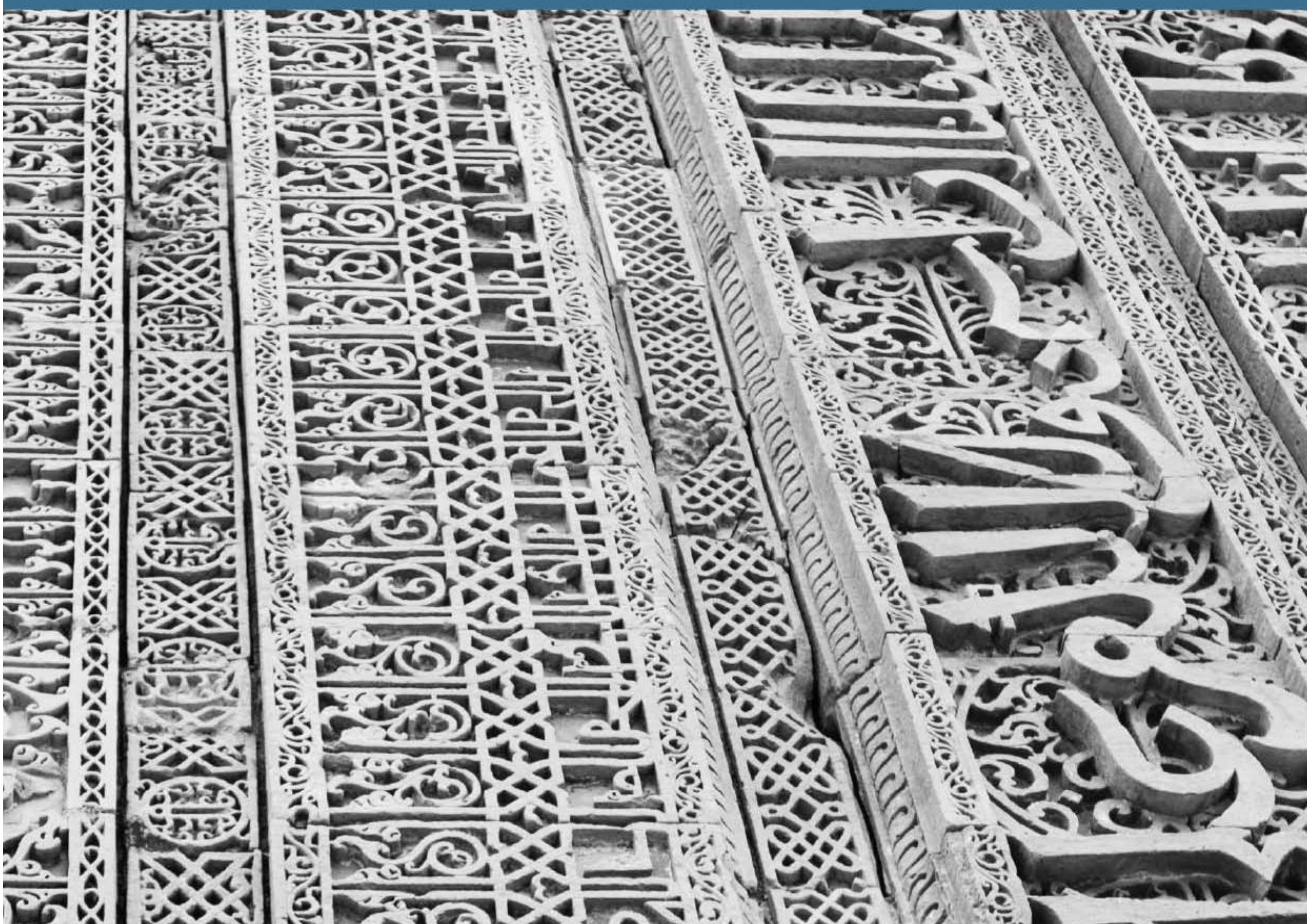
HAWKAMAH
THE INSTITUTE FOR CORPORATE GOVERNANCE

Policy Brief on Corporate Governance for Islamic Banks and Financial Institutions in the Middle East and North Africa Region



6 CASE STUDY-East Cameron Partners Sukuk[15]

Executive Summary

The East Cameron Partners Sukuk (the "**ECP Sukuk**") was issued in July 2006 and raised US$ 165.67 million. Despite being a relatively small sukuk issuance in monetary terms, the ECP Sukuk made the headlines for a number of reasons, including: (i) it was the first sukuk issue to come from a US-based entity, (ii) it was the first such issue to be rated by Standard and Poor's, and (iii) it was the first securitisation incorporating Shari'a compliant hedging.

On 16 October 2008, East Cameron Partners ("**ECP**") filed for bankruptcy under chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Western District of Louisiana (the "**Bankruptcy Court**").[16] Pursuant to a settlement among ECP, the trustee for the ECP Sukuk and certain of the ECP Sukuk investors that was consummated as an integral component of a sale of ECP's assets approved by the Bankruptcy Court, the ECP Sukuk has effectively been unwound, with the underlying assets being transferred for the benefit of the ECP Sukuk investors.

As a result of the settlement and the chapter 11 plan of reorganization, the ECP Sukuk became, in effect, an asset-backed equity investment rather than an asset-based sukuk. The ranking of the sukuk certificate holders in the capital structure of the issuer ensured that a beneficial interest in the revenues of the sukuk assets became an ownership right over those assets.

Further, both the ECP Sukuk and the ECP chapter 11 case reflect that in certain circumstances, conventional oil and gas law and conventional bankruptcy law may be adequate for dealing with Islamic structures when the issuer files for bankruptcy protection in the United States. The ECP chapter 11 case and related litigation did not, however, yield any controlling and binding precedent in the United States that may be used to require the same outcome in a future chapter 11 case involving another sukuk, because the disputes concerning the validity of the ECP sukuk were resolved in large part through a consensual settlement, rather than a judicial decision.

Background

ECP is an independent oil and gas exploration company, based in Houston, Texas. Its two key assets consist of rights to gas properties located in the Gulf of Mexico off-shore of the State of Louisiana.

Prior to the ECP Sukuk being issued, ECP had bought federal leases for the two underlying gas properties. They obtained financing for exploration from Macquarie Bank but it was expensive debt, and Macquarie took a 50% equity interest in the business. The debt was repaid relatively quickly as the gas reserves yielded a healthy cash-flow. For various reasons, including that ECP wanted to buy Macquarie out and regain control of the business, and raise further funds for

[15] Provided by Latham and Watkins LLP
[16] See *In re East Cameron Partners, L.P.*, Case No. 08-51207

exploration and operations. However, the terms offered by conventional banks and hedge-funds were not attractive to ECP. ECP therefore began to consider using a Shari'a compliant instrument with the advice of BSEC Investment Bank, finally settling on a sukuk structure.

Sukuk Structure

The key terms and parties of the ECP Sukuk were as follows:

Key Terms	
Amount	US$ 165.67 million
Certificates	Sukuk al-Musharaka
Security	Right to oil and gas over-riding royalty interests ("**ORRI**")
Closing Date	July 2006
Final Maturity	13 years from closing
Rating	CCC+ (Standard & Poor's)
Repayment	Quarterly based on volume produced
Return	11.25%
Governing law	USA
Key Parties	
Originator	East Cameron Partners (Texas, USA)
Issuer	East Cameron Gas Company (Cayman Islands SPV)
Arranger & Administrator	BSEC Bemo Securitisation (Beirut, Lebanon)
Co-Arranger & Bookrunner	Merrill Lynch (London, UK)
Trustee	East Cameron Gas Company (Cayman Islands SPV)
Sharia' Advisors	Sheikh Yusuf Talal De Lorenzo (USA) Sheikh Nizam M S Yaqoobi (Bahrain)

Interestingly, although there were some GCC investors, most of the ECP Sukuk investors were in fact conventionally-oriented hedge-funds.

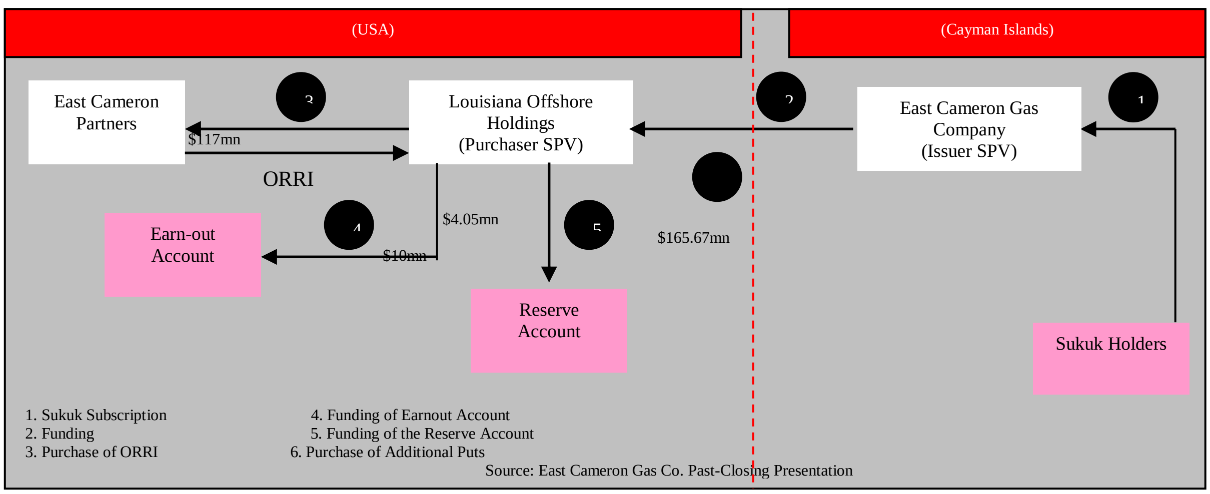
In the ECP Sukuk, a royalty or ORRI was chosen as the asset to support the sukuk. In many states in the United States, the law recognises that oil and gas in the ground and certain rights granted in such property are in effect real estate. That is, ORRI rights relate to a physical asset (in the ground) and do not depend on contractual or other rights against any individual people or companies (*i.e.*, they are *in rem* rights and not *in personam* rights). The owner of the surface property is able to grant a partial interest by way of royalty or ORRI to a third party without transferring rights to control the surface. The oil and gas operating company that owned and operated the two federal leases sold an ORRI to a US-based SPV named Louisiana Offshore Holdings (which was established using traditional structured financing techniques). The transaction was structured so that the sale of the ORRI would most likely be considered a 'true sale' of a real property interest under Louisiana law.

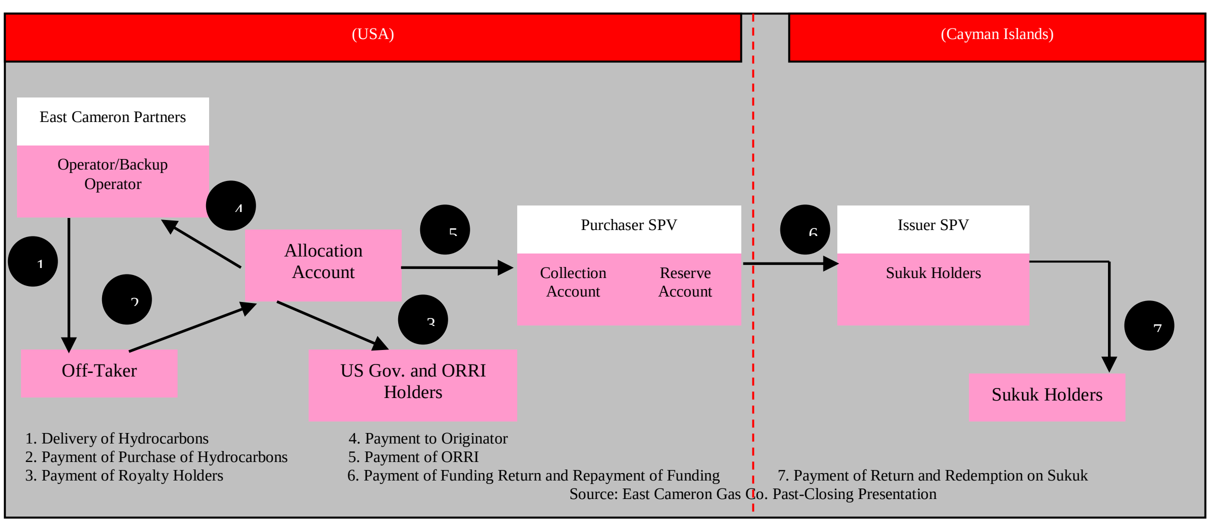
For a number of reasons, including bankruptcy remoteness and tax planning, the Issuer was a Cayman Islands SPV named East Cameron Gas Company. The Issuer entered into a funding arrangement with Louisiana Offshore Holdings, with the proceeds of the issue flowing back to the oil and gas operating company, ECP.

Proceeds from the gas production flowed to the Louisiana Offshore Holdings (the owner of the ORRI) and were shared between the Issuer and ECP. The Issuer passed along its share of the proceeds to the ECP Sukuk investors to repay the 11.25% expected return and part of the principal.

Two international Shari'a scholars were retained and after reviewing the structure and documentation, issued a fatwa, making it possible to market the ECP Sukuk to Islamic investors. We understand that the Shari'a scholars were involved from an early stage of the structuring discussions and were involved throughout documentation. It is worth noting that the underlying asset was a proven real estate asset with positive cash-flows. From a Shari'a perspective, the investors would share in the profits or losses derived from the success or failure of the underlying assets. The investors bore the risk of the oil and gas reserves being insufficient to fully support the issuance of the sukuk, natural disaster risk and price fluctuation risk.

The diagrams below help to illustrate the sukuk structure and the flow of funds.





On 16 October 2008, ECP filed for bankruptcy protection under chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Western District of Louisiana. The production from the gas fields where the ORRI was held had been falling steadily since the ECP Sukuk was issued and the price of gas had fallen significantly during the global credit crisis. Chapter 11 governs bankruptcy filings where companies seek to preserve the going concern value of their business through continued operations and consummate a reorganisation of their debts and/or operations though a sale of assets, plan of reorganisation or both. In order for a reorganisation to be approved in chapter 11, the court must first approve the disclosure statement as adequately describing, among other things, the plan of reorganisation, which is then distributed to creditors as the basis for voting. Following votes by creditors, if the plan receives sufficient support, it may be confirmed by the bankruptcy court upon a finding that the plan complies with the United States Bankruptcy Code. Following confirmation by the bankruptcy court, the plan may be implemented by the debtors.

ECP's chapter 11 proceedings are an informative test of how sukuk instruments are treated in a chapter 11 bankruptcy case, whether sukuk issuance transactions are respected as "true sales" and whether sukuk issuers and their assets are bankruptcy remote.

An important issue for the ECP Sukuk investors was whether ECP's chapter 11 filing caused a termination or suspension of the federal leases held by ECP, which could terminate the ORRI and therefore result in the ECP Sukuk investors losing the value of their investment. To mitigate this risk, the ECP Sukuk investors provided over US$ 4 million of debtor-in-possession financing during the bankruptcy case to ensure the continued operation of the business and that the federal leases were not terminated or suspended.

The first issue considered by the Bankruptcy Court was whether the transfer of the ORRI into the sukuk structure was a 'true sale', as that term is understood in conventional securitization structuring. The issue came before the Bankruptcy Court through a lawsuit filed ECP seeking to collapse the sukuk issuances transactions and deem the issuance a disguised secured loan under Louisiana state law. If the ECP prevailed on its claims, the remedy would be to turnover ownership of the ORRI to ECP and recharacterize the claims of the ECP Sukuk investors to secured claims against ECP in the chapter 11 process, as opposed to claims against the bankruptcy remote issuer. In the first stage of litigation on that lawsuit, the Bankruptcy Court granted a motion to dismiss the lawsuit but did so in a manner that permitted ECP to amend its complaint and seek to cure the legal deficiencies of its claims. In so doing, the Bankruptcy Court's holding arguably was restricted to the manner in which ECP presented its claims in that particular case and did not result in a definitive ruling on whether the ECP Sukuk issuance was a true sale or a disguised secured loan under Louisiana state law. Under the Bankruptcy Court's ruling, to prove a valid claim that the ECP Sukuk issuance was a disguised secured loan under Louisiana state law, ECP would have been required to show that the enforcement of the transaction as a true sale would produce an inequitable result.[17]

ECP filed an amended complaint. Thereafter, instead of proceeding with litigation, the parties entered into a settlement conditioned on an overall resolution of ECP's chapter 11 case through a sale of assets. Under the settlement, the ECP Sukuk was effectively unwound, and the underlying assets were transferred to the ECP Sukuk-issuing entity for the benefit of the ECP Sukuk investors, and under the terms of the sale, substantially all of the assets ECP (except for cash, books and records and certain litigation claims) were sold to the ECP Sukuk investors. The consideration provided for the sale took the form of the settlement of litigation and the forgiveness of the debtor-in-possession financing. Furthermore, ECP was granted a subordinated ORRI over future production, which would obtain value only after the ECP Sukuk investors had been repaid all of their principal in full under the ECP Sukuk.

The outcome of the ECP chapter 11 case reflects the negotiating dynamics that arise generally in chapter 11 cases. Generally speaking, chapter 11 is a fluid process driven by the varying commercial interests of the parties and their underlying legal rights. Parties often bring lawsuits as a means to obtain greater leverage in negotiating a consensual resolution, which is typically the most efficient means for all stakeholders to obtain value from a chapter 11 proceeding. In this context, the litigation initiated by ECP over the validity of the ECP Sukuk issuance set the stage for the parties to compromise their rights in a manner that provided some consideration for the general unsecured creditors of ECP (other than the ECP Sukuk investors) commensurate with the cost of litigation that the ECP Sukuk investors would have incurred plus a premium to avoid the risk that the ECP Sukuk transactions would have been unwound. The ECP Sukuk investors were motivated to enter into such a settlement to achieve a global resolution of ECP's chapter 11 case through their acquisition of ECP's assets. Future chapter 11 cases may very well follow the path of settlement of claims regarding the validity of sukuk transactions as part of a global reorganization, without definitive judicial rulings on the validity of sukuk, as seen in ECP's chapter 11 case or they may be fully litigated to conclusion.

It should be noted that bankruptcy courts generally favor consensual resolution of litigation. In addition, the United States Federal Rules of Bankruptcy Procedure require bankruptcy court approval of any settlement of a debtor's rights before such settlement may become effective. Bankruptcy courts will consider a variety of factors in doing so, including whether a settlement is in the best interests of the debtor and its creditors.

[17] The law of each state of the United States can vary to a very high degree even on such matters as secured transactions. Furthermore, the laws of the State of Louisiana are generally considered to be of an entirely different nature than the laws of all other states, because Louisiana law is based on the civil code, whereas the laws of all other states is based on the common law.