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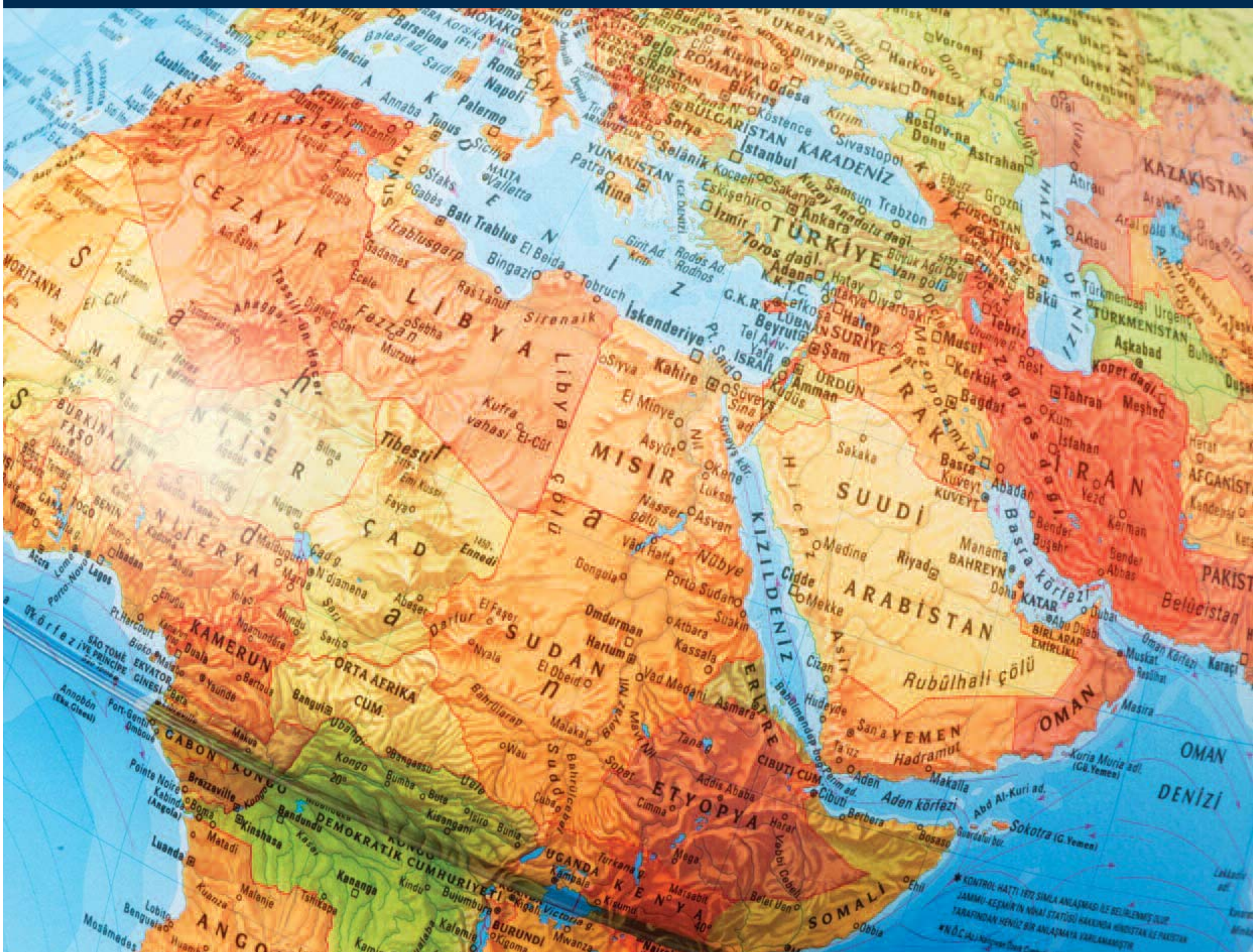


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# *Arcapita and the Need for Mideast Restructuring Regimes*

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The 2012 Chapter 11 case of Bahrain-based Arcapita was the first time U.S. bankruptcy proceedings were successfully used to restructure a Shari'ah-compliant Middle Eastern business. The transaction was recently named the Global Finance Deal of the Year: Restructuring and Insolvency (Middle East) by *The American Lawyer* in its 2014 Global Legal Awards.

Successful as it may have been, though, the case required Arcapita to request (and the U.S. court to approve) shoehorning Shari'ah-compliant financing arrangements into treatment as conventional Western debt. The challenging proposition Arcapita faced highlights the need for viable insolvency and restructuring alternatives in Middle Eastern jurisdictions.

## Arcapita's business and restructuring

The Arcapita Group was and is a leading global manager of Shari'ah-compliant alternative investments and operated as an investment bank and investment and asset manager. Specifically, its principal businesses included investing and providing investment opportunities to third-party investors in accordance with Islamic Shari'ah rules.

Over its history, Arcapita has made significant investments around the world – including in several U.S. and other Western companies – and, at the time of its bankruptcy filing, had over $7 billion in assets under management (along with over $1 billion in Shari'ah-compliant debt obligations).

Global financial downturns and European capital markets dislocation hampered Arcapita's ability to borrow and service its debt load. Faced with these financial difficulties, Arcapita engaged in creditor discussions for a potential consensual restructuring but failed to negotiate a solution acceptable to all of its stakeholders. After a minority group of creditors declined to agree to the proposed out-of-court restructuring, Arcapita filed for Chapter 11 in March 2012.

In Chapter 11, Arcapita obtained a $150-millon Shari'ah-compliant debtor-in-possession loan and continued to engage with its creditors to negotiate and implement a comprehensive restructuring or wind-down. Ultimately, Arcapita obtained creditor acceptance and court approval of a Chapter 11 plan (which included $350 million in Shari'ah-compliant exit financing) that contemplated an orderly wind-down and liquidation of the company's existing investment assets and businesses over the course of several years (with any value realized by the wind-down funding recoveries for creditors), while allowing the restructured company to pursue new investments on a going-forward basis.

## Why U.S. bankruptcy?

Arcapita's decision to restructure through a U.S. bankruptcy may at first blush seem surprising. With a closer look, though, it shouldn't.

While Arcapita itself is organized under Bahrain law, its subsidiaries include Cayman Islands, Hong Kong, Luxembourg, Singapore, U.K., and U.S. entities, and Arcapita maintains foreign offices in Atlanta, London, Hong Kong, and Singapore.[2] Most importantly, even though Arcapita was based in and regulated by Bahrain and had many Middle Eastern creditors (including its largest creditor, the Central Bank of Bahrain), it had no opportunity to pursue a viable restructuring in Bahrain, since Bahraini law offered no effective insolvency system.

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1 James H.M. Sprayregen, Kamran S. Bajwa, and Brad Weiland are attorneys of Kirkland & Ellis LLP. In connection with the Arcapita restructuring, Kirkland & Ellis LLP represented represented an *ad hoc* group of noteholders that supported the Chapter 11 plan and participated in successful negotiations regarding the plan and the transactions contemplated thereby.

2 Arcapita was not a licensed bank or formal bank "branch" or "agency" within the meaning of the U.S. Bankruptcy Code. Under (somewhat counter-intuitive) U.S. bankruptcy law, those qualifications could have made it harder for Arcapita to access the U.S. bankruptcy courts. *See* 11 U.S.C. § 109.

Bahrain is not alone in that regard. According to The World Bank, on average, an insolvency proceeding in the Middle East-North Africa region takes almost twice as long, costs over 50 percent more, and returns less than half in creditor recoveries in comparison to the average for OECD countries.[3]

Arcapita explained upon its bankruptcy filing that it "carefully considered reorganization options under the laws of various other jurisdictions" but that it had determined that "Chapter 11 is the proper – and indeed the most effective – venue for implementing a comprehensive restructuring."[4]

## The conundrum of restructuring Islamic financing under U.S. law

To successfully confirm its Chapter 11 plan under U.S. law, Arcapita was forced to take the position that its Islamic finance arrangements were equivalent to conventional Western debt.

That, though, is inconsistent with the position Arcapita takes with its Islamic-finance investors. Islamic law prohibits many elements of conventional debt (including the basic transaction structure of lending principal in exchange for interest and other fees). Arcapita's largest debt obligations were issued under Shari'ah *murabahah* facilities – a common trade-based, "cost-plus" financing arrangement under which the "seller" (akin to the "lender" in a Western financing) agrees to purchase goods for resale to the "buyer" (akin to the "borrower") at a markup to the lender's cost, with the markup amount (taking the place of interest) deferred and paid in periodic installments.

The particularities of Shari'ah-compliant financings and the region's general lack of viable restructuring and insolvency regimes present important choice of law and jurisdictional issues for debtors and creditors alike, which in turn create uncertainty and inefficiencies that all parties must address. The Arcapita case is just one example.

Arcapita operates as a Shari'ah-compliant investment bank and asset manager and markets itself to Islamic investors interested in Shari'ah-compliant investments. Nonetheless, it needed to abandon that position in order to accomplish its Chapter 11 restructuring under U.S. law.

## The need for viable mideast restructuring regimes

Shoehorning its Shari'ah-compliant financing arrangements into the mold of conventional debt may have been Arcapita's only viable option – but that option was not without risks of its own. If the U.S. court had found that the Islamic financings could not be characterized as conventional Western debt and so were not subject to restructuring under U.S. law, Arcapita could have foundered in bankruptcy.

Other Shari'ah-compliant borrowers may face the same risk in future restructuring cases (in the U.S. and other jurisdictions). Jurisdictions in the Middle East should consider implementing viable insolvency and restructuring alternatives. Reformed, tailor-made insolvency and restructuring systems founded on Islamic law principles will provide a better avenue to restructure companies like Arcapita and will offer increased certainty and efficiency in future Islamic financing transactions.

Certain jurisdictions are actively considering or have already started to implement new legal regimes – the coming years may be an exciting time for restructuring and insolvency reform in the region.

3 *See* The World Bank, *Doing Business 2014 Regional Profile: Middle East and North Africa (MENA)* 84–90 (2013).
4 *Declaration of Henry A. Thompson in Support of the Debtors' Chapter 11 Petitions and First Day Motions, In re Arcapita Bank B.S.C.(C)*, No. 12-11076 (Bankr. S.D.N.Y. Mar. 19, 2012).