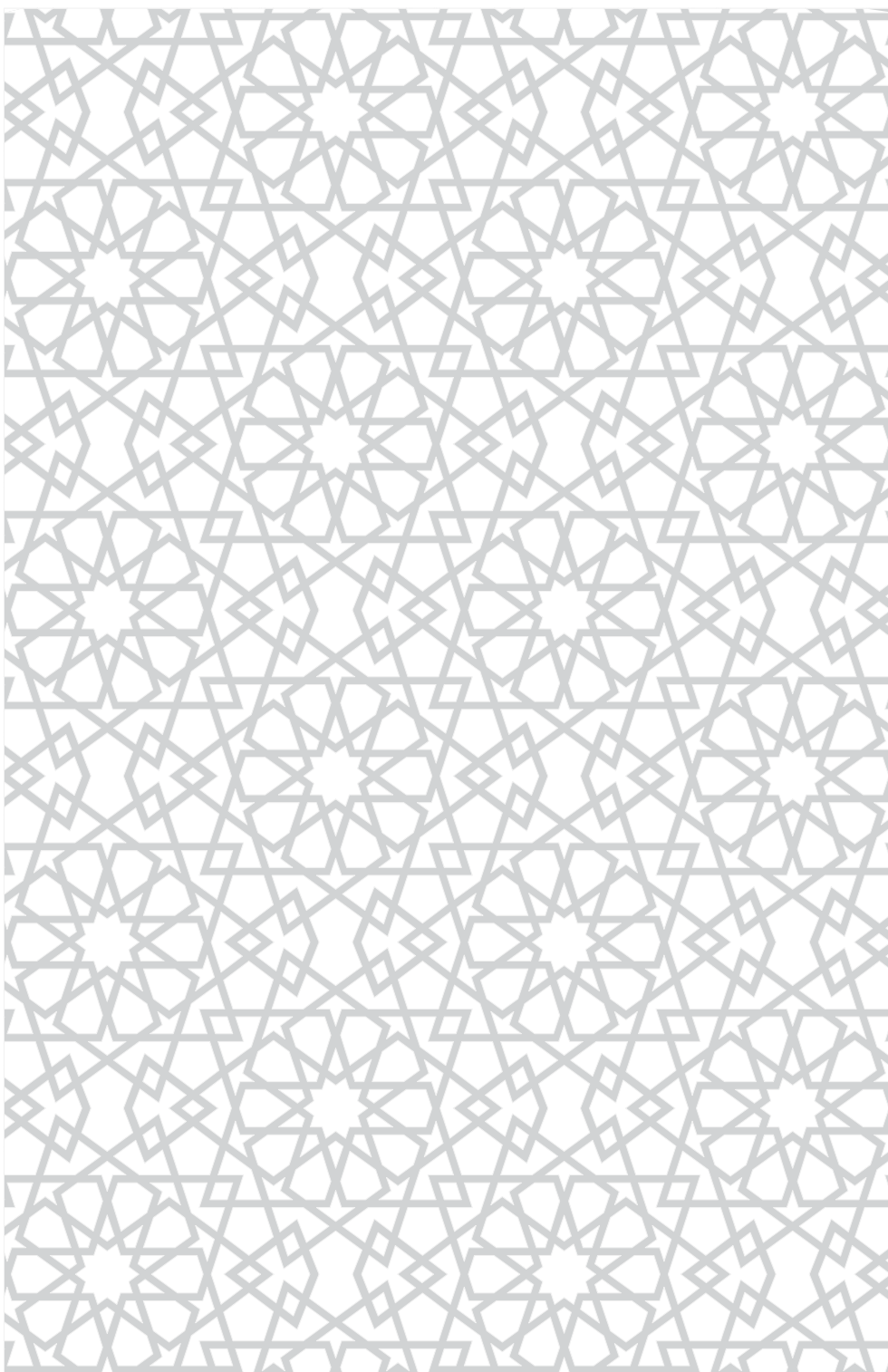


Shari'ah Standard No. (43)

Insolvency



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IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

This Standard aims to describe the rules of insolvency and the circumstances that precede it, whether they are faced by the institutions, companies or individuals, both businessmen and non-businessmen, with whom financial institutions⁽¹⁾ deal.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This Standard covers the Shari'ah rules relating to the causes and consequences of insolvency, whether faced by an institution or its institutional or individual business and non-business customers. It also addresses the judicial declaration of insolvency over an institution and its consequences, and in particular, the sale of its assets, the distribution of the proceeds among the creditors and how insolvency is revoked.

It does not cover financial difficulties (as defined by Islamic jurisprudence), liquidity shortfalls or delays in payment that do not lead to a declaration of insolvency.

2. Definitions of Insolvency and the Declaration of Insolvency

Insolvency (Ifilas): When the debt due of a person exceeds his assets.

Declaration of insolvency (Taflees): A judge's declaration that a debtor is insolvent, preventing him from disposing of his assets.

3. Shari'ah Ruling on Insolvency

3/1 A person whose debts exceed his assets has a moral obligation in Shari'ah to refrain from any action that may harm the creditors, even if he has not been declared insolvent.

3/2 The competent authorities should declare a person insolvent when his debts exceed his assets and sequester his assets if his creditors demand it, subject to the conditions mentioned in item 4/3.

3/3 When a debtor is declared insolvent, the declaration must be documented and certified as required by official procedures.

4. Stages of Insolvency

4/1 First stage: The creditors make a demand upon the debtor to pay the debt due to the creditors pro-rata and to refrain from making

donations, providing loans or disposing of or acquiring assets preferentially. The creditors can seek the assistance of concerned authorities in this regard.

4/2 Second stage: If the debtor refuses to pay what he owes to the creditors, the creditors are entitled to file a claim against him as a step towards seeking a declaration of insolvency. They can petition the competent authorities to seek to:

4/2/1 Prevent the debtor from making donations;

4/2/2 Prevent the debtor from providing loans;

4/2/3 Prevent the debtor from giving preferential treatment (for example to certain creditors or in the disposal or acquisition of assets);

4/2/4 Prevent the debtor from admitting financial liability to those who may be the subject of preferential treatment such as his blood relatives connected by up to four vertical steps (for example, a first cousin, who is connected vertically via the grandparents); and such as affiliates, subsidiaries and group entities of institutions;

4/2/5 Prevent the debtor from pre-paying debts that are not yet due;

4/2/6 Prevent the debtor from transferring any of his assets to some of the creditors or selling to or purchasing from them preferentially; and

4/2/7 Prevent the debtor from travel that causes harm to the creditors without appointing a surety to ensure his attendance if required, providing guarantors.

4/3 A declaration of insolvency requires:

4/3/1 An application made by creditors demanding that a debtor whose due debts exceed his assets be declared insolvent, subject to item 5/5; or

4/3/2 An application made by the debtor himself, except when the competent judicial authority considers his application to be fraudulent.

4/4 The creditors are not required to prove that they are the sole creditors. If another creditor appears before the distribution, he is entitled to a pro-rata share of the distribution. If a creditor appears after the distribution, the rule set out in item 8 shall apply subject to statutory procedures so long as they are not inconsistent with the rules and principles of Shari'ah.

4/5 The court has the sole authority to declare a person insolvent.

5. Consequences of Insolvency

Declaration of a debtor's insolvency gives rise to the following consequences:

5/1 An admission by a debtor, who has been declared insolvent, of any liability to another person relating to his sequestered assets has no legal effect, whether such admission relates to a debt incurred before or after the declaration of insolvency, unless the creditors accept that such debt was incurred before the declaration of insolvency.

5/2 The debts owed to creditors are attached to the existing property of the debtor at the time of sequestration as well as to any property that accrues to him without his dealing, such as gifts. All his property remains in his ownership until it is determined that such property be sold and that the proceeds be distributed among the creditors.

5/3 The debtor's acts of sale, gift or endowment subsequent to the declaration of insolvency have no legal effect, with the exception of acts relating to previous transactions, such as terminating a defective contract and exercising an option to terminate. Such lack of legal effect applies during the period of uncertainty that precedes the declaration of insolvency, as assessed by the competent authority.

5/4 After declaration of insolvency, all the debtor's subsequent acts of sale, purchase, admission (of liability) or guarantee, are attached to his future liability and not to the sequestered assets. He can be required to discharge such subsequent liabilities after revocation of the sequestration. Those whose rights attach to his liability are not entitled to share the sequestered assets with the creditors.

5/5/1 All of the debtor's undue debts become due despite the creditors of such undue debts having no present right to demand a declaration of his insolvency. The creditors of undue debts are entitled to share the sequestered assets with the creditors of due debts.

5/5/2 If the lessee becomes insolvent during the Ijarah term, the lessor shall be entitled, on a pro-rata basis along with other creditors, to the amount of rent corresponding to the period during which the usufruct was enjoyed. For the remaining period, the lessor shall have the option either to terminate the Ijarah contract or to carry on with it so that he has claims on the insolvency assets for the rent of the remaining period, while enabling the lessee to enjoy the usufruct unless the court considers continuity of the Ijarah to be in the interest of creditors, in which case the lessor shall receive the rent amount in full.

5/6 It is permissible, with the approval of the creditors, to agree to reduce undue debt that was accelerated by the declaration of insolvency and guarantors are liable to pay the reduced amount, rather than the amount originally guaranteed.

5/7 Undue debts owed to the insolvent debtor do not become due upon insolvency; all outstanding debts owed to the insolvent debtor before the declaration of insolvency (even if not yet due) are included in the insolvency assets (and are distributed to the creditors as and when they are paid).

5/8 After distribution, creditors have no legal right to demand any unpaid debt from the debtor. However, the debtor has a moral obligation in Shari'ah to pay all the debts in full.

6. Right of Claw-Back of an Item Sold to the Debtor Prior to the Declaration of Insolvency (the Right of Claw-Back)

The right of claw-back gives a creditor who sold an item to the insolvent debtor the right to demand return of the specific item if it is among the

sequestered assets or to have claims on these assets. This right shall be established for the seller who has not received any part of the selling price.

7. Sale of the Sequestered Assets and Allowances Made for the Insolvent Debtor

7/1 The concerned authorities will order the sale of the sequestered assets -other than the assets described below- whether they are in currencies different to the currency in which the insolvency is being administered, fungibles, stocks, commodities (goods or merchandise) or real estate. A reasonable period of time should be allowed before selling real estate assets, and assets should be sold in the order provided above. A survey of market prices should be conducted to ensure that a better price could not be achieved at auction. If the price offered is less than the value of the asset, the auction should be repeated to obtain the value of the asset. Otherwise, it should be sold at whatever price is achieved on the third auction. If possible, it is recommended to make the sale subject, for a reasonable period of time, to an option to reverse the sale.

7/2 Excluded from the sale are the insolvent debtor's tools of trade; whatever he needs to continue his business; a suitable home and basic expenses for him and his dependents. If his home exceeds his requirements, it should be sold and replaced by one that is suitable for him. The same applies mutatis mutandis to institutions.

7/3 The debtor is not required to earn or take out a loan if the proceeds of sale are not sufficient to pay off his debts.

8. Distribution of the Insolvent Debtor's Assets Among the Creditors

8/1 It is preferable to expedite the distribution but not with such excessive haste that it harms the insolvent debtor. It is not necessary to delay the distribution until all insolvency assets are sold. The proceeds may be distributed as and when they are received, which is required if the creditors demand it, taking into consideration the statutory procedures of insolvency provided that they do not conflict with the rules and principles of the Shari'ah are observed.

8/2 The judge should start the distribution with assets that are of the same denomination as the debt.

8/3 The following order should be observed during distribution:

8/3/1 Priority should be given to paying the fees of the administrators and their assistants who manage the process of sale and distribution.

8/3/2 Next in order should be secured creditors, as per the rules of granting security.

8/3/3 Non-employee contractors (such as tradesmen) and lessors of transport vehicles are entitled to declare a lien over any of the insolvent debtor's property in their possession in order to recover their full fees from the insolvency assets, and such property reverts to the insolvency assets once the fees are paid.

8/3/4 A person who finds a specific item of his property in the insolvency assets has a preferred claim over it. Such property may include safety deposits, portfolios, investment funds, the capital of Mudarabah or investment agency, and the share of a non-insolvent partner in a partnership managed by the institution declared insolvent and the insolvency assets in the case of an insolvent partner.

8/3/5 The rest should be distributed among the creditors, with each creditor receiving an amount pro-rata to his share of the total debt.

8/3/6 If a debt is discovered after the distribution, the new creditor should obtain his share from each of the existing creditors, either by mutual consent or through litigation.

9. Rules Specific to Institutions

9/1 The following items are included in the insolvency assets:

9/1/1 Current accounts held with the institution, because these are liabilities of the institution which must be borne by it alone and which should not be borne by the investment accountholders;

- 9/1/2 All debts outstanding against the institution.
- 9/2 Investment vehicles that are independent of an (insolvent) institution in their fund sources and revenues are not part of the insolvency assets. Such investment vehicles include restricted deposits, funds, portfolios and *Sukuk* assets that are not wholly or partially owned by the institution and in which the institution's responsibility is limited to managing on a paid agency or *Mudarabah* basis.
- 9/3 Any assets held by the institution as custodian, such as securities belonging to third parties and safety deposit boxes, are not part of the insolvency assets.

10. Revoking the Declaration of Insolvency

- 10/1 Upon distribution of the insolvent debtor's assets to the creditors, the declaration of insolvency is revoked by the court and announced according to the requirements of convention or statute.
- 10/2 After the declaration of insolvency is revoked, if an asset is discovered that came into the ownership of the insolvent debtor prior to the declaration of insolvency without reciprocal consideration, such as a gift, it is sequestered to be distributed among the creditors whose debts were outstanding before the declaration of insolvency. If statute restricts applications for a declaration of insolvency unless after expiry of a limitation period, the outstanding debt remains a liability of the debtor based on morality/religious credence.
- 10/3 If the insolvent debtor enters into a credit transaction after revocation of his declaration of insolvency and then owns property through new transactions, and is thereafter declared insolvent a second time, the creditors of the first insolvency are not entitled to a share of the assets of the second insolvency. If however, the new property came into his ownership without reciprocal consideration, such as a gift, the creditors of the first insolvency are entitled to a share of the assets of the second insolvency based on morality/religious credence.

11. Date of the Issuance of the Standard

This Standard was issued on 14 Jumada II, 1431 A.H., corresponding to 28 May 2010 A.D.

Adoption of the Standard

The Shari'ah Board adopted the Standard of Insolvency in its meeting No. (27) held in the Kingdom of Bahrain during the period of 12-14 Jumada II, 1431 A.H., corresponding to 26-28 May 2010 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

On 14 Jumada II, 1430 A.H., corresponding to 7 June 2009 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Insolvency.

In its meeting held in Dubai, United Arab Emirates, on 20 Shawwal 1430 A.H., corresponding to 9 October 2009 A.D., the Shari'ah Standards Committee discussed the draft of a Shari'ah Standard on Insolvency and made necessary amendments.

The revised draft of the Shari'ah Standard was presented to the Shari'ah Board in its meeting No. (25) held in the Kingdom of Bahrain, during the period of 2-4 Dhul-Qadah 1430 A.H., corresponding to 21-23 October 2009 A.D. The amendments that were deemed appropriate were included.

The General Secretariat held a public hearing in the Kingdom of Bahrain, on 27 Safar 1431 A.H., corresponding to 11 February 2010 A.D. All the comments made in the public hearing were listened to, and a member of the Shari'ah Board answered these comments and made commentary on them.

In its 26th meeting held in the Kingdom of Bahrain, during the period of 24-26 Rabi' I, 1431 A.H., corresponding to 10-12 March 2010 A.D., the Shari'ah Board discussed the amendments proposed by the participants in the public hearing and incorporated the amendments that it considered suitable.

In its meeting No. (27) held in the Kingdom of Bahrain, during the period of 12-14 Jumada II, 1431 A.H., corresponding to 26-28 May 2010 A.D., the Shari'ah Board discussed the draft of the Standard, incorporated

the necessary amendments that it deemed appropriate, and adopted the Standard.

In its meeting held in the United Arab Emirates on 7 Sha'ban 1436 A.H., corresponding to 25 May 2015 A.D., the Shari'ah Standards Review Committee reviewed this Standard. After deliberation, the committee approved necessary amendments, and the Standard was adopted in its current amended version.

Appendix (B)

The Shari'ah Basis for the Standard

- The basis for prohibiting a person overwhelmed by debts from disposals that harm the creditors is the Hadith, *"Allah will pay (the debts of) a person who takes the wealth of others with the intention of repaying it. But the one who takes it with the intention of destroying it, Allah will destroy him"*.
- The basis for the obligatory ruling of insolvency and interdiction against the one who has more debts than he can pay is the act of the Prophet (peace be upon him), who interdicted Mu'adh Ibn Jabal (may Allah be pleased with him) and sold his property for the debts against him and distributed it among his creditors.⁽²⁾ This is the stance of the majority, who include Abu Yusuf and Muhammad. This is also the formal legal opinion of the Hanafis as against Abu Hanifah.
- The multiplicity of three stages is the Maliki opinion, and this is what the (modern) legal codes also uphold. In insolvency, it is essential to consult these rules and the ruling of the court.
- The basis for the requirement that the insolvency should be demanded by the owners of due debts is that there is no demand (warranted) for undue debt. Even if such a demand is made of the debtor, he does not have to pay it because the deferred period has a share in the price.
- The basis for the right of a debtor to request a declaration of his own insolvency is the Shafi'i opinion and the fact that it is in his interest to stabilize his financial situation. The Standard excludes fraudulent insolvency according to the satisfaction of the court.
- The basis for the requirement of a judicial ruling for insolvency is the act of the Prophet (peace be upon him) in the case of Mu'adh. Also, in-

(2) This has been related by Al-Bayhaqi by both *muttasil* (fully connected) and *mursal* (incomplete) chains of transmission, but the *mursal* narrations are more correct: "*Sunan Al-Bayhaqi*" [6: 48]; and "*Talkhis Al- Habir*" [3: 37], as in "*Al-Mawsu'ah*" [5: 301].

solvency needs consideration and Ijtihad; therefore, a judicial decision is required for it.

- The basis for non-enforcement of an insolvent's confession regarding the right of others to his property -except with the approval of the creditors- and the non-enforcement of his dispositions that transfer ownership is that they prevent harm to the creditors, as per the Hadith: "*No harm and no reciprocal harm*".
- The basis for the attachment of new dispositions to the liability of the insolvent is that the right of the creditor is attached to the property existing at the time of insolvency. Thus there is no harm in the attachment of new dispositions to the liability of the debtor because his liability is fit for such a commitment.
- The basis for the view that gives the creditor the right to reclamation -a view accepted by the Malikis, Shafi'is, Hanbalis and some of the earliest scholars (the Salaf) as well as the majority of (modern legal) systems- is the Hadith related by Al-Bukhari and Muslim⁽³⁾ that affirms the right to recourse for the seller when he finds the exact commodity with the insolvent buyer. He has the option to take it or to leave it and become a partner of the creditors in the distribution of the price. It is subject to the following conditions:
 - a) The insolvent should be alive at the time of recourse. In the case of an institution or company, it should remain existent.
 - b) The insolvent remains liable for all of the compensation due. If the seller has received part of it, he will be given an option regarding the remainder.
 - c) The whole asset should remain in the ownership of the insolvent. If all or part of it has been destroyed, or if it has left his ownership through sale, or gift, or endowment, the right to reclamation will be cancelled regarding the remaining part except when the transaction involves multiple parties.
 - d) The asset should not be in a condition where it is mingled with something from which it cannot be distinguished, nor can its characteristics have changed to the point that the original name for it no longer applies or that its value has been reduced.

(3) See: "*Fath Al-Bari*" [5: 66]; and "*Sahih Muslim*" [3: 1193].

- e) The right of another person should not relate to it, e.g., when the insolvent has pledged it as security, except when the owner of the right (the mortgagee) renounces his right to the mortgage.

The right to reclamation is the cancellation of the sale. It can take place verbally or by a substitute means. It takes place immediately and does not need the decision of a judge, or the knowledge of the competent authority, or the ability to deliver.

Besides that, if the asset or its value or its feature decreased, or an inseparable increase occurred in it, like an increase in the weight of livestock, and he chose reclamation, he will only have that. But if the increase is separate, it would belong to the insolvent.

The right to reclaim land is not precluded by any building built on it by the insolvent nor by any trees he planted on it. The creditor will be given an option between having the insolvent remove the building and the trees, with the creditor bearing liability for any damage (to what is moved), or taking the building and trees and paying their price. In case of cultivated land, the crop will remain until harvest, free of any charge.

- The basis for the other view, which does not recognize the right to reclamation, is that the Hadith related by Al-Bukhari and Muslim contravenes the implication of a Shari'ah principle; i.e., the liability of the insolvent remains operative and the creditor's right regarding that liability remains stable. This group cited the Hadith: *"Anyone who died or went insolvent, and some of his creditors found exactly their property, they are on a par with the other creditors"*.⁽⁴⁾

Mursal Hadiths are valid evidence according to those who take this view. They are Hanafis and some of the Salaf.⁽⁵⁾

- The basis for non-inclusion of all types of deposits of safekeeping in the insolvency assets is that they are not the property of the insolvent; inter-

(4) This has been related by Al-Daraqutni by a mursal chain of transmission. See also *"Al-Mawsu'ah Al-Fiqhiyyah"* [5: 311].

(5) See: *"Al-Mawsu'ah Al-Fiqhiyyah"* [5: 311], for the documentation of the reference works of the madhhabs that affirm the right of reclamation and for the details related to the right of reclamation.

diction only occurs regarding his property, not the property of others entrusted to him.

- The basis for the requirement of a court ruling to rescind the interdiction of an insolvent is that it demands due consideration and Ijtihad, just as with a declaration of insolvency.

Appendix (C)

Definitions

I'sar

The present inability to discharge the financial obligations established in one's liability.

Prudential or Precautionary or Preventive Interdiction

Expedited and streamlined interdiction aiming at placing the debtor's assets under judicial supervision so that the creditor precludes the existence of a threat to his receipt of the full payment of his debt.



